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Accounting Myopia

Time to Reconsider the ITC?

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In Greek mythology, there was a man named Sisyphus, who was condemned by the gods to spend eternity pushing a large stone to the top of a high mountain. Each time he neared the summit, the stone would slip from his grasp and roll down the mountain. The issue of accounting for the Investment Tax Credit (ITC) in many ways has represented the Sisyphian task of the standard-setting bodies of the accounting profession. The ITC issue has a stormy history of dissension between Congress, the Accounting Principles Board (APB) and the business community. The Economic Recovery Act (ERA) of 1981 once again is forcing the profession to deal with the appropriate treatment of the ITC for financial statement purposes.

The new act allows corporations to sell their investment tax credits and accelerated cost recovery allowances (ACR). This is accomplished when one taxpayer (who cannot take advantage of the credit) "sells" equipment to another taxpayer, thus, selling the related ITC and ACR. In turn, the buyer (who can take advantage of the ITC) leases the equipment back to the original owner. Besides thrusting the ITC accounting issue into the forefront, the act raises several other knotty issues involved with accounting for capital leases and the cash received when the ITC is sold. The original issue of the proper accounting treatment of the investment credit also provides fuel in the controversy over the bigger issue of how taxes should be allocated to income.

Tax Rules for ITC

The Economic Recovery Tax Act of 1981 provides for an investment credit rate at 10 percent. The recovery period for Section 38 property qualifying for the credit has been revised. For five, ten, and fifteen year recovery property the full rate of 10 percent is applicable. The recapture provisions have also been revised, but there is no recapture for property held five years. For three-year property, the applicable investment tax credit is 6 percent.

The Investment Tax Credit has periodically been cancelled and reinstated, as Congress has attempted to utilize it as a stimulant to capital investment. The ITC is a permanent reduction of taxes, assuming the company holds the investment long enough to avoid recapture. However, the ITC has raised some thorny issues in terms of accounting for and reporting the credit in the financial statements.

Current Accounting Treatment

Presently, there are two allowable alternatives that can be used to account for the Investment Tax Credit. These are known as the cost-reduction (or deferred) method and the tax-reduction (or flow-through) method. Essentially, a corporation has complete freedom in selecting either method to report the effects of the Investment Tax Credit in its financial statements. Regardless of the method used to present the credit in financial statements, the *actual tax effects* are the same, as the credit produces a reduction of taxes in the year the asset is acquired.

Historical Development of the ITC

To better understand the accounting profession's dilemma concerning the nature and treatment of the Investment Tax Credit, it is important to briefly trace its history. Exhibit No. 1 presents a chronological history of the ITC. The exhibit makes quite obvious the fact that standards developed by the accounting profession have often been in direct contrast to Congressional intent and IRS rulings. President John F. Kennedy originally proposesd the investment tax credit in his tax message to Congress on April 20, 1961. As it proceeded through the legislative process, the bill underwent several major revisions before Kennedy signed it into law in 1962. It was not until late in 1962 that the APB gave serious consideration to the accounting treatment of the ITC. As the Board viewed it, there were three possible alternatives:[1]

(1) subsidy by way of a contribution to capital;

(2) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and

(3) reduction in a cost otherwise chargeable in a greater amount to future accounting periods.

Method No. 1 was quickly dismissed by the Board. However, Method No. 2, referred to as the tax reduction method, received serious consideration. The major argument for this method was that the Revenue Act of 1962 provided the credit to stimulate investment, and thus, in substance it should be a selective reduction in

Exhibit No. 1

CHRONOLOGICAL HISTORY OF THE INVESTMENT TAX CREDIT

Year	Legislative Action	Accounting Action
1961	Investment Tax Credit proposed by President Kennedy, April 20, 1961.	—
1962	ITC signed into Law by President Kennedy—October 16, 1962.	APB Opinion #2 Dec. 1962, requires the Cost-Reduction Method.
1963	SEC issues ASR#96 allowing either the Cost-Reduction or Tax Reduction Method. Jan. 1963.	—
1964	Revenue Act of 1964 eliminates requirement that Investment Credit be treated for income tax purposes as a reduction in the basis of the property.	APB Opinion #4 March, 1964, accepts both methods but indicates preference for cost reduction.
1970	—	APB proposes exposure draft on the ITC, which would require the Cost-Reduction method as the only acceptable method.
1971	1971 Act of Congress which made it legal for corporations to use either method.	—
1973	—	FASB adopts APB Opinions as Generally Accepted Accounting Principles.
1981	1981 Economic Recovery Tax Act. Corporations may "sell" ITC.	FASB issues exposure draft "Accounting for the Sale or Purchase of Tax Benefits Through Tax Leases" October 1981, with a revision in April, 1982.
		FASB issues Technical Bulletin No. 81-2 "Accounting for Unused Investment Tax Credits Acquired in a Business Combination Accounted for by the Purchase Method"
1982	—	FASB issues exposure draft "Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit"

taxes related to the act of investment rather than any future use of the asset.

However, the Board opted in favor of Method No. 3, referred to as the cost reduction method, citing several reasons. First, the Revenue Act of 1962 required that the investment credit reduce the basis of the property. Second, there were also recapture provisions making the realization of the credit dependent upon certain future events. Finally, the most important reason given was that earnings should arise from the use of assets and not solely from their acquisition.

In January of 1963, the SEC issued *ASR No. 96* which stated that either the cost reduction or the tax reduction method would be acceptable for SEC reporting purposes. The reasoning given was that there was substantial diversity of opinion among members of the business community and accounting profession. In addition, the Revenue Act of 1964 eliminated the requirement that the investment credit reduce the basis of the property, thus negating one of the reasons given by the APB for requiring deferral.

In response, although the Board stated that the Revenue Act of 1964 had no effect on their decision, *APB Opinion No. 4* stated that the tax reduction method would also be acceptable for reporting purposes, even though the cost reduction method was still preferable. The Board emphasized the need for full disclosure regardless of the method adopted.

The APB was severely criticized for issuing *Opinion No. 4*, because it permitted one item, the ITC, to be accounted for in either of two ways. The accounting profession believed that this was a dangerous precedent since the Board was charged with reducing alternatives, not fostering them. A great deal of pressure was exerted on the Board; thus, in 1970, they issued an Exposure Draft stating that the cost-reduction method of accounting was the only acceptable method.

The Exposure Draft met with a great deal of opposition from the business community, because many believed that the tax-reduction method was the preferable method. This opposition resulted in what amounted to an act of Congress. The 1971 Revenue Act made it legal for corporations to use either the deferred or the flow-through method in their financial reports. Reluctantly, the APB was forced to withdraw its Exposure Draft.

In 1973, the APB was replaced by the Financial Accounting Standards Board (FASB). The FASB essentially adopted all the existing opinions of the APB, thus, in effect giving its blessings to the dual treatment allowed in *APB No. 4*. To date, the FASB has not given any reconsideration to the accounting treatment of the ITC.

Congressional Intent

The ITC has had a stormy past in the accounting profession and has again surfaced as a result of the provisions in the Tax Recovery Act of 1981, and Section 205 of the Tax Equity and Fiscal Responsibility Act of 1982. Such controversy warrants an extended discussion of the nature of and accounting treatment of the Investment Tax Credit. Is the credit really a reduction of cost? Was that the intent of Congress? At first glance it would seem so, as evidenced by the following statement:[2]

> *"It is the understanding of the conferees on the part of both the House and the Senate that the purpose of the credit for investment in certain depreciable property, in the case of both regulated and nonregulated industries, is to encourage modernization and expansion of the nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of the new facilities over their productive lives."*

However, as Moonitz indicated, there are other possible interpretations of the above passage. A passage taken from the *Annual Report of the Council of Economic Advisors* states in part, "The investment credit will stimulate investment by reducing the net cost of acquiring depreciable assets, thus increasing expected profitability."[3]

Moonitz emphasizes that economists and other laymen may have a different interpretation of "cost" than do accountants. Moonitz contends that the concept of "net cost" referred to in the preceding passage is the one used in capital-budgeting problems, that is, it increases the profitability of a project by decreasing tax outflows.

The evidence on Congressional intent favors the view that the ITC is a direct reduction of taxes, and not a reduction in asset cost. This is supported by the actions of Congress and other governmental bodies. Whenever the accounting profession has attempted to enforce the use of the deferred method, there has been a corresponding governmental action.

Nature of the ITC

The accounting profession has argued that the ITC is directly related to the asset acquired and, thus, the benefit of the credit should be related to the useful life of that asset. Accountants argue that a company will not receive the benefit if the asset is not held for a specified period of time, (thus the recapture provisions).

Advocates of the flow-through method, on the other hand argue that the credit is a selective reduction in tax that should be recognized in the year in which it becomes available to the corporation. They contend that the tax benefit is not directly related to holding the asset for a specified period of time.

As Moonitz stated, in his dissent to *APB Opinion No. 2*, the treatment of the credit as a reduction in cost would mean that two companies acquiring an identical asset would record it at a different acquisition cost depending upon the tax status of the acquiring corporation. As another writer stated, "the many and complex provisions of the law relating to credit limitation, credit carryback, credit carryforward, loss carryback, and loss carryforward make it clear that it is primarily a part of the income tax structure. . ."[4] These are two strong arguments for the tax reduction method.

The investment tax credit has had a stormy past in the accounting profession.

Additional evidence that the ITC should be treated separately from the accounting for the asset is contained in the Economic Tax Recovery Act of 1981. According to the Act corporations may sell their tax credits through a leasing arrangement. This further confirms Congressional intent that the ITC is a separable item and supports the flow-through method of accounting.

FASB Action

The FASB's response must be analyzed in the overall context of the present state of accounting for taxes in general. Many of the issues specific to accounting for the ITC are directly related to the theoretical aspects of deferral of *any* tax related amounts. Perhaps the FASB is choosing to postpone definitive action on the ITC issue until the more general questions of tax allocation have been addressed.

Issues of Tax Allocation

The primary question concerning income tax allocation is simple: When taxable income differs from income calculated for financial reporting, where and how should the different amounts of tax expense be presented? Permanent differences in taxable and financial income present no difficulties. For example, municipal bond revenue will never be taxable, so it is simply ignored in calculating tax expense for financial statements. However, some differences simply represent timing differences, or more simply expressed, postponement or prepayment of taxes. The most common example arises when a company uses an accelerated method of depreciation for tax purposes and straight-line depreciation for financial reporting purposes. Under current standards, the "temporary" difference is set up as a deferred amount that eventually will be reversed.

It is this usage of the deferred method of tax allocation that has come under attack. Two major criticisms of the method deal with the basic definition of "tax expense" and the nature of the deferred amount. Many opponents of this method believe that tax expense should be defined as the *actual* amount of taxes that must be paid each year, thus advocating elimination of any form of deferred or prepaid tax amounts. Often cited is the statement of the purpose of financial accounting espoused in the first issuance of the FASB's conceptual framework project. In attempting to define *what* accounting principles should accomplish, the FASB emphasized prediction of cash flows. By restricting tax expense to actual tax payment, it is argued that net income is more indicative of the cash expended for taxes.

Other opponents of deferred taxes question the nature of the deferred amount in the statements. Presently it is shown as a liability, in other words, "We have made income on which these taxes will have to be paid eventually." Yet the deferred portion does not fulfill the definition of a liability as defined by the FASB.[5] It is an estimated amount which is dependent upon many future factors. The taxes will be paid in the future only if the company has future income, and the amount may differ drastically as a result of differing tax rates and the political environment at the time.

The FASB has indicated its dissatisfaction with current requirements and may choose a different method in the near future. Possibilities include presenting deferred amounts at their present value only if they are actually expected to reverse. This would reduce deferred amounts drastically, for by considering the time value of money, present amounts could be very small. In addition, there is little evidence to prove that these amounts *do* reverse at all. In fact, several studies indicate that for growing companies, deferred taxes increase, almost taking on the qualities of assets, in that they represent successful management ability to permanently postpone payment of taxes.

Relation to the ITC

How do these issues affect accounting for the ITC? The deferred method of accounting for the ITC is directly related to the deferred method of tax allocation. It results in a deferred account on the balance sheet which has the appearance of being a liability. Yet in this instance, it is almost impossible to rationalize this classification. For deferred taxes there is the possibility that the taxes will have to be paid eventually. However, the ITC amounts are not temporary at all. They are permanent, specific amounts which have *already* been realized. The only argument that can be advanced supporting the liability classification is the possibility of recapture. However, recapture is the exception rather than the rule, and a method which applied some type of probability criterion to future loss of the benefits would almost always result in elimination of the deferred amounts.

Summary

The Investment Tax Credit is an issue which ties together many of the controversies of the accounting profession. The standards setting bodies have been faced with the difficult task of trying to satisfy numerous parties in both the business and governmental sectors. At the same time, they are faced with the need to determine how these various, and often opposing, viewpoints can be incorporated into a theoretically acceptable framework for promulgation of accounting standards. Until the FASB adopts the flow-through method, the ITC will continue to resemble the large boulder which never quite reaches an acceptable position on top of the mountain.Ω

Notes

[1]APB Opinion #1, "Accounting for the Investment Credit," December, 1972. Paragraph No. 3.

[2]Moonitz, Maurice, "Some Reflections on the Investment Credit Experience" *Journal of Accounting Research*, p. 56. The passage was extracted from the "Report of the Committee of Conference on the Disagreeing Votes of the Two Houses."

[3]Ibid.

[4]Thruckmorton, Jerry J. "Theoretical Concepts for Interpretating the Investment Credit," *Journal of Accountancy*, April, 19, p. 51.

[5]Liabilities are defined as ". . . probable future sacrifices of economic benefits stemming from present legal, equitable, or constructive obligations of a particular enterprise to transfer assets or provide service to other entities in the future as a result of past transactions or events affecting the enterprise." *Statement of Financial Accounting Concepts No. 3*, (FASB, Stamford, Conn.) Dec., 1980, para. 28.

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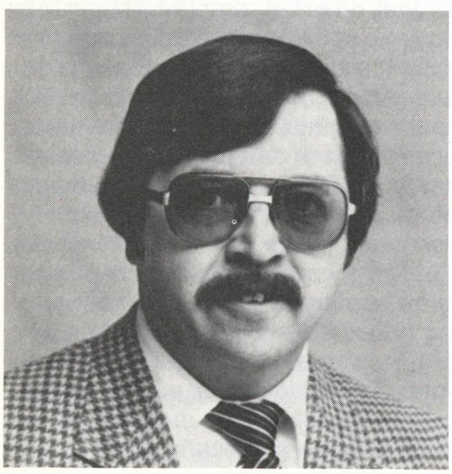

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