

INITIAL ACCOUNTING FOR THE  
INVESTMENT CREDIT BY CORPORATIONS

by

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# INITIAL ACCOUNTING FOR THE INVESTMENT CREDIT BY CORPORATIONS

## INTRODUCTION

The Revenue Act of 1962 represented the most substantial tax legislation since 1954 and was passed by Congress on October 2, 1962, and signed by President Kennedy 14 days later.<sup>1</sup> To encourage modernization and expansion of productive facilities and thereby stimulate economic growth, Section 38 of this Act contained the following provision: "There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under sub-part B."<sup>2</sup> Sub-part B provided that the amount of the credit against the tax liability be equal to 7 per cent (3 per cent for public utilities) of the qualified investment in certain depreciable property acquired after 1961. The investment credit has resulted in more than a billion dollar tax break annually and has been regarded by this nation's industry as a major help in its battle with foreign competition.<sup>3</sup> The idea of an investment credit to stimulate economic growth has no precedent in the United States, but has previously been applied in the United Kingdom, Belgium, the Netherlands, and Australia.<sup>4</sup> On

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<sup>1</sup>Dale D. Baker, "Principle Features of the Income Tax Credit for New Investment," NAA Bulletin, April, 1963, 44:13.

<sup>2</sup>Opinions of the Accounting Principles Board, "Accounting for the Investment Credit," December, 1962, p. 6.

<sup>3</sup>Kenneth B. Berg and Fred J. Muller, "Accounting for Investment Credits," Accounting Review, July, 1963, 38:554.

<sup>4</sup>Senate, Report No. 1881, 87th Cong., 2nd Sess. 1962, p. 11.

November 5, 1962, the British Government announced an increase of their investment credit allowed from 10 to 15 per cent on buildings and from 20 to 25 per cent on plant and machinery.<sup>1</sup>

The Revenue Act of 1962, Public Law 87-834,<sup>2</sup> limits the allowed investment credit in any single year to \$25,000 plus one-fourth of the tax liability in excess of \$25,000. Any credit not allowed because of the limit may be carried back for three years or forward for five with the earliest year being applied first. Under Section 38 of the Internal Revenue Code, both tangible personal property and real property with the exception of buildings and their structural components are eligible for this credit whether new or used. However, the used property that qualifies is subject to a \$50,000 limit. To qualify fully for the credit the property must have a useful life of at least eight years. If the useful life is six or seven years, then only two-thirds of the cost qualifies; if the useful life is four or five years only one-third qualifies. Property with a useful life of less than four years is not eligible for the credit. If the property is disposed of before the end of its useful life, any unearned investment credit must be paid as additional income tax in the year of disposal.<sup>3</sup>

In addition to reducing the tax liability, the investment credit also reduces the basis of the property for future

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<sup>1</sup>New York Times, November 6, 1962, p. 5.

<sup>2</sup>"The Investment Credit and Generally Accepted Accounting Principles," The Lybrand Newsletter, 5:1-3.

<sup>3</sup>Berg and Mueller, op. cit., pp. 554-555.

depreciation. If \$1,000,000 is invested in machinery and equipment with a useful life of eight years or more, a tax credit of \$70,000 results ignoring the possible limitation based on the tax liability. The basis of the property to be depreciated over the useful life is reduced to \$930,000. This reduction must be made even though the tax limitation (\$25,000 plus one-fourth of the excess of the tax liability over \$25,000) prevents the full application of the credit currently.<sup>1</sup> The Internal Revenue Service Form 3468 is included on the following two pages to summarize the essentials of the tax credit and to clarify its computation.

With the corporation income tax rate at the 52 per cent level, the investment credit results in a net tax savings of 48 per cent of the 7 per cent credit. If \$1,000,000 is invested in qualified property, the tax liability is decreased by \$70,000 in the year of the investment. However, during the useful life of the machinery and equipment purchased, the depreciation will be \$930,000 instead of \$1,000,000 which will result in \$70,000 more net income and \$36,400 (52 per cent of \$70,000) more tax liability. The net benefit over the useful life will be \$33,600 (48 per cent of the 7 per cent investment credit). If the investment credit did not provide for reduction in the depreciable base of the assets, the tax benefit would be the full seven per cent. At the present time, there is a tax bill (H. R. 8363) before the

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<sup>1</sup>Loc. cit.

COMPUTATION OF INVESTMENT CREDIT—1962

TO BE ATTACHED  
TO YOUR  
TAX RETURN

or taxable year beginning....., 1962, ending....., 19...

Name (as shown on page 1 of your tax return)

Your social security number (if other than individual, give employer identification number)

Address (number and street)

City or town, postal zone number, State

1. Qualified investment in new or used property

NOTE: Include your share of investment in property by partnerships, estates, trusts or small business corporations.

Type of property	Line	(1) Life years	(2) Cost or basis	(3) Applicable percentage	(4) Qualified investment (column 2 x column 3)
NEW PROPERTY	(a)	4 to 6		33⅓	
	(b)	6 to 8		66⅔	
	(c)	8 or more		100	
USED PROPERTY  (for dollar limitation see instructions)	(d)	4 to 6		33⅓	
	(e)	6 to 8		66⅔	
	(f)	8 or more		100	

2. Total qualified investment—add lines 1(a) through (f).....

3. Tentative investment credit—7% of line 2 (for public utility property, enter 3% of line 2).....

COMPUTATION OF TAX FOR PURPOSES OF LIMITATION

4. (a) Individuals (enter amount from line 12, page 1, Form 1040).....

(b) Estates and trusts (enter amount from line 25 or 26, page 1, Form 1041).....

(c) Corporations (enter amount from line 7, Tax Computation Schedule, Form 1120).....

5. Individuals, estates and trusts:

Less: (a) Foreign tax credit.....

(b) Dividend received credit.....

(c) Partially tax exempt interest credit.....

(d) Retirement income credit.....

(e) Total (add lines (a), (b), (c) and (d)).....

6. Balance (line 4 less line 5(e)).....

LIMITATION BASED ON AMOUNT OF TAX

(Married persons filing separately, affiliated groups, estates and trusts—see instructions)

7. (a) Enter amount on line 6 or \$25,000, whichever is lesser.....

(b) If line 6 is in excess of \$25,000, enter 25% of the excess.....

(c) Total (add lines (a) and (b)).....

8. Investment credit (enter amount on line 3 or 7(c), whichever is lesser).....

SCHEDULE A

If any part of the investment in 1 above was made by a partnership, estate, trust, small business corporation, or lessor complete the following:

Name (Partnership, estate, trust, etc.)	Address	Property		
		New	Used	Life years
		\$.....	\$.....	

## GENERAL INSTRUCTIONS

**A. Who Must File.**—Any individual, estate, trust, or corporation claiming an investment credit against its tax must attach this form to its income tax return. Partnerships and small business corporations are not required to file this form because the credit is claimed by the partner or shareholder. However, partnerships and small business corporations should attach a statement to their returns showing the allocation of investment to the partners or shareholders by amount, type and life of property as shown in item 1 of this form. Estates and trusts which apportion the investment between the estate or trust and the beneficiaries should in addition to filing this form attach a statement showing the allocation of the investment among the beneficiaries.

**B. Effective Date.**—For taxable years ending after December 31, 1961, a credit is allowed against your tax for investment in certain depreciable property, acquired after December 31, 1961, having an estimated useful life of 4 years or more. The credit is allowed for the first year property is placed in service, even though under the depreciation convention used you may not be able to claim a deduction for depreciation on the property until the following year.

**C. Property Defined.**—The investment credit is applicable to (a) tangible personal property and (b) real property (except for buildings and their structural components) if used as an integral part of manufacturing, production or extraction, or used as a research or storage facility in connection with these activities.

The investment credit is not applicable to (1) certain property which is used predominantly outside the United States; (2) property used for lodging or in connection with furnishing lodging, except (a) property used in certain commercial facilities located therein (such as a restaurant) or (b) property used by a hotel or motel; (3) property used by a tax-exempt organization (other than in a business to which the unrelated business income tax applies); (4) property used by governmental units; (5) livestock (including racehorses).

**D. Election for Leased Property.**—A lessor may elect to treat an investment in new property as if made by the lessee instead of the lessor. If the lessor makes this election, then the lessee is treated as if he had acquired the property for the lessor's cost or other basis at the fair market value of the property if it was constructed by the lessor. Where the lessee is allowed the investment credit there is no adjustment of the lessor's basis for depreciation (see K below) but a reduction of the lessee's deduction for rent must be made.

**E. Replacement Property.**—Where insured property is lost, destroyed as a result of a casualty or is stolen, reinvestment of insurance proceeds in replacement property may not be eligible for investment credit.

**F. Disposition of Property.**—Where property is disposed prior to the life used in computing the investment credit, the tax for the year in which the property is so disposed of must be increased by the difference between the credit taken on such property and the credit which would have been allowed had the actual life been used.

**G. Limitations With Respect to Certain Persons.**—In the case of (1) mutual savings banks, building and loan associations or cooperative banks, (2) a regulated investment company or a real estate investment trust subject to taxation under Subchapter M, or (3) a cooperative organization described in section 1381(a), if qualified investment and the \$25,000 limitation shall equal such person's ratable share of such items.

**H. Carryback and Carryover of Unused Credits.**—If the amount of the investment credit for any taxable year exceeds the limitation, the excess shall be an investment credit carryback to each of the 3 preceding taxable years and an investment credit carryover to each of the 5 succeeding taxable years and shall be added to the amount allowable as a credit for such years. However, such excess may be a carryback only to a taxable year ending after December 31, 1961.

The amount which may be carried to this year and added to line is limited to the excess of line 7(c) over line 3.

**I. Deduction for Certain Unused Investment Credit.**—After applying the carryback and carryover provisions the unused credit has not been completely absorbed, the balance may be allowed as a deduction in the first taxable year following the last taxable year in which it could have been used as a credit except for the limitation.

**J. Basis and Cost.**—The credit for new property applies to the basis of the property. The credit for used property applies to the cost of the property. The cost (of used property) does not include the basis of any property traded in.

**K. Adjustments to Basis of Property.**—For purposes of computing depreciation the basis of any property which qualifies for the investment credit shall be reduced by an amount equal to 7 percent (3 percent in the case of a public utility) of the qualified investment.

## SPECIFIC INSTRUCTIONS

**Line 1. New Property.**—Enter the basis of property as described in General Instructions C and J placed in service during the taxable year. In the case of property constructed, reconstructed or erected by you, enter only that portion of the basis which is properly attributable to construction, reconstruction or erection after December 31, 1961.

**Used Property.**—Enter the cost (subject to dollar limitation below) of used property placed in service during the taxable year.

**Dollar Limitation on Used Property.**—In general, the amount of used property taken into account may not exceed \$50,000. In the case of a husband and wife filing separate returns, and each has used property taken into account on their returns, the amount may not exceed \$25,000. In the case of a partnership, the \$50,000 limitation shall apply with respect to the partnership and with respect to each partner. In the case of affiliated groups, the \$50,000 limitation shall be reduced for each member of the group by apportioning \$50,000 among the members of such group in accordance with

their respective amounts of used property which may be taken into account.

**Estates and Trusts.**—In the case of an estate or trust the amount of the investment is apportioned between the estate or trust and beneficiaries on the basis of the income of the estate or trust allocated to each.

**Line 7. Limitation Based on Amount of Tax.**—In the case of a husband and wife filing separate returns and both have qualified investments, the amount specified on lines 7(a) and (b) shall be \$12,500 instead of \$25,000. In the case of affiliated groups, the \$25,000 specified on lines 7(a) and (b) shall be reduced for each member of the group by apportioning the \$25,000 among the members of such group. In the case of an estate or trust the \$25,000 limitation specified on lines 7(a) and (b) shall be reduced to the amount which bears the same ratio to \$25,000 as the amount of qualified investment allocated to the estate or trust bears to the total qualified investment.



Senate that has been passed by the House of Representatives that contains a provision to repeal this downward adjustment in the basis of property subject to depreciation.<sup>1</sup>

#### CONGRESSIONAL INTENT

An examination of the purpose of the investment credit will reveal the logic behind its main covenants. In proposing the investment credit, President Kennedy stated:

. . . the tax credit increases the profitability of productive investment by reducing the net cost of acquiring new equipment. It will stimulate investment in capacity expansion and modernization, contribute to the growth of our productivity and output, and increase the competitiveness of American exports in the world markets.<sup>2</sup>

Secretary of the Treasury Dillion stated before the Senate Finance Committee:

The investment credit will stimulate investment in a number of ways. Because it reduced the net cost of acquiring depreciable assets it increases the rate of profitability.<sup>3</sup>

The House Ways and Means Committee stated:

The investment credit will stimulate investment because--as a direct offset against the tax otherwise payable--it will reduce the cost of acquiring depreciable assets. This reduced cost will stimulate additional investment since it increases the expected profit from their use. The investment credit will also encourage investment because it increases the funds available

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<sup>1</sup>"GAO States Position on Investment Credit for Government Contracts," The Journal of Accountancy, November, 1963, 115:24.

<sup>2</sup>Economic Report of the President, 1962, p. 26, H. R. Doc. No. 278, 87th Cong., 2nd Sess. (1962) Hearings, Part., p. 83.

<sup>3</sup>Leonard Spacek, Accounting Treatment of Investment Credit, p. 2.



for investment.<sup>1</sup>

The Senate Finance Committee report read as follows:

... the investment credit will stimulate investment, first by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition. Second, investment decisions are also influenced by the availability of funds.

This downward adjustment is provided because your committee believes that there is no reason to allow the taxpayer depreciation with respect to the portion of the investment in effect paid for by the government.<sup>2</sup>

The House of Representatives and the Senate issued their joint conference report summarizing their views regarding the tax bill of 1962. In reference to the investment credit, it stated:

It is the understanding . . . 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.<sup>3</sup>

To condense the intentions of the Administration and Congress, it is clear that they planned the investment credit to encourage investment by reducing the net cost of property and thereby increase the rate of return over the property's useful life. How did they construct the credit to achieve their intended goals? The Revenue Act of 1962 granted a credit against the tax

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<sup>1</sup>House of Representatives, Report No. 1447, 87th Cong., 2nd Sess. (1962), p. 14.

<sup>2</sup>Senate, Report No. 1881, 87th Cong., 2 Sess. (1962), pp. 11, 12, 19.

<sup>3</sup>House of Representatives, Report No. 2508, 87th Cong., 2nd Sess. (1962), p. 14.

liability and also contained a provision to reduce the basis of the property for future depreciation. Thus, in effect, they have reduced the net cost of acquiring property which was their major objective.

#### ACCOUNTING PROBLEM

It is widely agreed that the investment credit will cause net income to be larger. The accounting controversy over the investment credit concerns the timing of the effect of the credit in the operating statement. Stated in another way, at what time or during what period should the benefit be reflected in net income?

There are three main alternatives (100 per cent flow-through, deferred tax, and cost-reduction) that have received substantial support. First, the 100 per cent flow-through method does not reduce the cost of the property on the books, but reduces taxes expense by the amount of the investment credit. This causes net income to be increased by the full amount of the credit in the year of acquisition. Second, the deferred tax method recognizes that only 48 per cent of the investment will be a permanent tax savings. This 48 per cent is reflected in net income in the year of acquisition and the remaining 52 per cent is set up as a deferred credit to be amortized over the useful life of the property against the increased tax liability caused by the decreased depreciation allowance. Third, the cost-reduction method spreads the effect on net income of the investment

credit over the useful life of the property. This can be accomplished by different techniques, the simplest being to reduce the cost of the property in the year of acquisition. Net income will be increased by the same amount during each year of the useful life of the asset because of the smaller depreciation charges.<sup>1</sup> It should be pointed out that these three methods have many different names, but they will be referred to in this paper by the preceding descriptions.

The effect of the investment credit should be reflected in income over the useful life of the property. This is accomplished by the cost-reduction method. It is the purpose of this paper to show that the cost-reduction method is the accounting method that most clearly and accurately reflects the facts underlying the investment credit transaction.

#### THE 100 PER CENT FLOW-THROUGH METHOD

To illustrate the three methods, the example mentioned previously will be continued, and it is assumed that the investment was made during the last month of the accounting period (related depreciation charges will start in the next period). This will segregate the effects of the credit on income in the year of acquisition and during the useful life of the property.

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<sup>1</sup>Berg and Mueller, op. cit., pp. 556-558.

Investment in machinery and equipment.....	\$1,000,000
Estimated useful life.....	10 years
Net income before taxes.....	\$500,000
Tax expense before credit.....	<u>260,000</u>
Net income after taxes before credit.....	<u>\$240,000</u>

This results in an investment credit of \$70,000 to be applied against the tax liability of \$260,000. Under the 100 per cent flow-through method, the following entries would be made:

Machinery and equipment.....	\$1,000,000	
Cash.....		\$1,000,000
(to record the acquisition)		
Taxes Expense.....	\$260,000	
Taxes Payable.....		\$260,000
(to record income taxes)		
Taxes Payable.....	\$ 70,000	
Taxes Expense.....		\$ 70,000
(to record investment credit)		

Net income after taxes would be \$310,000 (\$500,000 income before taxes less the net Taxes Expense of \$190,000). Net income in the year of acquisition has been increased by the full amount of the investment credit; thus, it is said to flow-through to income. During the useful life of the machinery and equipment, only \$930,000 will be depreciated for tax purposes causing \$70,000 more income before taxes and \$36,400 more Taxes Expense and Taxes Payable. Under the 100 per cent flow-through method, the cost of the asset is not decreased on the books so the full \$1,000,000 will be depreciated. During the useful life, book net income before taxes would not be affected by the investment

credit. However, because of the depreciation not allowed, the tax liability will be increased by \$36,400 and book net income after taxes will be decreased by \$36,400. The net effect on income in the year of acquisition and during the useful life is a \$33,600 increase.

Table 1. Effect on net income after taxes:

100 per cent flow-through method

Year of acquisition . . . . .	\$70,000 increase
During useful life . . . . .	<u>36,400 decrease</u>
Net effect. . . . .	<u>\$33,600 increase</u>

It should be pointed out that the net effect on income in the year of acquisition and during the useful life will be the same under each method (a \$33,600 increase). The thing that differentiates the methods will be the timing of the effects on net income. For the 100 per cent flow-through method, net income after taxes is decreased by \$36,400 during the following ten years (the estimated useful life).

The Federal Communications Commission has prescribed that all utilities under its jurisdiction must use the 100 per cent flow-through method. The Commission, with three of its seven members dissenting, issued the following order and reasons:

The proper accounting treatment . . . is to account for it as a reduction in income taxes and let such reduction flow through to operating income.

. . . that basing the credit on depreciable property is merely a convenient tool used to compute the dollar amount of the tax reduction voted by Congress . . . the same effect . . . could have been accomplished by some other means such as a reduction in the income tax rates . . . the law, however, does not

restrict the manner in which the tax reduction should be used . . . Thus it appears to us that the true nature of the credit is best reflected by the increased earnings resulting from the tax reductions.<sup>1</sup>

The Federal Communications Commission in defending its position emphasized that the investment credit causes a reduction of the tax liability and the tax expense. If a company had no income and thus no tax liability, the investment credit would be of no value unless it was carried to another year. To gain a benefit from the investment credit, a company must have taxable income. If the investment credit depends upon having taxable income, should not the benefit be shown in net income when the credit is granted? Do we not have more cash because of the reduction of the tax liability? Should not this reduction of taxes be shown in net income? The Federal Communications Commission would answer yes to these questions.

The three dissenting members of the Commission issued the following statement:

The Federal Communications Commission order . . . is not consistent with accounting regulations previously approved by the Commission, is inconsistent with accounting principles supported by a preponderance of opinion in the accounting profession, is contrary to the legislative intent . . . and results in . . . a substantial distortion of income for the initial year as compared to the remaining years . . .

. . . earning fluctuations created by initial year flow-through accounting are not legitimate, and when accounting does not meet this test of legitimacy, it is requiring the publication of dis-

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<sup>1</sup>"Federal Communications Commission Rules Investment Credit Must Flow-Through to Income," The Journal of Accountancy, September, 1963, 115:11.



torted earnings results.<sup>1</sup>

The support for the 100 per cent flow-through method is mainly limited to public utilities. The public utilities in favor of the 100 per cent flow-through method insist that taxes on income by their very nature are expenses that decrease net income at the time when the liability for the payment is incurred, and should not be subject to any accrual principles that are applied to other expenditures. Therefore, since current cash requirements to pay the tax liability are reduced, this benefit should be recognized as enhancing current net income.<sup>2</sup>

The Securities and Exchange Commission and the Accounting Principles Board of the American Institute of Certified Public Accountants both believe that the 100 per cent flow-through method is an improper method for reflecting the effect of the investment credit, but will accept it for financial statement purposes where government regulatory agencies such as the Federal Communications Commission require its use.<sup>3</sup>

When Congress granted the investment credit, it stated that the credit would "encourage modernization and expansion . . . by reducing the net cost of acquiring new equipment, thereby increasing the earnings of the new facilities over

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<sup>1</sup>Loc. cit.

<sup>2</sup>James C. Bonbright, Report on Accounting and Rate Treatment of the Investment Tax Credit, pp. 2-3.

<sup>3</sup>"Institute and SEC Positions on Investment Credit," The Journal of Accountancy, February, 1963, 115:11-13.



their productive lives."<sup>1</sup> The 100 per cent flow-through method directly contradicts the intent of Congress by increasing income in the year of acquisition and by decreasing income over the useful life of the assets giving rise to the credit. Also, the assets are not shown in the financial statements at net cost.

The Federal Communications Commission in its order dated July 31, 1963, commented that to interpret literally the several statements made by Congress that the tax credit in effect reduces the cost of the new plant does not convey the true meaning contained in these statements. The cash expenditure for a new asset is the same with or without the investment credit. No benefits are realized until taxpaying time, and then only as a reduction of the tax liability. The extra dollars available at this time are the true benefit and investment stimulant. The Commission placed this interpretation on "the general effect that Congress hoped to achieve."<sup>2</sup>

The Federal Communications Commission stated that the investment credit represents a reduction of income taxes and should accordingly be recorded in the accounts. It pointed out the similarity of the investment credit and the tax credits for dividends received and foreign taxes paid which reduce the tax expense. According to the Commission, the reduction of the

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<sup>1</sup>House of Representatives, Report No. 2508, 87th Cong., 2nd Sess. (1962), p. 14.

<sup>2</sup>Report, Order and Dissent, FCC Docket 14850, Unpublished letter, July 31, 1963.

basis of the property "is merely a method adopted by Congress to avoid duplication of a portion of the tax reduction . . . over future years".<sup>1</sup> The purpose of the investment credit is to encourage modernization and expansion and thus stimulate the economy. This is accomplished by reducing taxes payable and increasing the net income under the 100 per cent flow-through method. The Federal Communications Commission has built a strong case for this method, but it has received little support from other government agencies and the accounting profession.

#### THE DEFERRED TAX METHOD

The arguments for the deferred tax method, sometimes called the 48 per cent flow-through method, are based on much of the same reasoning underlying the 100 per cent flow-through method.

Investment in machinery and equipment . . . . .	\$1,000,000
Estimated useful life . . . . .	10 years
Net income before taxes . . . . .	\$500,000
Tax expense before credit . . . . .	<u>260,000</u>
Net income after taxes before credit . . . . .	<u><u>\$240,000</u></u>

Using the deferred tax method, the following journal entries would be made:

Machinery and equipment . . . . .	\$1,000,000	
Cash . . . . .		\$1,000,000
Taxes Expense . . . . .	\$260,000	
Taxes Payable . . . . .		\$260,000

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<sup>1</sup> Loc. Cit.

Taxes Payable . . . . .	\$70,000	
Taxes Expense . . . . .		\$33,600 (48%)
Deferred Taxes Payable . . .		\$36,400 (52%)
(to record the investment credit)		

The deferred tax method recognizes that only 48 per cent of the investment credit is a permanent tax savings, and this is the part that flows-through to income. Net income after taxes in the year of acquisition would be \$273,600 under this method. Because of the reduced depreciation for tax purposes over the life of the machinery and equipment, the tax liability will be increased by \$36,400. Since the cost of the asset is not decreased, the full \$1,000,000 will be depreciated. Book net income before taxes will be unaffected, and the \$36,400 increase in the tax liability is absorbed by the above credit to Deferred Taxes Payable causing book net income after taxes to be unaffected. The credit to Deferred Taxes Payable is set up in anticipation of this increased tax liability and is amortized over the useful life of the machinery and equipment. The annual amortization entry would be:

Deferred Taxes Payable . . . . .	\$3,640	
Taxes Expense . . . . .		\$3,640

Table 2. Effect on net income after taxes:

Deferred tax method

Year of acquisition . . . . .	\$33,600 increase
During useful life . . . . .	<u>no effect</u>
Net effect . . . . .	<u>\$33,600 increase</u>

The advocates of the deferred tax method use many of the same reasons that were given as support for the 100 per cent

flow-through method. The methods are similar in that both affect net income in the year of acquisition; they are both flow-through methods. However, the deferred tax method flows-through to income only that part of the tax credit that is a permanent tax savings. The flow-through to income is based on the argument that the investment credit causes a reduction in taxes expense instead of a reduction in the cost of the asset purchased. The amount of money received by the seller doesn't change; the money paid represents the cost of the asset. The Civil Aeronautics Board prescribes this method and says that reducing the "cost of related property for accounting purposes . . . is a departure from the conventional practice of reflecting assets at purchase cost."<sup>1</sup>

The Securities and Exchange Commission will accept this method and the cost-reduction method. The Accounting Principles Board of the American Institute of Certified Public Accountants concluded in favor of the cost-reduction method thus ruling out the flow-through methods.<sup>2</sup> However, in reaching its conclusion, there were six dissenting votes cast by the 20 member Board. Three of these votes were in favor of the deferred tax method because they believed that the investment credit represents a reduction in income tax expense. They stated:

The generation of taxable income for the year in

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<sup>1</sup>"CAB Investment Credit Treatment Differs from that of APB," The Journal of Accountancy, November, 1963, 115:26.

<sup>2</sup>"Institute and SEC Positions On Investment Credit," The Journal of Accountancy, February, 1963, 115:11-13.

and by itself, rather than the future productive use of the related property, effects the realization of the credit. They point out that opinions received by the Board from practitioners and businessmen make it clear that the 48-52 method . . . has at least as wide acceptance among these groups as the method sponsored by the majority of the Board. They believe that, in the circumstances, the 48-52 method must be also considered to have substantial authoritative support and, therefore, to be generally acceptable.<sup>1</sup>

The 48-52 method is another name for the deferred tax method.

Two other members dissented from the Board's conclusion that the cost-reduction method is the only acceptable accounting treatment, and that the deferred tax method should also be accepted. The other dissenting vote concurred that the cost-reduction method was the preferred treatment, but that the deferred tax method with adequate disclosure should be an acceptable alternative. Although the majority of the Accounting Principles Board favored the cost-reduction method, the six dissenting votes lend considerable support for the deferred tax method.<sup>2</sup>

The British accounting profession has recommended the following accounting treatment for its investment credit:

Investment allowances are essentially a tax relief and not a reduction in the capital cost of the assets to which they relate. It would therefore be inappropriate for the tax relief on investment allowances to be deducted from the cost of the assets instead of . . . the taxation charge. The effect of deducting the relief from the cost of the assets shown in the balance sheet would be to overstate the taxation charge in the profit and loss account, the amount

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<sup>1</sup>Opinions of the Accounting Principles Board, "Accounting for Investment Credits," December, 1962, p. 6.

<sup>2</sup>Loc. cit.

of the overstatement being in effect what would otherwise have to be provided as depreciation over the life of the assets.<sup>1</sup>

Britain's investment credit does not require a reduction in the basis of the property acquired for tax purposes and the flow-through method is the recommended accounting treatment.

#### THE COST-REDUCTION METHOD

The conclusion reached by the Accounting Principles Board was

. . . that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service.

While we believe the reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases, we recognize as equally appropriate the treatment of the credit as deferred income, provided it is amortized over the productive life of the acquired property.<sup>2</sup>

According to the Accounting Principles Board, the cost-reduction method is the preferred treatment; however, the Board recognizes an alternative that does not reduce the cost of the acquired property, but does spread the benefit over the useful life.

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<sup>1</sup>LeBoeuf, Lamb & Leiby, letter to Federal Power Commission, February 21, 1963.

<sup>2</sup>Opinions of the Accounting Principles Board, "Accounting for the Investment Credit," December 1962, p. 7-9.



Investment in machinery and equipment . . . . .	\$1,000,000
Estimated useful life . . . . .	10 years
Net income before taxes . . . . .	\$500,000
Tax expense before credit . . . . .	<u>260,000</u>
Net income after taxes before credit . . . . .	<u>\$240,000</u>

Using the cost-reduction method, the following journal entries would be made:

Machinery and equipment . . . . .	\$1,000,000	
Cash . . . . .		\$1,000,000
Taxes Expense . . . . .	\$260,000	
Taxes Payable . . . . .		\$260,000
Taxes Payable . . . . .	\$70,000	
Equipment and Machinery . . . . .		\$70,000
(to record the investment credit)		

The credit to Machinery and Equipment could preferably be made to a special contra account to the related asset without affecting the results of the method.

Under the cost-reduction method, there would be no effect on net income after taxes in the year of acquisition. During the useful life of the equipment and machinery, \$930,000 will be depreciated for tax purposes and also for book purposes since the assets have been written down. Because of the investment credit, net income before taxes over the useful life of the assets will be increased by \$70,000. Net income after taxes will be increased by \$33,600.



Table 3. Effects on net income after taxes:

## Cost reduction method

Year of acquisition . . . . .	no effect
During useful life . . . . .	<u>\$33,600 increase</u>
Net effect . . . . .	<u>\$33,600 increase</u>

The effect on any single year during the useful life of the asset would be an increase of \$3,360, the benefit being spread equally over the productive life of the acquired assets.

Under the alternative method, the entries would be as follows:

Machinery and equipment . . . . .	\$1,000,000	
Cash . . . . .		\$1,000,000
Taxes Expense . . . . .	\$260,000	
Taxes Payable . . . . .		\$260,000
Taxes Payable . . . . .	\$70,000	
Deferred Investment Credit (to record the investment credit)		\$70,000

The credit to Deferred Investment Credit is amortized over the life of the asset by the following entry:

Deferred Investment Credit . . .	\$7,000	
Taxes Expense . . . . .		\$7,000
(entry made at end of each year of useful life)		

During the useful life of the equipment and machinery, \$1,000,000 will be depreciated on the books, but only \$930,000 will be allowed for tax purposes. The tax liability and tax expense for this period before amortization of the credit will be increased by \$36,400 (52 per cent of \$70,000). The amortization entries would decrease Taxes Expense by \$70,000; the net effect would be a \$33,600 decrease of Taxes Expense and a

\$33,600 increase of net income.<sup>1</sup>

Table 4. Effects on net income after taxes:

Alternate method to cost reduction

Year of acquisition . . . . .	no effect
During useful life . . . . .	<u>\$33,600 increase</u>
Net effect . . . . .	<u>\$33,600 increase</u>

The alternate method accomplishes the same effect on net income, but does not reduce the cost of the assets acquired.

The journal entries under the alternate method can be made to show the part of the deferred credit that represents the actual tax benefit (48 per cent) and the part that represents the deferment of income taxes (52 per cent). The entry to record the credit is:

Taxes Payable . . . . .	\$70,000	
Deferred Investment Credit . . . . .		\$33,600 (48%)
Deferred Taxes Payable . . . . .		\$36,400 (52%)

The annual amortization entry is:

Deferred Investment Credit . . . . .	\$3,360	
Deferred Taxes Payable . . . . .	3,640	
Taxes Expense . . . . .		\$7,000

The effect on net income is the same as under the alternative. The advantage of this approach is that it breaks down the tax benefit and deferred taxes.

The arguments for the cost-reduction method are many. The Accounting Principles Board based its decision on two points. First, earnings result from the use of productive facilities,

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<sup>1</sup>Loc. cit.

not from their mere acquisition. Second, the future realization of the investment credit is to a degree contingent on earnings and holding the assets the required length of time. From an accounting standpoint, where the realization of income is uncertain, it is better to spread the income over the future periods than to recognize it at the earliest possible date.<sup>1</sup>

The cost-reduction method is based on the words of Congress that the investment credit will encourage investment "by reducing the net cost of acquiring assets, thereby increasing the earnings . . . over their productive lives."<sup>2</sup> Nowhere did Congress mention or imply that net income should be increased in the year of acquisition.

Should Congressional intent control the accounting for the investment credit? The facts underlying the investment credit cannot be overlooked. Congress intended to reduce the net cost of acquiring assets and constructed the credit in such a manner as to accomplish this objective. To ignore the intentions of Congress in this case would be the same as ignoring the basic facts underlying the credit. The Accounting Principles Board in reaching its conclusion stated the following ". . . we have evaluated the pertinent portions of the legislative history of the investment credit, which we regard as significant but not

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<sup>1</sup>Loc. cit.

<sup>2</sup>House of Representatives, Report No. 2508, 87th Cong., 2nd Sess. (1962), p. 14.

decisive."<sup>1</sup>

The General Accounting Office concurred with the Accounting Principles Board in advocating the cost-reduction method. Comptroller General Joseph Campbell stated the General Accounting Office's position:

Our review . . . leads us to the conclusion that the Congress not only expressed its intent specifically with respect to the purpose of the credit but also clearly indicated the nature of the credit . . .<sup>2</sup>

The conclusion of the Florida Public Utilities Commission issued July 12, 1963, stated:

. . . we are forced to conclude along with the Accounting Principles Board of the American Institute Of Certified Public Accountants, the regulatory commissions of 22 sister states, innumerable independent accounting experts, and our own staff, that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service. We find little support for, and we have been completely unimpressed with, the 52 per cent Deferral or 48 per cent Flow-through Method. We are convinced that the 100 per cent or Cash Flow-through Method is contrary to Congressional intent.<sup>3</sup>

Dr. James C. Bonbright, a well-known consultant on finance for government agencies and private corporations and Professor Emeritus of Finance of the Graduate School of Business and of the Department of Economics at Columbia University stated

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<sup>1</sup>Opinions of the Accounting Principles Board, "Accounting for the Investment Credit," December 1962, p. 6.

<sup>2</sup>"GAO States Position on Investment Credit for Government Contracts," The Journal of Accountancy, November 1963, 115:24.

<sup>3</sup>"Florida Utilities Group Adopts APB Investment Credit Procedures," The Journal of Accountancy, August 1963, 115:12.

another argument for cost-reduction:

. . . the principle underlying . . . rests on the traditional, basic accounting distinction between an outlay that should be "capitalized" (charged to income) and an outlay that should be at once "expensed" (charged to current operations). Just as the acquisition cost of a fixed asset will first be "capitalized" and then gradually amortized over the productive life of the acquired asset by annual charges to operation called "depreciation", so a reduction in acquisition cost resulting from an investment tax credit should at first be credited (directly or indirectly) to plant account and then gradually transferred to income account through the resulting reduction in depreciation charges, or else through offsetting credits to income that take the place of any overt reduction in these charges.<sup>1</sup>

Leonard Spacek, speaking for Arthur Andersen and Company, stated

Unless the facts pertaining to the creation of the investment credit . . . are wrong, there is only one proper basis of accounting for the credit and that is to record it as a credit against property cost, either directly or in an account offsetting that cost.<sup>2</sup>

In summary, the 100 per cent flow-through, the deferred tax, and the cost-reduction methods have received substantial support. These three methods have one thing in common. In the journal entry recording the investment credit, they all debit Taxes Payable to reduce the tax liability. The credit part of this entry differentiates the three methods.

According to a recent survey conducted by one of the larger accounting firms, the following table summarizes how major companies handled the investment credit in their 1962

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<sup>1</sup>James C. Bonbright, Report on Accounting and Rate Treatment of the Investment Tax Credit, pp. 2-3.

<sup>2</sup>Spacek, op. cit., p. 8.

annual reports.<sup>1</sup>

Table 5. Survey of 1962 annual reports.

Public Utilities (64 of 70 disclosed the method used)

Full deferral*	53 (83%)
100% flow-through	11 (17%)

Other than Public Utilities (234 of 295 disclosed method used)

Full deferral*	139 (59%)
Deferred tax	95 (41%)

\*Cost-reduction method or the alternative.

#### OTHER METHODS

What are the other methods that have been proposed, but haven't received substantial support? Since the government is granting this credit, the net tax benefit could be regarded as donated capital. This method was considered by the Accounting Principles Board along with the cost-reduction and the flow-through methods. The entry to record the investment credit under this treatment is as follows:

Taxes Payable . . . . .	\$70,000	
Donated Capital . . . . .		\$33,600 (48%)
Deferred Taxes Payable . . .		36,400 (52%)

This method treats the tax credit as donated capital accomplished by the cancellation of a debt. The Deferred Taxes Payable account will be amortized over the life of the asset to

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<sup>1</sup>"How Accountants Are Handling the Investment Credit on Financial Statements," Accountant's Weekly Report, June 17, 1963.

offset the increased tax liability. This method is similar to the deferred tax method in that it defers 52 per cent and flows-through 48 per cent. However, the deferred tax method flows-through 48 per cent to income rather than to donated capital. The donated capital method has the advantages of recording the asset at the purchase price, and does not distort net income in the year of acquisition. To justify this method is difficult. Is a debt actually being cancelled? Since the investment credit is part of the computation to determine taxes payable, the debt for the investment credit part was never assumed, just the debt for the net taxes payable.<sup>1</sup> The Accounting Principles Board stated that "this concept, in our opinion, is the least rational because it runs counter to the conclusion that the investment credit increases the net income of some accounting period(s)."<sup>2</sup>

Since the investment credit is earned in full by holding the property for eight years, the tax credit could be spread over this period. This method is similar to the cost reduction alternative where the investment credit was spread over the useful life of the assets. The entry to record the credit would be the same:

Taxes Payable . . . . .	\$70,000
Deferred Investment Credit . . . . .	\$70,000

The annual entry to amortize the tax credit over the holding

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<sup>1</sup>Berg and Mueller, op. cit., p. 559-560.

<sup>2</sup>Opinions of the Accounting Principle Board, "Accounting for Investment Credits," December 1962, p. 6.



period would be:

Deferred Investment Credit . . .	\$8,750	
Taxes Expense . . . . .		\$8,750
(1/8 of \$70,000 = \$8,750)		

The basic reasoning underlying this method rests on the fact that the investment credit is not subject to recapture after the eight year holding period. If the equipment and machinery is sold during this holding period, part of the investment credit will have to be paid back to the government in the form of additional taxes in the year of disposal.<sup>1</sup>

A refinement of the previous method provides for the problem of income tax allocation. The entry to record the investment credit would be as follows:

Taxes Payable . . . . .	\$70,000	
Deferred Taxes Payable . . .		\$36,400 (48%)
Deferred Investment Credit .		\$33,600 (52%)

The annual amortization entry would be:

Deferred Taxes Payable . . . . .	\$3,640	
Deferred Investment Credit . . .	4,200	
Taxes Expense . . . . .		\$7,840

As in the previous method, the Deferred Investment Credit is spread over the holding period; however, in this case only the actual tax savings is amortized. A credit to Deferred Taxes Payable is set up to offset the increased tax liability over the life of the assets and is amortized over this ten year period. This method has one advantage over the previous method in that it recognized the portion of the tax credit that constitutes an actual tax savings and the portion that is a post-

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<sup>1</sup>Berg and Mueller, op. cit., p. 559-560.

ponement of the tax liability caused by the reduction in the basis of the acquired property for tax purposes.<sup>1</sup> By basing amortization of the investment credit on the length of the holding period, these methods imply that earnings result from holding an asset a certain length of time rather than from using an asset over its useful life.

As stated before, the donated capital method and the methods based on amortization over the holding period have not received much support. All three are based on the idea that the investment credit does not reduce the cost of the acquired asset. The merit of these methods is that they recognize that net income is not realized through the acquisition of assets. The effect of all methods discussed on net income is summarized in the following table.

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<sup>1</sup>Loc. cit.

Table 6. Effect on net income: increase (decrease)

METHODS	METHODS				
	100% flow-through	deferred tax	cost-reductions*	donated capital**	holding period methods: deferred 100%      deferred 48/52
acquisition	\$70,000	\$33,600	0	0	0
1	(3,640)	0	\$2,360	0	\$5,110
2	(3,640)	0	3,360	0	5,110
3	(3,640)	0	3,360	0	5,110
4	(3,640)	0	3,360	0	5,110
5	(3,640)	0	3,360	0	5,110
6	(3,640)	0	3,360	0	5,110
7	(3,640)	0	3,360	0	5,110
8	(3,640)	0	3,360	0	5,110
9	(3,640)	0	3,360	0	5,110
10	(3,640)	0	3,360	0	5,110
NET INCOME	\$33,600	\$33,600	\$33,600	0	\$33,600

\* The alternative to the cost-reduction method yields the same results.

\*\* Donated Capital is increased by \$33,600.

## CONCLUSION

The cost-reduction method reflects the effect of the investment tax credit on income over the useful life of the property. Therefore, it is the accounting method that most clearly and accurately reflects the facts underlying the investment credit transaction.

The different accounting methods for the investment credit have been explained and their effects illustrated. Convincing arguments and reasons, both for and against each method, have been stated by the various groups that have studied the credit and have proposed an answer. The stature and prestige of the group, itself, lends a proportional amount of support to the method it selects, as does the number of groups supporting each method. However, the quality and logic of the underlying reasons from an accounting viewpoint are the most important considerations. The problem is an accounting problem; and, accordingly, accounting principles and concepts should be used in its solution.

The accounting principle of objectivity requires the recording of every transaction according to the underlying facts and conditions. To ignore these facts and conditions would lead to improper accounting results. The Administration and Congress made their intentions very clear (to reduce the net cost of acquiring property and thereby increase the rate of return over the property's useful life), and constructed the investment credit in such a way as to accomplish their stated

objectives. Should Congressional intent control accounting? As a general rule, it should not. But in the case of the investment credit, is there any conflict between the intentions of Congress and sound accounting principles? To ignore the words of Congress would be the same as ignoring the facts and conditions underlying the transaction. Congress intended for the effect on income to be spread over the property's useful life and included a provision to reduce the basis of the property subject to depreciation. This provision was included to disallow depreciation on the part of the investment in effect paid for by the Federal government. Nowhere did Congress indicate or imply that the purpose of the credit was to increase corporation income in the year of investment. If Congressional intent is a factor underlying the investment credit transaction, then the flow-through methods disregard the principle of objectivity. Congressional intent is an important factor, but not a decisive factor by itself.

The similarity of the preferred treatment of purchase discounts and the cost-reduction method for the investment credit illustrates another accounting principle.

It is a basic principle of accounting that profits are not made on purchases. A company cannot earn income merely by making purchases and taking the discounts, without making a sale.<sup>1</sup>

Proper accounting requires that property be in productive use before it can earn income. It is inconceivable that income

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<sup>1</sup>H. A. Finney and Herbert E. Miller, Principles of Accounting: Intermediate, p. 55.

can be earned merely by the purchase of certain qualified property. However, the flow-through methods increase income in the year of acquisition, a violation of the above principle.

The accounting principle of conservatism used to imply: "Anticipate no profit and provide for all possible losses."<sup>1</sup> This extreme view has been compromised somewhat, but conservatism still remains a principle of accounting. The realization of the investment credit is contingent on future earnings and on holding the property the required period. Where the realization of income is contingent on future developments, it is better from an accounting standpoint and also more conservative to spread the effect over the future periods than to recognize the income at the earliest possible date.

The emphasis has been placed on how the investment credit will affect net income, and the justification for this emphasis lies in the fact that the income statement has become the most significant financial statement. The investment credit will also affect the balance sheet. The property is recorded originally at cost, but because of the tax credit that is granted only to those who purchase certain qualified assets and is based on the purchase price, the cost is decreased. It doesn't seem important that this cost-reduction is in the form of a decreased tax liability granted by the government instead of being a decreased purchase price granted by the seller. The net cost that the buyer considers would be the

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<sup>1</sup>Ibid., p. 181.

same. Because of the cost-reduction provision included by Congress, only the net cost will be subject to future depreciation.

Flow-through advocates claim that to record the asset at net cost is a departure from the cost principle of accounting. The precise definition of cost is not clear and is subject to many interpretations. Depending upon the interpretation derived, a strong argument can be made for either cost-reduction or flow-through accounting. By crediting a contra account (similar to accumulated depreciation) instead of the asset directly, the cost-reduction method does not violate the cost principle under any definition. The contra account technique is the preferred treatment of the cost-reduction method.

In summary, each argument advanced is not, by itself, decisive evidence in favor of one method or the other, but together they represent a conclusive case for the cost-reduction method. The one argument that contributes the most to the above conclusion is based on the idea that earnings result from the use of assets, not from their acquisition. The benefit should be spread over the productive life of the property acquired. This is accomplished by the cost-reduction method.



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INITIAL ACCOUNTING FOR THE  
INVESTMENT CREDIT BY CORPORATIONS

by

PATRICK B. MCKENZIE

B. S., Kansas State University, 1962

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AN ABSTRACT OF A MASTER'S REPORT

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## ABSTRACT

The Revenue Act of 1962 provides for a credit against the income tax liability equal to 7 per cent (3 per cent for utilities) of the investment made in certain qualified property. Congress intended the credit to stimulate economic growth by reducing the net cost of certain depreciable assets and thereby increasing the rate of return of these assets over their useful lives. A provision to reduce the basis of the property subject to depreciation by the amount of the investment credit was included. The accounting problem involves the timing of the benefit from the credit in the income statement.

Three methods have received substantial support. The 100 per cent flow-through method reflects the entire credit in income in the year of acquisition. Because of the reduction in basis subject to depreciation, only 48 per cent of the credit represents a permanent tax savings. The 100 per cent flow-through method decreases net income over the useful life of the assets acquired by 52 per cent of the credit.

The deferred tax method recognizes 48 per cent as the permanent tax benefit and increases income in the year of acquisition by 48 per cent of the credit. Income during the useful life of the assets acquired is not affected.

The cost-reduction method decreases the cost of the assets by the amount of the investment credit. Income in the year of acquisition is not affected; the 48 per cent benefit is spread over the useful life of the assets acquired.

The cost-reduction method is the method that most clearly and accurately reflects the facts underlying the investment credit transaction. The major argument is based on the idea that earnings result from the use of assets, not from their acquisition. The 100 per cent flow-through and deferred tax methods increase earnings in the year of acquisition. The cost-reduction method spreads the benefit over the useful life of the assets acquired.