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# PLANNING WITH THE CHANGED COST RECOVERY RULES

JERE D. MCGAFFEY

The Economic Recovery Tax Act of 1981 made major changes to provide increased benefits to investments in depreciable assets. The system of deductions were not tied to any theory of useful life. Such changes may be justified on encouraging investment to "reindustrialize" the economy to enable it to more effectively compete on a worldwide basis. The changes may be viewed as a response to benefits provided in other industrialized countries and to inflation which caused future deductions to be inadequate relief for current costs. The resulting system should provide for simplification in that fewer options for depreciation are available.

## I. THE BENEFITS

### A. Accelerated Cost Recovery

For property, both new and used, placed in service after December 31, 1980, the following tables indicate the depreciation with respect to personal property:<sup>1</sup>

“(A) FOR PROPERTY PLACED IN SERVICE AFTER  
DECEMBER 31, 1980, AND BEFORE JANUARY 1, 1985. —

*The applicable percentage for  
the class of property is:*

*If the recovery is:*

	<i>3-year</i>	<i>5-year</i>	<i>10-year</i>	<i>15-year public utility</i>
1 .....	25	15	8	5
2 .....	38	22	14	10
3 .....	37	21	12	9
4 .....		21	10	8
5 .....		21	10	7
6 .....			10	7
7 .....			9	6
8 .....			9	6
9 .....			9	6
10 .....			9	6
11 .....				6
12 .....				6
13 .....				6
14 .....				6
15 .....				6"

<sup>1</sup> *Sec. 168(b)(1).*

“(B) FOR PROPERTY PLACED IN SERVICE IN 1985. —

*The applicable percentage for  
the class of property is:*

*If the Recovery Year is:*

	<i>3-year</i>	<i>5-year</i>	<i>10-year</i>	<i>15-year public utility</i>
1 .....	29	18	9	6
2 .....	47	33	19	12
3 .....	24	25	16	12
4 .....		16	14	11
5 .....		8	12	10
6 .....			10	9
7 .....			8	8
8 .....			6	7
9 .....			4	6
10 .....			2	5
11 .....				4
12 .....				4
13 .....				3
14 .....				2
15 .....				1

“(C) FOR PROPERTY PLACED IN SERVICE AFTER  
DECEMBER 31, 1985. —

*The applicable percentage for  
the class of property is:*

*If the recovery year is:*

	<i>3-year</i>	<i>5-year</i>	<i>10-year</i>	<i>15-year public utility</i>
1 .....	33	20	10	7
2 .....	45	32	18	12
3 .....	22	24	16	12
4 .....		16	14	11
5 .....		8	12	10
6 .....			10	9
7 .....			8	8
8 .....			6	7
9 .....			4	6
10 .....			2	5
11 .....				4
12 .....				3
13 .....				3
14 .....				2
15 .....				1

Deductions are computed by taking the unadjusted basis of the property and applying the various percentages indicated.

Three-year property was deemed to be property which had a present class life of four years or less,<sup>2</sup> which include principally cars and light trucks. Five-year property is most machinery and equipment and includes everything that is not in another category.<sup>3</sup> Ten-year property is public utility property with a class life of more than 18 years but not more than 25 years and real property with a class life of 12.5 years or less<sup>4</sup> which is principally theme parks. Fifteen-year public utility property is public utility property with a class life of more than 25 years.<sup>5</sup> The combined present value of the investment credit and the accelerated cost recovery is more than the value of expensing in many instances which may cause corporations to want to capitalize what they previously expensed. (See Schedule A.)

In the case of transfers of property under Sections 351, 361 and 332 (other than Section 334(b)(2)), the new holder continues the transferor's deductions.<sup>6</sup> Thus, if five-year property costs \$100,000 prior to 1985 and is transferred after being held three years, the fourth year depreciation is \$21,000, not 15% of \$42,000. In the case of other nontaxable exchanges, regulations are to be issued.<sup>7</sup>

Real estate is to be depreciated over a 15-year period; but, rather than using what was, in effect, a half year convention that was used in the case of personal property, the real estate tables are to be computed based upon the month in which the property is acquired. A 175% declining balance method is used, switching to a straight line method at a time to maximize the deductions allowable and in the case of low cost housing a 200% declining method is used.<sup>8</sup> These result in the following percentage deductions:

1. *All Real Estate (Except Low-Income Housing)*

The applicable percentage is:

*(Use the Column for the Month in the First Year the Property is Placed in Service)*

<i>If the recovery year is:</i>	1	2	3	4	5	6	7	8	9	10	11	12
1	12	11	10	9	8	7	6	5	4	3	2	1
2	10	10	11	11	11	11	11	11	11	11	11	12
3	9	9	9	9	10	10	10	10	10	10	10	10
4	8	8	8	8	8	8	9	9	9	9	9	9
5	7	7	7	7	7	7	8	8	8	8	8	8
6	6	6	6	6	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	6	6	6	6	6	6	5	6	6	6	6	6
9	6	6	6	6	5	6	5	5	5	6	6	6
10	5	6	5	6	5	5	5	5	5	5	6	5
11	5	5	5	5	5	5	5	5	5	5	5	5
12	5	5	5	5	5	5	5	5	5	5	5	5
13	5	5	5	5	5	5	5	5	5	5	5	5
14	5	5	5	5	5	5	5	5	5	5	5	5
15	5	5	5	5	5	5	5	5	5	5	5	5
16	—	—	1	1	2	2	3	3	4	4	4	5

*(footnotes on next page)*

## 2. *Low-Income Housing*

The applicable percentage is:

*(Use the Column for the Month in the First Year the Property is Placed in Service)*

<i>If the Recovery Year is:</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>	<i>9</i>	<i>10</i>	<i>11</i>	<i>12</i>
1	13	12	11	10	9	8	7	6	4	3	2	1
2	12	12	12	12	12	12	12	13	13	13	13	13
3	10	10	10	10	11	11	11	11	11	11	11	11
4	9	9	9	9	9	9	9	9	10	10	10	10
5	8	8	8	8	8	8	8	8	8	8	8	9
6	7	7	7	7	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	5	5	5	5	5	5	5	5	5	5	6	6
9	5	5	5	5	5	5	5	5	5	5	5	5
10	5	5	5	5	5	5	5	5	5	5	5	5
11	4	5	5	5	5	5	5	5	5	5	5	5
12	4	4	4	5	4	5	5	5	5	5	5	5
13	4	4	4	4	4	4	5	4	5	5	5	5
14	4	4	4	4	4	4	4	4	4	5	4	4
15	4	4	4	4	4	4	4	4	4	4	4	4
16	—	—	1	1	2	2	2	3	3	3	4	4

Leasehold improvements will be deducted over the lesser of the accelerated cost recovery life or the period of the lease.<sup>9</sup>

### B. *Expensing*

In lieu of the former ability to have additional first-year depreciation allowance, it is possible for taxpayers to elect to expense certain depreciable assets in an amount of \$5,000 in 1982 and 1983, \$7,500 in 1984 and 1985, and \$10,000 thereafter; but, in the case of taking such expenses, the investment credit will not be available and such amount will reduce the amount that would otherwise be subject to depreciation.<sup>10</sup> The advantage of this deduction is questionable in cases where investment credit could be utilized. (See Schedule A.) This section does not apply to estates and trusts nor to noncorporate lessors.<sup>11</sup> Investment in property acquired from a related

<sup>2</sup> *Sec. 168(c)(2)(A).*

<sup>3</sup> *Sec. 168(c)(2)(B).*

<sup>4</sup> *Sec. 168(c)(2)(C).*

<sup>5</sup> *Sec. 168(c)(2)(E).*

<sup>6</sup> *Sec. 168(f)(10).*

<sup>7</sup> *Sec. 168(f)(7).*

<sup>8</sup> *Sec. 168(b)(2).*

<sup>9</sup> *Sec. 168(f)(6).*

<sup>10</sup> *Sec. 179.*

<sup>11</sup> *Sec. 179(d)(4) and (5).*

party as defined in Sections 267 and 707(b) may not be expensed,<sup>12</sup> but for applying Section 267(c)(4) "family" shall include only spouse, ancestors and lineal descendants. Property may not be acquired from a component member of controlled group<sup>13</sup> nor may it have a carry-over basis or be inherited property.<sup>14</sup>

### C. Investment Tax Credit

An investment tax credit of 6% is available for three-year property<sup>15</sup> and 10% for all other property.<sup>16</sup> Used property up to \$125,000 qualifies for the investment tax credit and the limit is increased to \$150,000 in 1985 and thereafter.<sup>17</sup> The changes are effective for investments made after-December 31, 1980.<sup>18</sup>

### D. Rehabilitation Credit

Since the Economic Recovery Tax Act of 1981 provided significant depreciation advantage which might encourage the construction of new

<sup>12</sup> Sec. 179(d)(2)(A).

Sec. 267:

"(b) RELATIONSHIPS. — The persons referred to in subsection (a) are:

"(1) Members of a family, as defined in subsection (c)(4);

"(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

"(3) Two corporations more than 50 percent in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

"(4) A grantor and a fiduciary of any trust;

"(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

"(6) A fiduciary of a trust and a beneficiary of such trust;

"(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

"(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; or

"(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual." §267(b).

Sec. 707(b)(1):

"(A) a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

"(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests."

<sup>13</sup> Sec. 179(d)(2)(B).

<sup>14</sup> Sec. 179(d)(2)(C).

<sup>15</sup> Sec. 46(c)(7)(B).

<sup>16</sup> Sec. 46(c)(7)(A).

<sup>17</sup> Sec. 48(c)(2)(A).

<sup>18</sup> Sec. 211(i)(1) ERTA 1981.

structures, it was believed desirable that comparable advantage ought to be given to rehabilitation of existing structures. One portion of the theory behind such a provision was that otherwise there might be an advantage to shift from the northern sections of the country to the southern sections of the country to build new construction in those areas.

A credit similar to the investment credit was provided for qualified rehabilitation expenditures in an amount of 20% of the expenditures for a building of 40 years or older, 15% for a building of 13 years or older, and 25% for a certified historical structure. The credit would reduce the basis for depreciation purposes except in the case of historical structures.<sup>19</sup>

A qualified rehabilitation building would be one which had been substantially rehabilitated and been placed in service before the beginning of the rehabilitation and 75% or more of the existing external walls were retained.<sup>20</sup> In order to be substantially rehabilitated, during a period of 24 months ending on the last day of a taxable year, the rehabilitation expenditures must exceed the greater of the adjusted basis of the property or \$5,000.<sup>21</sup> In the case of fully depreciated property, the \$5,000 limit may be applicable. The statutory reference is not clear as to the use of the term "property" as to whether or not it would include land or only buildings. If the land is included, it would have seemed that the \$5,000 amount was inappropriate and, therefore, it is more appropriate to construe the statute not to include the land as part of the definition of the property. In certain cases a 60-month period can be used rather than the 24-month period if the rehabilitation was completed in phases set forth in architectural plans and specifications which were completed before the rehabilitation began.<sup>22</sup> The cost of acquiring the property or costs of enlargements do not qualify for the credit and a lessee's expenditures can qualify only if the remaining term of the lease without considering renewal periods is 15 years or greater.<sup>23</sup>

Only straight line depreciation may be used on property for which the rehabilitation credit has been taken.<sup>24</sup>

The rehabilitation credit is subject to recapture in the same manner as other investment credit and is earned 2% each year and, if held for five years, there would be no recapture.<sup>25</sup> To the extent the credit is recaptured, the basis is increased for the amount of the recapture if the basis was reduced previously by the amount of the credit.<sup>26</sup>

Historic structures include certified historic structures which are listed in the National Register or a structure which is located in a registered historical district and is certified by the Secretary of the Interior and the Secretary of the Treasury as being of historical significance to the district.<sup>27</sup> Whereas, in general, the rehabilitation credit will not be available for structures used primarily for lodging, this limitation does not apply to certified historical structures.<sup>28</sup>

<sup>19</sup> *Sec. 48(g)(5)*.

<sup>20</sup> *Sec. 48(g)(1)(A)*.

<sup>21</sup> *Sec. 48(g)(1)(C)(i)*.

<sup>22</sup> *Sec. 48(g)(1)(C)(ii)*.

<sup>23</sup> *Sec. 48(g)(2)(B)*.

<sup>24</sup> *Sec. 48(g)(2)(B)(i)*.

<sup>25</sup> *Sec. 47(a)(5)*.

<sup>26</sup> *Sec. 48(g)(5)(B)*.

<sup>27</sup> *Sec. 48(g)(3)*.

<sup>28</sup> *Sec. 48(a)(3)(D)*.

## II. MAKING THE CHANGES WORK

The Economic Recovery Tax Act of 1981 substantially increased the rate at which equipment and real estate could be depreciated. It was recognized that a number of corporations might not be able to take advantage of this faster depreciation because of a lack of taxable income. In order to give encouragement to such taxpayers to make additional capital additions in accordance with economic policy behind the Act, the carry-over provisions were extended and provisions were made whereby the leasing rules were substantially liberalized.

### A. *Carry-overs*

The carry-over of net operating losses was extended to 15 years<sup>29</sup> for years ending after December 31, 1975.<sup>30</sup> The carry-over of investment credit was also extended to 15 years for years after December 31, 1973.<sup>31</sup> Extension of carry-overs provide only partial relief. The present value of a benefit deferred 15 years is obviously rather small.

### B. *Leasing*

Current benefits from investment by business without current taxable income was possible by liberalized leasing rules. These rules permitted the investor in capital equipment to, in effect, sell the tax benefits in exchange for lower leasing costs. These rules were substantially based upon a concept of relatively free transferability so that documents that were called leases would be accepted as leases.

The parties must characterize the agreement as a lease and must elect to have the provisions with respect to leasing apply to them.<sup>32</sup>

Both the lessor and the lessee must file information returns with their tax return for the year in which the lease term commences with respect to their election on particular property.<sup>33</sup> The information return shall contain the following items: the name, address and taxpayer identification number of the lessor and the lessee; the district director's office with which the income tax returns of the lessor and lessee are filed; a description of each property with respect to which the election is made; the date on which the lessee places the property in service; the date on which the lease begins and the term of the lease; the recovery property class of the leased property under Section 168(c) (2); the lessor only must include the unadjusted basis of the property as defined in Section 168(d) (1); and, if the lessor is a partnership or grantor trust, the name, address, and taxpayer identification number of the partners or the beneficiaries; the district office with which the income tax return of each partner or beneficiary files; and such other information as the return may request.<sup>34</sup> The election once made is irrevocable.<sup>35</sup>

<sup>29</sup> *Sec. 172(b)(1)(B).*

<sup>30</sup> *Sec. 172(b)(1)(C).*

<sup>31</sup> *Sec. 46(b)(1).*

<sup>32</sup> *Sec. 168(f)(8)(A).*

<sup>33</sup> *Temp. Reg. §5c.168(f)(8)-2(a)(3).*

<sup>34</sup> *Temp. Reg. §5c.168(f)(8)-2(a)(3).*

<sup>35</sup> *Temp. Reg. §5c.168(f)(8)-2(a)(4).*

The lessor must be a corporation. This benefit was not to be extended to individuals because of concern of its use in tax shelter operations. It is a somewhat questionable limitation in view of the fact that the top individual bracket is reduced to 50% so that the advantage to the individual was not significantly different than to a corporation at 46%. Nevertheless, it was confined to corporations not including small business corporations or personal holding companies.<sup>36</sup> Such corporations could form partnerships if all the partners were qualified corporations or a grantor trust could be used if all of the beneficiaries in the trust were either corporations or partnerships of qualifying corporations.<sup>37</sup>

If at any time during the term of the agreement the lessor ceases to be a qualified lessor, the agreement will lose its characterization as a lease. In the case of any partner or beneficiary of any trust, the entire partnership entity or trust will lose its qualification.<sup>38</sup> Such a harsh rule was evidently prescribed in the temporary regulations because of the difficulty of dealing with the situation of one partner or one beneficiary failing to qualify. It is surprising that such a strict rule has to be made in view of the fact that the partner's or beneficiary's interest could be segregated out and treated as if an undivided portion of the property still qualified.

The lessor must have a minimum investment at the time the property is first placed in service under the lease and at all times during the terms of the lease of at least 10% of the adjusted basis of the property.<sup>39</sup> The minimum investment was defined to be the amount that the lessor had at risk with respect to the property other than financing from the lessee or related party of the lessee.<sup>40</sup>

The 10% requirement is reduced as the adjusted basis of the leased property is reduced by capital cost recovery deductions.<sup>41</sup> The amount treated at risk, however, is not reduced by any of the tax benefits derived from the leased property.<sup>42</sup> An agreement between the lessor and the lessee requiring either or both parties to purchase or sell the property at a specified price at the end of the lease term does not affect the amount the lessor has at risk with respect to such property; but, if there is an option by the lessor to sell the property exercisable before the end of the period for the recovery property class of the leased property, it shall reduce the amount the lessor is considered to have at risk by the amount of the option price at the time the option becomes exercisable.<sup>43</sup> Such an option could limit the amount of any investment which the lessor had in the property.

The term of the lease could not exceed 90% of the useful life of such property or 150% of the class life of such property.<sup>44</sup> This is not based upon the period of time of recovery under the accelerated cost recovery system but is based upon the economic useful life or the class life that had previously been established.

<sup>36</sup> *Sec. 168(f)(8)(B)(i).*

<sup>37</sup> *Sec. 168(f)(8)(B)(i).*

<sup>38</sup> *Temp. Reg. §5c.168(f)(8)-3(b).*

<sup>39</sup> *Sec. 168(f)(8)(B).*

<sup>40</sup> *Sec. 168(f)(8)(E).*

<sup>41</sup> *Temp. Reg. §5c.168(f)(8)-4(a).*

<sup>42</sup> *Temp. Reg. §5c.168(f)(8)-4(b).*

<sup>43</sup> *Temp. Reg. §5c.168(f)(8)-4(b).*

<sup>44</sup> *Sec. 168(f)(8)(B)(iii).*

The lease must have a minimum term at least equal to the recovery property class life.<sup>45</sup> This undoubtedly was included in order to prevent increasing the deductions by shortening the period over which they might be taken.

If these factors of the qualification of the lessor, the amount at risk, and the lease term are met, no other factors are to be taken into account in determining that there is a lease.<sup>46</sup>

The temporary regulations specifically provide that the following factors will not be taken into account in determining whether the transaction is a lease: (1) whether the lessor or lessee must take the tax benefits into account in order to determine that a profit is made from the transaction; (2) the fact that the lessee is the nominal owner of the property for state or local purposes; (3) whether or not a person other than the lessee may be able to use the property after the lease term; (4) the fact that the property may or must be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time; (5) the fact that the lessee or related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10% investment); and (6) the fact that the obligation of any person is subject to any contingency or offset.<sup>47</sup> This is contrary to the prior law which gave consideration to various of these factors. For example, there is nothing that would prohibit the purchase of the property at the end of the lease term for \$1.00.

Also, in sale and leaseback transactions, it is possible for the lessor to pay an amount of 10% or more and pay the rest with the money purchase obligation from the lessee and that the lessee's lease payments may be exactly equal to the payments under the money purchase obligation with the right of offset by both parties.<sup>48</sup> However, it is desired that the parties cannot structure such an arrangement to increase the amount of the deductions which would otherwise be available. Therefore, in such a transaction, the lessor's money purchase obligation must be coterminous with the term of the lease,<sup>49</sup> and the lessor's obligation must bear a reasonable rate of interest within the meaning of Regulation Section 1.385-6(e) or an arm's length rate of interest as defined in Section 1.48 *e.g.*, 2. The safe harbor rates under the 385 regulations are not likely to be helpful as they apply only if the debt-equity ratio is no more than 1:1. The interest deductions by the lessor can be no greater than they would be if the payments were on a level payment mortgage amortized over a period equal to the term of the lessor's obligation and cannot be less than a deduction that would be allowed under straight line amortization of the principal.<sup>50</sup> This may cause a problem in the case of financing which would be based upon balloon principal payments. The lessee is to include the interest in income at the same time and in the same amount as the lessor receives interest deductions. The rental amounts are the pro rata portion of the aggregate amount required to be paid by the lessee to the lessor under the terms of the lease agreement which will be reduced, however, by

<sup>45</sup> *Temp. Reg. §5c.168(f)(8)-5(c).*

<sup>46</sup> *Sec. 168(f)(8)(C).*

<sup>47</sup> *Temp. Reg. §5c.168(f)(8)-1(c).*

<sup>48</sup> *See example 2, Temp. Reg. §5c.168(f)(8)-1(e).*

<sup>49</sup> *Temp. Reg. §5c.168(f)(8)-7(b).*

<sup>50</sup> *Temp. Reg. §5c.168(f)(8)-7(c)(1).*

any amount required to be paid at the end by the lessee equal to the lesser of the lessee's purchase obligation or the fair market value of the property at the end of the lease term as estimated at the beginning of the term.<sup>51</sup> Thus the rental payments must be structured for tax purposes basically equally over the terms of the lease; and, if the purchase obligation is larger than fair market value, it will be considered part of the rent. The lessor includes amounts in income as the lessee takes deductions except in the case of prepayments in rent which must be included at the earlier of the time such rent is paid or accrued.<sup>52</sup>

The new lease rules will apply to all new Section 38 property leased within three months after the time the property was put in service and, if acquired by the lessee, would have been new Section 38 property of the lessee, or property which was new Section 38 property leased within three months after such property was placed in service by the lessee and with respect to which the lessor's basis did not exceed the adjusted basis of the lessee at the time of the lease or property that was qualified as mass commuting property.<sup>53</sup>

The temporary regulations take the position that only one person may be a qualified lessor under a liberalized lease. Thus the property may not be subject to sublease and, if the lessor sells or assigns its interest in a taxable transaction, the lease ceases to qualify and no other lease may be executed. However, there is provision for lease brokers to enter into executory contracts which would be signed by the final lessor and lessee.<sup>54</sup> If there is a loss of safe harbor protection, that may be treated as if the lessor has sold the property to the lessee with accompanying recapture requirements.<sup>55</sup> Events which may cause such disqualification in addition to the lessor selling or assigning include the failure of the lessor to file the required information return, the lessee selling or assigning its interest and having the transferee failing to execute the consent required, the property ceasing to be Section 38 property due to conversion to personal use or other purposes, the lessor ceasing to be a qualified lessor by becoming a Subchapter S corporation or a personal holding company, the minimum investment falling below 10%, the termination of the lease, or the property becoming subject to one or more leases.<sup>56</sup> As indicated, the lessee may sell or assign its interest if the transferee executes a consent. The consent must be furnished to the lessor within 60 days following the transfer and the transferee and the lessor must file a statement with their income tax returns indicating the name, address and taxpayer identification number of the lessor and the transferee, the district director's office with which income tax returns of the lessor and transferee are filed, and a description of the property.<sup>57</sup>

The at-risk rules may apply and both the lessee and lessor may be subject to such rules. The application is based upon what the lessee would be deemed to have at risk if there had been no election to treat the lease as

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<sup>51</sup> *Temp. Reg. §5c.168(f)(8)-7(d)(1).*

<sup>52</sup> *Temp. Reg. §5c.168(f)(8)-7(d)(2).*

<sup>53</sup> *Sec. 168(f)(8)(D).*

<sup>54</sup> *Temp. Reg. §5c.168(f)(8)-3(c).*

<sup>55</sup> *Temp. Reg. §5c.168(f)(8)-8(c), (d).*

<sup>56</sup> *Temp. Reg. §5c.168(f)(8)-8.*

<sup>57</sup> *Temp. Reg. §5c.168(f)(8)-2(a)(5).*

a lease. In addition, the lessor, if the lessor is subject to at-risk rules, must satisfy both the lessor and the lessee's limit. The at-risk rules are only applicable to closely held corporations but would require an investment of the entire amount in order to obtain the investment tax credit which may be particularly troublesome for the lessor.<sup>58</sup> In determining the qualified research expenditure for purposes of the special credit applicable thereto, it must be made without considering the liberalized lease rules so amounts paid by the lessee are not amounts paid for the right to use the property.<sup>59</sup>

### III. THE PRICE TO BE PAID

#### A. *Recapture*

The accelerated cost recovery system gives deductions to the extent that the property is continued to be held. If equipment is sold, the gain would be ordinary income to the extent of the accelerated cost recovery. Real estate which had been subject to recapture only to the extent of accelerated depreciation would be subject to recapture to the full extent of the accelerated cost recovery deductions,<sup>60</sup> with the exception of residential real property and property to which an election had been made that something other than the 15-year accelerated cost recovery might be taken. This makes it perhaps more advantageous to take 15-year straight line depreciation because in such event there will be no recapture upon subsequent sale. With respect to residential real property, to the extent that the accelerated cost recovery percentage exceeds straight line depreciation, such excess will be subject to recapture; and in the case of low-cost housing, that amount is decreased at a 1% per month rate.<sup>61</sup>

Investment credit is subject to recapture based upon the concept that a 2% credit is earned each year.<sup>62</sup> Therefore, if the property is held for five years there will be no recapture.

#### B. *Investment Tax Credit Limited to At Risk*

Investment tax credit, in general, will be available only to investments made at risk.<sup>63</sup> Exceptions for general at-risk rules are continued<sup>64</sup> which exclude real estate<sup>65</sup> and corporations other than Subchapter S corporations, personal holding companies and closely held corporations.<sup>66</sup> Certain nonrecourse financing will qualify for at risk.<sup>67</sup> Taxpayer must at all times

<sup>58</sup> *Temp. Reg. §5c.168(f)(8)-7(f).*

<sup>59</sup> *Temp. Reg. §5c.168(f)(8)-1(b).*

<sup>60</sup> *Sec. 1245(a)(5).*

<sup>61</sup> *Sec. 1250.*

<sup>62</sup> *Sec. 47(a)(4).*

<sup>63</sup> *Sec. 46(c)(8).*

<sup>64</sup> *Sec. 46(c)(8)(A).*

<sup>65</sup> *Sec. 465(b)(3)(D)(i).*

<sup>66</sup> *Sec. 465(a)(1).*

<sup>67</sup> *Sec. 46(c)(8)(B)(ii).*

have at risk 20% of basis, financing must be from a bank, insurance company, pension, trust or person normally engaged in lending but not a related person to borrow on personally acquired property and may not receive a fee with respect to taxpayer's investment. The debt may not be convertible and the property may not be acquired from a related person. This section is intended to eliminate tax shelters based on investment credit with inflated values and financed with nonrecourse debt from the seller of the property.

### C. *Minimum Tax Treatment*

A preference item was created for the difference between the depreciation taken on accelerated cost recovery property subject to a lease and that which would be taken on a straight line method with a half year convention, for three-year property on a five-year period, for five-year property on an eight-year period, for ten-year property on a 15-year period, and for 15-year public utility property on a 22-year period.<sup>68</sup> A preference is created for real property whether or not leased for the difference between the deduction taken had it been depreciated on a 15-year straight life method.<sup>69</sup> (See Schedule B.) A preference tax of 15% is imposed on the amount of such preferences less the actual tax paid.<sup>70</sup> Such item is not a preference item for corporations except for Subchapter S corporations and personal holding companies.

### D. *Earnings and Profits*

There was concern that such accelerated cost recovery could eliminate earnings and profits and thus permit corporations to pay out distributions which would otherwise be dividends. Thus for purposes of computing earnings and profits, the recovery period was based upon a straight line basis and for three-year property it is five years, for five-year property 12 years, for 10-year property 25 years, for 15-year property, whether real property or public utility property, 35 years.<sup>71</sup> (See Schedule B.)

## IV. MISCELLANEOUS

### A. *Property Not Subject to Accelerated Cost Recovery*

The only exception from use of accelerated cost recovery is if the taxpayer elects to exclude the property from this section and it is being depreciated on a unit of production method or another method not expressed in terms of years.<sup>72</sup> In all other cases, whether the property is new or used and no matter what the facts and circumstances are, one of these methods must be used.

<sup>68</sup> Sec. 57(a)(12)(A).

<sup>69</sup> Sec. 57(a)(12)(B).

<sup>70</sup> Sec. 56(a).

<sup>71</sup> Sec. 312(k)(3).

<sup>72</sup> Sec. 168(e)(2).

Recognizing that these lives were shorter than existing lives, limitations were provided in order that property which was being used prior to January 1, 1981, could not be converted to these methods without a bona fide third-party sale. Thus, in the case of Section 1245 property, it would not be considered recovery property if it was owned or used at any time during 1980 by the taxpayer or a related person.<sup>73</sup> Similarly, it could not be acquired from a person who owned such property at any time during 1980 and as part of the transaction the user of such property did not change.<sup>74</sup> This would prevent an acquisition of property that was being leased from being sold from one lessor to another. If the taxpayer leases such property to a person or a related person who owned or used such property at any time during 1980, the new provisions do not apply.<sup>75</sup> If the property is acquired in a transaction as part of which the user of such property does not change and the property is not recovery property in the hands of the person from whom the property is so acquired, by one of the prior reasons it will not qualify.<sup>76</sup> For this purpose a related person is defined in Sections 267(b) and 707(b) substituting 10% for 50%.<sup>77</sup>

Section 267(b) includes members of a family including brothers and sisters, spouse, ancestors and lineal descendants, an individual in a corporation more than 10% of the value of the stock is owned directly or indirectly by or for such individual, two corporations more than 10% of the value of the outstanding stock of each is owned directly or indirectly by or for the same individual. If either one of such corporations with respect to the taxable year of the corporation preceding the date of sale or exchange was a personal holding company or a foreign personal holding company, a grantor and a fiduciary of trust, fiduciary of a trust, a fiduciary of another trust is the same person as the grantor of both trusts, a fiduciary of trust and a beneficiary of another trust, the same person is a grantor of both trusts, a fiduciary of a trust and a corporation more than 10% of the value of the outstanding stock of which is owned directly or indirectly by or for the trust or by or for the person who is the grantor of the trust, and a person in an organization to which Section 501 applies and which is controlled directly or indirectly by such person or by members of the family of such person.

Section 707, as modified, includes losses between a partnership and a partner owning directly or indirectly more than 10% of the capital interests or the profit interest in such partnership or two partnerships in which the same person owned directly or indirectly more than 10% of the partnership interest or profit interest.

In the case of real estate, the property is not considered recovery property if the property was owned by the taxpayer or a related person at any time during 1980 or the taxpayer leases such property to a person who owned such property at any time during 1980 or it was acquired in exchange in certain of the tax-free exchanges, such as for like-kind property, involuntary conversions, re-acquisition of real property in partial satisfaction of the in-

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<sup>73</sup> *Sec. 168(e)(4)(A)(i).*

<sup>74</sup> *Sec. 168(e)(4)(A)(ii).*

<sup>75</sup> *Sec. 168(e)(4)(A)(iii).*

<sup>76</sup> *Sec. 168(e)(4)(A)(iv).*

<sup>77</sup> *Sec. 168(e)(4)(B). See fn 12.*

debtedness on the sale of the property, or low-income housing projects which have been acquired in order to eliminate gain upon the sale of the low-income housing project.<sup>78</sup> Thus the lessor may sell real property subject to a lease and the new lessor-buyer may use the accelerated cost recovery system. Other nonrecognition transactions in corporate transactions which involve a carry-over basis, such as liquidations of subsidiaries, formations of corporations, tax-free reorganizations and similar rules with respect to partnerships, will not cause real or personal property to be recovery property if it was not recovery property in the hands of the transferor.<sup>79</sup> In all cases this limitation only applies to the extent the basis carries over. To the extent there was boot in these tax-free transactions resulting in a change of basis, it is eligible for the new accelerated cost recovery.

In the case of a liquidation of a corporation which will be governed by Section 334(b)(2) and the stock was acquired by purchase after December 31, 1980, the corporation will not be considered a related person.<sup>80</sup>

There is a general anti-avoidance rule permitting the Secretary to issue regulations to make sure that transactions do not permit the use of the new rules if they were intended to avoid the purposes of these limitations.<sup>81</sup>

### B. *Components of Real Estate*

Component depreciation for real estate will no longer be permitted.<sup>82</sup>

To the extent there are substantial improvements to the property, a new election as to depreciation may be made with respect to such improvements; and thus, if there was a substantial improvement to a property which had been in use prior to 1981, it would be possible to have the improvement subject to the accelerated cost recovery system, or a substantial improvement could be depreciated on a straight line method even though the building is depreciated on the accelerated method. A substantial improvement is defined to be an amount added to the capital account with respect to a building during any 24-month period if it exceeds 25% of the adjusted basis at the first day of such period.<sup>83</sup> A substantial improvement does not include any improvement, however, made during the first three years after the building was placed in service.<sup>84</sup> For property that was placed in service before January 1, 1981, it is possible to elect with respect to the first component what method of accelerated cost recovery is to be used and such method will be applicable to all subsequent components.<sup>85</sup>

### C. *Elections of Different Recovery Period*

Depreciation is permitted on other class lives on a straight line basis with a half year life convention using either 3, 5 or 12 years for three-

<sup>78</sup> *Sec. 168(e)(4)(B)*.

<sup>79</sup> *Sec. 168(e)(4)(C)*.

<sup>80</sup> *Sec. 168(e)(6)(E)*.

<sup>81</sup> *Sec. 168(e)(6)(F)*.

<sup>82</sup> *Sec. 168(f)(1)*.

<sup>83</sup> *Sec. 168(f)(1)(C)*.

<sup>84</sup> *Sec. 168(f)(1)(C)(iii)*.

<sup>85</sup> *Sec. 168(f)(1)(B)*.

year property; 5, 12 or 25 years for five-year property; 10, 25 or 35 years for ten-year property; and 15, 35 or 45 years for 15-year public utility property.<sup>86</sup> The other methods that may be used for real property are straight line of 15 years, 35 or 45 years.<sup>87</sup> These are the only methods of deduction for depreciation to be permitted with respect to such property. Shorter lives will not be permitted on facts and circumstances and the taxpayer may not elect longer lives.

## V. CONCLUSION

The Economic Recovery Tax Act of 1981 has made major changes in tax policy. It has unhinged cost recovery deductions from useful life and when combined with investment credit has given a benefit greater than expensing. It has provided a means for easily trading in tax losses through liberalized lease rules. These provisions represent economic not tax policy. As economic policy it must be recognized that tax modifications have limits. The effect of interest rates, availability of capital and demand for product are more significant factors bearing on investment.

## SCHEDULE A

Investment tax credit and 50% depreciation deductions of \$10,000 investment.

<i>Tax Benefit</i>	<i>Present Value</i>		
	<i>7%</i>	<i>10%</i>	<i>12%</i>
<i>Total</i>			
2,000	1,869	1,810	1,775
1,600	1,397	1,311	1,260
1,200	980	890	839
800	610	537	496
400	285	243	220
	5,141	4,801	4,590
Present value of expense is \$10,000 at 50% tax bracket.	4,673	4,526	4,437
	(468)	(275)	(153)
Difference			

<sup>86</sup> *Sec. 168(b)(3)(A).*

<sup>87</sup> *Sec. 168(f)(6).*

### SCHEDULE B

<i>Year</i>	<i>15-Year 175% DB</i>	<i>15-Year St Line</i>	<i>Difference</i>	<i>Cumulative Difference</i>	<i>35-Year St Line</i>	<i>Difference</i>	<i>Cumulative Difference</i>	<i>45-Year St Line</i>	<i>Difference</i>	<i>Cumulative Difference</i>
1	12%	7%	5	5	3%	9	9	2%	10	10
2	10	7	3	8	3	7	16	2	8	18
3	9	7	2	10	3	6	22	2	7	25
4	8	7	1	11	3	5	27	2	6	31
5	7	7	0	11	3	4	31	2	5	36
6	6	7	(1)	10	3	3	34	2	4	40
7	6	7	(1)	9	3	3	27	2	4	44
8	6	7	(1)	8	3	3	40	2	4	48
9	6	7	(1)	7	3	3	43	2	4	52
10	5	7	(2)	5	3	2	45	2	3	55
11	5	7	(2)	3	3	2	47	2	3	58
12	5	7	(2)	1	3	2	49	2	3	61
13	5	7	(2)	(1)	3	2	51	2	3	64
14	5	7	(2)	(3)	3	2	53	2	3	67
15	5	2	3		3	2	55	2	3	70