

Reduction in Tax Basis from the ITC

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For property placed in service after December 31, 1982, TEFRA 1982 reduces the tax benefit of the investment tax credit by requiring that the tax basis of an asset be reduced by one-half of the amount of the investment credit taken or, as an alternative, that the investment credit itself be reduced by two percentage points—from ten percent to eight percent and from six percent (for three year property under ACRS) to four percent. The election is on a property-by-property basis.

The reduction-of-investment-credit option does not apply for the energy credit or for the credit for certified historical structure rehabilitation. For those credits, the tax basis of the property must be reduced; and taxpayers continue to be required to reduce the tax basis of other rehabilitation expenditures by the full amount of a 15 percent or 20 percent credit as provided by ERTA.

If a company chooses to reduce its investment credit in lieu of reducing the basis of the asset for tax purposes, no particular financial reporting problem will result. The investment credit, while reduced in amount, will be accounted for in the usual manner by either the flow-through or the deferral method. However, many, perhaps most, companies will choose the alternative of reducing the tax basis of the asset. These companies will have to deal with the accounting problems created by the reduced tax basis of the asset.

In July 1983, the FASB issued FASB Technical Bulletin No. 83-1 entitled *Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Credit*, referred to herein as the Bulletin. The Bulletin provides accounting guidance for companies using the flow-through method of accounting for the investment credit. While the Bulletin contains an "Example of Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Credit," there is a need for amplification of the explanations and amounts related to this example and the extension of it to show the required accounting entries. This need has been evidenced by numerous inquiries received by technical advisory services since the Bulletin was issued.

With respect to accounting for the reduced tax basis when a company uses the deferral method of accounting for the investment credit, paragraph 5 of the Bulletin states:

This Technical Bulletin does not address accounting for the reduction in the tax basis of an asset by enterprises

HEADNOTE: *The election to accept a reduction in tax basis of property eligible for the Investment Tax Credit, when accompanied by ACRS rates for depreciation, gives rise to a significant example of deferred tax accounting requirements. This article amplifies FASB Technical Bulletin 83-1 on this subject.*

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that recognize investment tax credits by the deferral method. Application of its provisions by those enterprises would not affect net income and might cause only minor changes in balance sheet classifications. . . .

However, net income of those companies using the deferral method *will* be affected and an error in reported net income *will* result if a company using the deferral method fails to account for the reduced basis properly. The author believes that many companies are likely to interpret paragraph 5 erroneously in a way that will lead to reporting errors. Accounting methods for companies using the deferral method, which are consistent with present GAAP relating to the reporting of income taxes in financial statements, are explained and illustrated.

Accounting for Reduced Asset Basis Under Flow-Through Method

In the Bulletin, the FASB took the position that the reduction in the tax basis of the asset is, in substance, a timing difference. The Bulletin states in paragraph 4:¹

. . . perhaps most, companies will choose . . . reducing the tax basis of the asset.

The portion of the investment credit that reduces the tax basis of an asset is, in substance, a timing difference . . . rather than a permanent difference . . . because it will be offset by corresponding differences (reduced ACRS deductions) or "turn around" in other periods. . . . Accordingly, the effect of the basis reduction should be reported as a timing difference under Opinion 11. Deferred taxes should be provided for a reduction in the tax basis of an asset in the year that the related investment credit is recognized as a credit to income tax expense. Those deferred taxes should be amortized to income tax expense as taxable income exceeds financial reporting income as a result of the basis reduction. . . .

Thus the FASB has provided in this Bulletin that companies using the flow-through method in accounting for the investment credit should provide deferred taxes for the tax effect of the reduced tax basis in the first year, i.e., the year in which the investment credit is taken and the tax basis of the asset reduced. Because of the reduced tax basis, the financial statement depreciation will eventually exceed the

tax depreciation; and the resulting additional amount debited to the balance sheet deferred tax credits because of this excess will offset (amortize) the extra amount credited to balance sheet deferred tax credits in the first year.

An example of this is set forth in Exhibit A. The assumptions reflected in Exhibit A are the same as in the Bulletin and there is no inconsistency between Exhibit A and the schedule included in paragraph 8 of the Bulletin. However, Exhibit A amplifies the data in order to demonstrate the necessary entries and clarify the concepts involved. Exhibit A also reflects an additional assumption—that the company's earnings each year, before depreciation and income tax, amount to \$800,000. The assumptions for Exhibit A are shown below:

The company's income tax rate: 46 percent
Income before depreciation and income taxes (each year): \$800,000
The enterprise recognizes investment tax credits by the flow-through method
Cost of the equipment purchased: \$1,000,000
Investment credit realized (10% x \$1,000,000): \$100,000
Reduction in the tax basis of the equipment (50% x \$100,000): \$50,000

The asset is depreciated on the straight-line method over ten years for financial reporting purposes. ACRS guidelines are followed for tax purposes (five years at 15 percent, 22 percent, 21 percent, 21 percent and 21 percent in the years one through five respectively).

The enterprise has no differences between pretax accounting income and taxable income other than differences related to depreciation and the reduction in the tax basis of the equipment.

The accounting entries for income taxes for year one are:

(1)		
Income tax expense—deferred	\$ 23,000	
Deferred tax credits—depreciation		\$ 23,000
To provide deferred tax provision for loss of tax benefits due to the reduced asset basis		
(2)		
Income tax expense—current	\$202,450	
Income tax payable		\$202,450
[46% x (\$800,000 - \$142,500)] - \$100,000		
To provide current provision for income taxes		
(3)		
Income tax expense—deferred	\$ 19,550	
Deferred tax credits—depreciation		\$ 19,550
(\$142,500 - \$100,000) x 46%		
To provide deferred tax for depreciation timing differences		

¹ The FASB position that the portion of the investment credit that reduces the tax basis of an asset is a timing difference is explained and elaborated in paragraphs 2 and 3 of the Bulletin.

EXHIBIT A

Accounting for Reduction in Tax Basis of Asset Caused by Investment Credit Under Flow-Through Method

Year	Income Tax Expense Dr./Cr.)		Tax Return
	Current	Deferred	Depreciation ^a
1	\$ (100,000) ^p	\$ 23,000 ^a	\$142,500
	302,450 ^o	19,550 ^d	
1 Totals	\$ 202,450	\$ 42,550	
2	271,860 ^o	50,140	209,000
3-5, each year	276,230 ^o	45,770	199,500
Subtotals (Yrs. 1-5)	\$1,303,000	\$ 230,000	\$950,000
6-10, each year	\$ 368,000 ^o	\$ (46,000)	\$ -0-
Subtotals (Yrs. 6-10)	\$1,840,000	\$(230,000)	\$ -0-
Totals-10 Yrs.	\$3,143,000	\$ -0-	\$950,000

^a \$50,000 asset basis reduction \times 46% effective tax rate = \$23,000

^b Investment credit: $\$1,000,000 \times 10\% = \$100,000$

^c $(\$800,000 \text{ income before depreciation and tax} - \text{tax depreciation}) \times 46\%$

^d $\$42,500 \text{ depreciation timing difference} \times 46\% = \$19,550$

^e $(\$1,000,000 \text{ cost} - \$50,000 \text{ basis reduction}) \times \text{ACRS rates}$

^f Financial statement depreciation is \$100,000 per year, and \$1,000,000 for 10 yr. period; and exceeds tax depreciation by \$50,000 for the 10 years.

Under the method adopted by the FASB, the tax effects of both the investment credit and the reduced asset basis are reflected in income tax expense in the initial year. An advantage of this treatment, from a conceptual point of view, is that it is consistent with the flow-through method, since all tax effects related to the investment credit are reflected in the total income tax provision in the initial year. An additional advantage is the method's simplicity and ease of application.

... treating the tax/financial statement differences caused by the reduced asset basis as permanent differences will be even easier ...

ences. Also, in year one and subsequent years, there are no permanent differences to quantify each year in order to determine the correct amount of depreciation timing differences.

Possible Avoidance of Interperiod Tax Allocation

Companies, using their ACRS tax depreciation for financial reporting purposes also, can avoid interperiod tax allocation for depreciation altogether by opting to reduce the investment credit instead of the asset basis, thereby retaining the same asset basis for both tax and financial reporting purposes. Many of these companies may perceive the avoidance of deferred tax accounting for depreciation timing differences as outweighing any cash flow advantage of reducing the asset basis instead of the investment credit. However, many companies which use accelerated ACRS depreciation for tax purposes, will find that the ACRS amortization period is too short to enable them to use the same depreciation for financial statement purposes also.² If that is the case, and a company must deal with interperiod tax allocation, it will, as the foregoing discussion shows, find that accounting for the reduced asset basis in accordance with the Bulletin is not difficult either in concept or in implementation.

² This statement, that many companies will be unable to use ACRS accelerated depreciation for financial statement purposes, is based on an analysis by the author, reported in "Accounting for Income Taxes—Recent developments," *The CPA Journal*, July 1983. See especially pages 19-21.

The following summary calculation verifies the total income tax expense in Exhibit A, \$3,143,000 for the entire ten years:

$$46\% \times [(\$800,000 \times 10 \text{ yrs.}) - \$1,000,000] - \$100,000 + \$23,000 = \$3,143,000$$

As shown in Exhibit A, after entry one (shown above) for year one has been made, no further accounting effort for the reduced asset basis is needed in year one of any other year. In all the years, the tax/financial statement depreciation differences including those caused by the reduced asset basis, are all treated as normal timing differ-

Accounting for the Reduced Asset Basis Under the Deferral Method

Paragraph 5 of the Bulletin (quoted previously) states that application of the Bulletin's provisions by enterprises that recognize the investment credit by the deferral method "would not affect net income and might cause only minor changes in balance sheet classifications. . . ." The author is concerned that some accountants may interpret this as meaning that no recognition need be given: in a company's accounts, by companies using the deferral method, for the reduced asset basis; and that somehow, through the normal, routine working of the deferral method over time, everything will work out as it should. That would be erroneous and is certainly not the message that paragraph 5 is intended to convey.

The FASB had encountered opposition . . . from accountants concerned about the accounting overload . . .

Using the same data as in the preceding illustration, if the \$50,000 reduction in tax basis is ignored except in calculating depreciation for tax purposes, and the tax/financial statement depreciation differences that result each year are routinely treated as timing differences subject to the usual interperiod tax allocation procedures, the result will be that the aggregate \$23,000 increase in current tax expense in the first five years (\$50,000 reduced tax basis x 46 percent) will be offset in the second five years by the extra \$23,000 credits to *deferred* tax expense resulting from the excess of the aggregate financial statement depreciation (\$1,000,000) over the aggregate tax depreciation (\$950,000). This, together with the routine amortization of the entire \$100,000 investment credit (\$10,000 per year) will result in overstating income by \$23,000 with an accompanying excess of debits to Deferred Tax Credits in the balance sheet for the same amount.

The easiest, most convenient way to account correctly for the reduced tax basis for most companies using the deferral method is illustrated in Exhibit B. Because the company uses the deferral method, Income Tax Expense—Deferred is debited for the entire \$100,000 investment credit. In making this entry, an amount equal to the unfavorable tax effect of the reduced asset basis (\$23,000) is credited to Deferred Tax Credits—Depreciation; only the difference, \$77,000, is credited to Deferred Investment Credit, to be amortized over the ten years at \$7,700 (instead of \$10,000) per year.

This accounting method is easy to apply, since the tax/financial statement depreciation differences, as seen in Schedule B, are treated as normal timing differences subject to normal interperiod tax allocation. Thus, the only non-

routine accounting items are the entry in year one in which part of the amount of the investment credit is credited to Deferred Tax Credits—Depreciation instead of the Deferred Investment Credit and the subsequent amortization of the amount actually credited to Deferred Investment Credit. In the balance sheet, the debits to Deferred Tax Credits—Depreciation in years six-ten for the extra \$23,000 (\$50,000 x 46 percent) are offset by the extra credit to that same account described in the preceding paragraph. The aggregate additional \$23,000 debited to Income Tax Expense—Current because of the reduced asset basis for tax purposes is offset by the additional credits to Income Tax Expense—Deferred during the depreciation reversal years; but the lower amortization of the investment credit, \$7,700 per year, reflects in the income statement the unfavorable effect of the reduced asset basis over the useful life of the asset.

There is another method of accounting for the reduced basis that achieves the same satisfactory result, under the deferral method, as that previously described. This method is illustrated in Exhibit C where it is seen that each year's total current and each year's total deferred income tax expense amounts are the same as those shown in Exhibit B. This is achieved, even though the entire investment credit is amortized (\$10,000 a year), by considering the \$50,000 asset cost in excess of the amount depreciable for tax purposes, and the \$5,000 financial statement depreciation each year related to it, to be permanent differences. This has the effect of increasing the originating timing differences (by \$25,000) and the related deferred taxes in the first five years, and decreasing the reversing timing difference (by \$25,000) and the related amortization of deferred tax credits in the second five years. As a result, as seen in Exhibit C, the originating and reversing timing differences are equal. An undesirable aspect of this method is that it requires that the amount of permanent differences be determined every year in order to determine the correct amount of the timing differences. As indicated earlier, this is inconvenient and difficult to implement on a continuing basis.

. . . the FASB chose not to become involved in a controversy . . .

However, for those companies using ACRS tax depreciation for fixed assets for financial statement purposes also, treating the tax/financial statement differences caused by the reduced asset basis as permanent differences will be even easier to implement than the method shown in Exhibit B since no non-routine entries will be necessary for the deferred investment credit and no accounting entries at all will be necessary for deferred taxes related to depreciation.³ For these companies, provided that they use the deferral

³ However see footnote 2 regarding the author's reservations about using accelerated ACRS depreciation for financial reporting purposes.

EXHIBIT B

Accounting for Reduction in Tax Basis of Asset Caused by Investment Credit Under Deferral Method—No Permanent Differences

Year	Income Tax Expense Dr./Cr.			Tax Return Depreciation
	Current	Deferred	Total	
1	\$ (100,000) ^a	\$ 100,000		
	302,450	19,550		\$ 142,500
		(7,700) ^b		
1 Totals	\$ 202,450	\$ 111,850		
2	\$ 271,860	\$ 50,140		209,000
		(7,700)		
3-5, each year	276,230	45,770		199,500
		(7,700)		
Subtotals (Yrs. 1-5)	\$1,303,000	\$ 268,500	\$ 1,571,500	\$950,000
6-10, each year	\$ 368,000	\$ (46,000)	\$ 322,000	-0-
		(7,700)		
Subtotals (Yrs. 6-10)	\$1,840,000	\$(268,500)	\$1,571,500	\$ -0-
Totals (Yrs. 1-10)	\$3,143,000	\$ -0-	\$3,143,000	\$950,000

^a Calculations for all current and deferred tax amounts except those related to the deferred investment credit are shown in the footnotes to Exhibit A.

^b Amortization (10 percent) of the investment tax credit reduced by the unfavorable tax effect of the reduced asset basis.

EXHIBIT C

Accounting For Reduction in Tax Basis of Asset Caused by Investment Credit Under Deferral Method—With Permanent Differences

Year	Income Tax Expense Dr. (Cr.)		Depreciation				
	Current	Deferred	Tax	Financial Statement	Total	Permanent	Timing
1	\$ (100,000) ^a	\$ 100,000					
	302,450	21,850 ^b	\$ 142,500	\$ 100,000	\$ 42,500	\$ 5,000 ^c	\$ 47,500
		(10,000) ^d					
1 Totals	\$ 202,450	\$ 111,850					
2	271,860	52,440	209,000	100,000	\$ 109,000	5,000	114,000
		(10,000)					
3-5, each year	276,230	48,070	199,500	100,000	99,500	5,000	104,500
		(10,000)					
Subtotals (Yrs. 1-5)	\$1,303,000	\$ 268,500	\$950,000	\$ 500,000	\$ 450,000	\$25,000	\$ 475,000
6-10, each year	\$ 368,000	\$ (43,700)	\$ -0-	\$ 100,000	\$(100,000)	\$ 5,000	\$ (95,000)
		(10,000)					
Totals (Yrs. 6-10)	\$1,840,000	\$(268,500)	\$ -0-	\$ 500,000	\$(500,000)	\$25,000	\$(475,000)
Totals (Yrs. 1-10)	\$3,143,000	\$ -0-	\$950,000	\$1,000,000	\$ (50,000)	\$50,000	\$ -0-

^a Calculations for all current tax amounts are the same as in Exhibits A and B.

^b \$47,500 timing difference × 46% tax rate = \$21,850.

^c Even though the financial statement depreciation is \$100,000 each year, \$5,000 of it is disregarded each year (as a permanent difference) in calculating the timing difference.

^d Yearly amortization of ITC.

method of accounting for the investment credit, this option exists since paragraph 5 of the Bulletin states that the Bulletin "does not address accounting for the reduction in the tax basis of an asset by enterprises that recognize investment tax credits by the deferral method."

The treatment shown in Exhibit B spreads the unfavorable tax effect of the reduction in asset basis over the life of the asset, and therefore is consistent with the deferral method of accounting for the investment credit. In other respects, it resembles the method promulgated in the Bulletin.

tin for companies using the flow-through method. Why then was this method not included in the Bulletin as the required method for companies using the deferral method?

The FASB had encountered opposition to the treatment of the tax effect of the reduction in tax basis as a timing rather than as a permanent difference from accountants concerned about the accounting overload problem for smaller companies, which are most likely to use ACRS depreciation for financial reporting as well as for tax purposes. Since the entire area of income tax accounting is now being studied with the hope of issuing an authoritative pronouncement, perhaps in 1985, and since the financial statement results are identical in all the years under both "deferral" methods (as seen in Exhibits B and C), the FASB chose not to become involved in a controversy whether a company should use the method which this author has described in Exhibit B, which does not treat any part of the depreciation differences as permanent, or the method described in Exhibit C, which does. However, any company which chooses to reduce the asset basis, and also uses the deferral method of accounting for the investment credit, should use one or the other of these two methods.

In some situations, . . . the option to reduce the investment credit is not available.

Also note that if the FASB had actually required the Schedule B method (which reduces the amount of the investment credit *per se* that is reflected in income) it would probably have been in violation of Sec. 46(f) of the IRC which states that a taxpayer may not be required to use a particular method of accounting for the investment credit in financial statements that fall under the jurisdiction of any federal agency, including the SEC.

Conclusions

For property placed in service after December 31, 1982, companies realizing investment tax credits will have to reduce the tax basis of the asset generating an investment credit by 50 percent of the amount of the investment credit or reduce the investment credit itself by two percentage points. In some situations, listed in this article, the option to reduce the investment credit is not available.

Those companies that use the flow-through method of accounting for investment credits and choose to reduce the tax basis of the asset will have to account for the reduction in the tax basis in accordance with the method promulgated by FASB Technical Bulletin No. 83-1 entitled *Accounting for the Reduction in the Tax Basis of an Asset Caused by Investment Credit*. This method is explained and illustrated in this paper.

The basic approach of the accounting method prescribed by the Bulletin is that the portion of the investment credit that reduces the tax basis of an asset is, in substance, a timing difference. Thus, under this method, the tax/financial statement depreciation differences that result each year because of the reduced asset basis as well as those that result each year because of different depreciation lives and/or methods for tax and for financial statement purposes, are all treated the same—as normal timing differences. Therefore, as demonstrated in this article, this accounting method is easy to implement.

Companies deciding to reduce the investment credit, solely because they believe the accounting method prescribed by the Bulletin will be difficult to implement, will be making a mistake. This article demonstrates that for companies that have timing differences for depreciation anyway, i.e., not related to the reduced asset basis, the additional accounting effort to carry out the accounting method prescribed in the Bulletin is practically nil.

Some companies may opt for the reduced investment credit in order to avoid interperiod tax allocation for depreciation timing differences altogether. These will be companies that use or intend to use the ACRS tax depreciation for financial reporting purposes also; and by avoiding the different asset basis for tax purposes, they will avoid having any timing differences at all for depreciation.

The FASB stated that the Bulletin does not address accounting for the reduction in the tax basis of an asset by enterprises that recognize investment credits by the deferral method. As the present author points out, the reduced tax basis cannot be ignored and certain accounting methods are required to correctly reflect the effects of the reduced tax basis in a company's financial statements. For companies recognizing investment credits by the deferral method the two possible correct accounting methods that are consistent with present GAAP relating to the reporting of income taxes in financial statements are illustrated, analyzed, and compared.

For companies using the flow-through method, i.e., most companies, the FASB refused to permit the use of the permanent difference approach and insisted on the timing difference approach illustrated in Exhibit A. For these companies, use of the permanent difference approach would cause reported income to be different in certain years from the income reported under the timing difference approach. The timing difference approach requires the unfavorable tax effect of the reduced tax basis to be reflected in the financial statements in the same year the investment credit is taken, and is therefore consistent conceptually with the flow-through method of accounting for investment credits.

By requiring the timing difference approach rather than the permanent difference approach for all companies using the flow through method, the FASB (1) insisted on uniformity by companies in accounting for the reduced basis; (2) refused to saddle companies with the difficult financial accounting burden that would result from the permanent difference approach; and (3) chose a conceptually superior method. Ω