

NOTES

THE BIFURCATED BASIS CONCEPT: AN ALGORITHM FOR THE SYNTHESIS OF THE MERCHANT MARINE ACT AND THE INVESTMENT TAX CREDIT

I. INTRODUCTION

The investment tax credit (ITC) is designed to spur new investment¹ in qualified² assets by directly reducing the taxpayer's income tax liability. The investment credit may be characterized, in the argot of academia, as a tax expenditure.³ The Internal Revenue Code (Code) contains a number of such provisions,⁴ but the Merchant Marine Act of

1. S. REP. NO. 1881, 87th Cong., 2d Sess. 11, reprinted in 1962 U.S. CODE CONG. & AD. NEWS 3304, 3314.

2. *Id.* at 14, reprinted in U.S. CODE CONG. & AD. NEWS at 3316. Qualified investment is defined by the Internal Revenue Code as:

- A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus
- B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service during such taxable year.

I.R.C. § 46(c)(1) (1976). The applicable percentage, according to I.R.C. § 46(c)(2), depends upon the useful life of the asset. Because I.R.C. § 38 is titled "Investment in Certain Depreciable Property," it should be apparent that the investment tax credit is granted on basis which is generally equal to the applicable percentage times the cost basis in depreciable property.

3. A tax expenditure may be described as follows:

[W]henver government decides to favor an activity or group through monetary assistance, it may elect from a wide range of methods [such as a] government grant or subsidy, a government loan, perhaps at a special interest rate, or a private loan guaranteed by the government. Instead of direct assistance the government may work within the income tax system to reduce the tax otherwise owed by a favored activity or group. Examples of this indirect government assistance are investment credits [and] special depreciation deductions. . . . These tax reductions, in effect monetary assistance provided by the government, represent tax expenditures.

Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, 228 (1979). See generally S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973); Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B. C. INDUS. & COM. L. REV. 679 (1976).

4. Several of the major tax expenditure provisions include deductions for state and local nonbusiness taxes, I.R.C. § 164 (1976 & Supp. IV 1980), deductions for charitable contributions, I.R.C. § 170 (1976 & West Supp. 1982), deductions for interest expense, I.R.C. § 163 (1976), and credit for the elderly, I.R.C. § 37 (West Supp. 1982). See generally W. ANDREWS, *BASIC FEDERAL*

1970 (MMA)⁵ is tax expenditure legislation that Congress enacted outside the confines of the Code. The MMA grants tax deferred status to funds set aside for new ship construction. It provides for a current deduction for cash set aside and a concomitant reduction in the basis of vessels acquired with such funds.⁶ Congress designed this basis reduction to prevent the taxpayer from taking deductions at both the time of deposit of the funds and again while depreciating the newly acquired asset.⁷

This Note demonstrates that, although Congress did not clearly contemplate interaction between the MMA and the investment tax credit when the ITC was enacted,⁸ the policy behind the tax credit and the nature of the MMA benefits support a statutory interpretation granting full ITC benefits to MMA beneficiaries.⁹ The reduction in depreciable basis that occurs when deductible deposits are made to a capital construction fund¹⁰ should not affect the calculation of the investment credit amount.¹¹ This Note examines the legislative intent manifested in the ITC, and analyzes the concept of basis in light of that intent. It compares the differing functions of basis for depreciation as opposed to investment tax credit purposes.¹² Finally, this Note concludes that because the MMA creates nothing more than a depreciation form analogous to accelerated depreciation,¹³ all vessel operators¹⁴ should receive full ITC benefits.¹⁵

INCOME TAXATION 317-22 (2d ed. 1979); B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 26-33 (5th ed. 1980).

5. Pub. L. No. 91-469, 84 Stat. 1018 (codified in scattered sections of 46 U.S.C.).

6. Merchant Marine Act of 1970, 46 U.S.C. § 1177(d), (g) (1976).

7. See *infra* notes 19-27 and accompanying text.

8. See *infra* note 75 and accompanying text.

9. See *infra* notes 41-64 and accompanying text.

10. See *infra* note 20.

11. The amount of the investment tax credit available to a taxpayer is calculated by taking the appropriate basis in the depreciable asset and multiplying it by the product of the regular percentage times the applicable percentage. See I.R.C. § 38 (1976); I.R.C. § 46(a)(2)(A) (Supp. IV 1980); I.R.C. § 46(a)(2)(B) (Supp. IV 1980); I.R.C. § 46(c) (1976 & Supp. IV 1980).

12. See *infra* notes 88-97 & 118-24 and accompanying text.

13. See *infra* note 135.

14. Fleet owners using cash from a capital construction fund to acquire an eligible vessel are granted only 50% of the applicable percentage as the rate to be used in calculating the credit. That is, if 10% was the regular percentage, the taxpayer would get only a 5% tax credit. See I.R.C. § 46(g) (1976 & Supp. IV 1980); *infra* notes 37-40 and accompanying text.

15. Taxpayers receiving full investment credit benefits would receive the credit, as calculated *supra* note 11, over and above the floor created by I.R.C. § 46(g) (1976 & Supp. IV 1980). See *infra* notes 37-40 and accompanying text.

II. THE MERCHANT MARINE ACT AND THE ITC: THE MECHANICS OF APPLICATION

Congress enacted¹⁶ the MMA to stimulate the growth and modernization of the United States merchant fleet.¹⁷ In order to stimulate new investment, the MMA provides a subsidy for ship construction in the form of a tax deferral.¹⁸ A vessel owner¹⁹ can deposit cash into any of three "accounts,"²⁰ which may be commingled for investment pur-

16. According to the Senate Report, "[t]he purpose of the legislation is to revitalize our merchant marine by providing a long range merchant shipbuilding program of 300 ships in the next 10 years. . . ." S. REP. NO. 1080, 91st Cong., 2d Sess. 9, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4188, 4188. Furthermore, "[s]ection 21 [of the Merchant Marine Act of 1970] would entitle certain shipping companies to defer payment of income taxes upon agreement to deposit this income into a fund to replace or add new ships for use in the U.S.-flag merchant marine. . . . The privilege [of using tax deferrals] is being extended to presently unsubsidized American flag carriers." *Id.* at 39, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS at 4212-13.

17. The size and quality of the United States merchant marine declined precipitously between 1945 and 1970. *Id.* at 9-17, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS at 4189-91. *See also* Moore-McCormack Lines, Inc. v. United States, 413 F.2d 568, 570-74 (Ct. Cl. 1969) (explains the problem and the MMA solution).

18. For an illustration of the value of a tax deferral, see *infra* notes 27 & 135.

19. A qualified vessel owner is "[a]ny citizen of the United States owning or leasing one or more eligible vessels. . . ." 46 U.S.C. § 1177(a) (1976). An eligible vessel is any ship:

- (A) constructed in the United States and, if reconstructed, reconstructed in the United States,
- (B) documented under the laws of the United States, and
- (C) operated in the foreign or domestic commerce of the United States or in the fisheries of the United States.

Any vessel which (i) was constructed outside of the United States but documented under the laws of the United States on April 15, 1970 or (ii) constructed outside the United States for use in the United States foreign trade pursuant to a contract entered into before April 15, 1970, shall be treated as [an eligible vessel]. . . .

Id. § 1177(K)(1).

20. There is no floor on the amount that a taxpayer must deposit each year to his capital construction fund. There is, however, a ceiling on yearly deposits, equal to the sum of: (1) taxable income for the year, (2) depreciation expenses allowable under Section 167 of the Code, (3) proceeds from the disposition of vessels purchased using cash from the capital construction fund, and (4) income on the investments held in the capital construction fund. *Id.* § 1177(b). For a general explanation, see S. REP. NO. 1080, 91st Cong., 2d Sess. 44-46, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4188, 4217-20. These deposits go into three accounts: the capital account, the capital gain account, and the ordinary income account. The capital account contains funds that did not result in any tax deferral, such as tax exempt interest income earned on debt instruments held as investments by the fund. The capital gain account contains the proceeds of any transaction that is tax deferred and that yields long term capital gains. An example of a transaction eligible for tax deferral and deposit to this account is the sale of a vessel acquired using capital construction funds. Finally, the ordinary income account contains only "deposits which resulted in the deferral of ordinary income tax." *Id.* at 48, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS at 4222. *See* 46 U.S.C. § 1177(e)(4) (1976). Examples of deposits to this account include interest income, short term capital gains, and ordinary income arising from the operation of ships covered by an agree-

poses, and can take a deduction in the deposit year equal to the amount of that deposit. These accounts, which are jointly referred to as the capital construction fund, are not subject to the accumulated earnings tax.²¹ In the event of a nonqualified withdrawal²² from the fund, the vessel owner must recapture and pay, with interest,²³ the taxes deferred

ment between the vessel owner and the Secretary of Commerce. For further discussion of the operation of the three accounts and other related rules, see generally Blackwell, *Implementation of the Merchant Marine Act of 1970*, 5 J. MAR. L. & COM. 167 (1974); Gallagher, *Maritime Tax: The Capital Construction Fund of the Merchant Marine Act of 1970*, 6 J. MAR. L. & COM. 105 (1974); Lewis, *Merchant Marine Act of 1970 Changes and Improves Available Tax Incentives*, 34 J. TAX'N 300 (1971); Merrigan, *New Tax Saving Opportunities for Small Watercraft, 'Sea Tug' Crew Boats and Fishing Boats Under the Merchant Marine Act of 1970*, 21 TUL. TAX INST. 327 (1972); Richardson, *Capital Construction Funds Under the Merchant Marine Act*, 29 TAX L. REV. 751 (1974); Seago, *Investing in Ships: Amendments to Merchant Marine Act Open Up New Tax Shelter*, 37 J. TAX'N 306 (1972); Seago, *Using a Capital Construction Fund to Defer Income from Shipping and Fishing Vessels*, 8 TAX ADVISER 541 (1977).

21. In order to avoid frustrating the purpose of the capital construction fund, that is, the accumulation of capital for the acquisition of new American-made vessels, Congress exempted the fund from the accumulated earnings penalty. 46 U.S.C. § 1177(d)(1)(E) (1976).

22. Any withdrawal made pursuant to the agreement signed between the Commerce Department and the ship owner constitutes a qualified withdrawal. The withdrawal, however, may only be for purposes of acquiring, constructing or reconstructing a qualified vessel or barge. *Id.* § 1177(f). With respect to nonqualified withdrawals:

- (h)(1) [A]ny withdrawal from the fund [except withdrawals for research and development on ship designs] which is not a qualified withdrawal shall be treated as a nonqualified withdrawal.
- (2) Any nonqualified withdrawal from a fund shall be treated—
 - (A) first as made out of the ordinary income account,
 - (B) second as made out of the capital gain account, and
 - (C) third as made out of the capital account.
- ...
- (3) For purposes of the Internal Revenue Code . . .
 - (A) any [withdrawal from an ordinary income account] shall be included in income as an item of ordinary income for the taxable year in which the withdrawal is made,
 - (B) any amount [withdrawn from the capital gain account] shall be included in income for the taxable year in which the withdrawal is made as an item of gain realized during such year from the disposition of an asset held for more than 6 months.

Id. § 1177(h)(1)-(3).

23. A nonqualified withdrawal may result in an increase in tax liability for the period because the amount of the withdrawal may be included as ordinary income. *See supra* note 22. The IRS imposes an interest charge that is calculated on the amount of the deposit, in the tax year in which the deposit occurs, and compounds the interest until the year of the nonqualified withdrawal. *Id.* § 1177(h)(3)(C)(ii). This interest charge is not a penalty. Congress designed the charge to discourage the use of the capital construction fund for purposes not contemplated in the Merchant Marine Act of 1970. The interest charge is an attempt to put the taxpayer in the same position as one who had never received the tax deferral. S. REP. NO. 1080, 91st Cong., 2d Sess. 52, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4188, 4226. The IRS recalculates applicable

as a result of the earlier deductions. The Internal Revenue Service (IRS) does not tax withdrawals from the fund provided the cash is reinvested in an eligible vessel.²⁴ If the owner later sells the vessel, the disposition triggers recapture unless the owner redeposits the cash into the capital construction fund.²⁵

In order to prevent the taxpayer from receiving a double tax benefit from the same funds, the IRS reduces the taxpayer's depreciable basis in an eligible vessel by the amount of money withdrawn from a capital construction fund and invested in that vessel.²⁶ The IRS thus recovers the tax benefits of the early deductions from gross income over the life of the asset through reduced depreciation deductions.²⁷ In effect, the

interest rates each year. *See, e.g.*, Notice 81-12, 1981-2 C.B. 543 (interest rates for tax year 1981 set at 12.41%).

24. *See supra* notes 19 & 22.

25. The owner must include any gain on the sale of a vessel as ordinary income for that tax year unless he redeposits such gain in the capital construction fund. 46 U.S.C. §§ 1177(d)(1)(B), 1177(g)(5) (1976). Because basis in a new vessel is reduced to the extent of capital construction funds used to purchase the vessel, the gain for tax purposes, and the resulting tax liability, could be substantial. In contrast, the gain for book or cash purposes might be relatively small. *See also infra* notes 26-31 and accompanying text (contrasting treatment of basis for ITC and depreciation purposes).

26. *Id.* § 1177(g)(2)-(4).

27. This concept is best illustrated using a simple numerical example based on the following fact pattern. Doe Corporation will earn gross revenues of \$1,000,000 per year for at least the next 20 years, and that the company plans to buy a new ship in year six. Doe's current vessels are fully depreciated as of year one and will have a zero fair market value in year five, and the new ship will cost \$500,000 and have a five year useful life. Because Doe's assets are fully depreciated, it has no depreciation expenses in years one through five. Rather, it takes a deduction for each annual deposit of \$100,000 to the capital construction fund. In years six through ten, Doe still has no depreciation expenses for tax purposes because the acquisition costs have been fully recovered, and depreciable basis reduced dollar for dollar, by virtue of the withdrawal of capital construction fund cash to purchase the vessel. *See supra* note 26.

Example 1: assume money has no time value (this assumption will be relaxed in example two). Thus, after five years the company has accumulated \$500,000. Its income statements for tax purposes will resemble Fig. 1-1. Note that in section B of Fig. 1-1, the government recovers the total tax benefit gained in the first five years via reduced depreciation deductions mandated by the basis reduction provisions. The taxpayer has received three benefits: (1) the loan of taxes that would normally be paid to the government, (2) the ability to accumulate \$100,000 per year for future ship purchases, and (3) an exemption from the accumulated earnings tax, *see supra* note 21.

Example 2: Assume money has a time value, assume a 10% interest rate, and to simplify the analysis, assume that the capital construction fund does not earn income. Assume further that the other facts of the first example are the same. During years one through five, the government lends the taxpayer \$50,000 per year in the form of deferred taxes. The taxpayer thus has the use of this money for five years (see Fig. 1-2, *Deferred Taxes*). The government recovers this tax money in years six through ten. The difference between present value of the taxes deferred and the present value of the taxes recovered, or \$71,853, is the net gain to the taxpayer as a result of the deferral.

MMA provides an interest-free loan in the amount of the taxes deferred; the government recovers the principal of this loan over the life of the asset through the diminished depreciation deductions. The interest that could be earned on the "loan" represents the "loan's" time value and constitutes a subsidy to the investor.²⁸

In contrast to a tax deferral, the investment tax credit directly and often permanently, depending on the method which the taxpayer chooses, reduces an asset owner's tax liability.²⁹ The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),³⁰ has made the ITC a hybrid of sorts by permitting the taxpayer to elect between two alterna-

The principle in the capital construction fund earned interest at the rate of 10%, but this income flow was not analyzed in this example in order to simplify the analysis. For those who wish to see an analysis of the fund's investment income, Example 3 will prove enlightening.

Example 3: The fund's investment income is tax free as long as it is invested in an eligible vessel. Because basis in new ships is reduced dollar for dollar for any cash in the ordinary income account used to purchase the new vessel, the government eventually taxes any income earned on the account, again in the form of reduced depreciation deductions. Assuming that annual deposits to a capital construction fund are designed to permit the purchase of a \$500,000 asset at the end of year five, each yearly deposit would be \$74,453.40. This calculation is analogous to a bond sinking fund, in which equal amounts of cash are set aside each year to retire the principle when it matures. In terms of arithmetic calculations, the fund is treated herein as if it were a five year annuity in advance. The example in Fig. 1-1 was simplified to make the numbers more illustrative of simple principles. A more realistic portrayal appears in Fig. 1-3: Deposits to the fund are made at the beginning of each year. Withdrawal is on day one of year 6. The right to use a tax deferral is worth approximately \$70,562 to the taxpayer. See figures on the following pages.

28. See *supra* note 27, Example 2.

29. Tax credits directly reduce a taxpayer's tax liability on a dollar for dollar basis. Deductions are merely subtractions from gross income. Deductions reduce tax liability in an amount approximately equal to the average tax rate times the amount of the deduction. A \$100 tax credit would reduce taxes payable by \$100. Assuming a 50% average tax rate, a \$100 deduction however would reduce taxes payable by only \$50.

30. Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of U.S.C.). TEFRA makes one significant change for present purposes. It permits the taxpayer to use 10% as the regular percentage but requires a reduction in depreciable basis by 50% of the credit determined under § 46(a)(2). I.R.C. § 48(q)(1) (West Supp. 1983). In the alternative, the taxpayer may elect to use 8% as the regular percentage; such taxpayers receive this reduced credit in lieu of any basis adjustments. *Id.* § 48(q)(4).

The impact of these changes depends upon the taxpayer's choice of treatment. If a taxpayer wants a large, immediate tax reduction, he will use 10% as the regular percentage. Section 48(q) converts half of this ITC, or 5%, into a tax deferral by requiring a basis reduction. Thus, only 50% of the credit is unrecovered asset cost reduction, see *infra* notes 88-97 and accompanying text, while the remainder of the credit is recovered in part over the depreciable life of the asset. If the taxpayer elects to use the § 48(q)(4) election, however, then the taxpayer may use an 8% ITC with no basis reductions—and therefore no recovery of the ITC by the I.R.S. Congress altered the ITC rules because it believed that the ACRS in tandem with a 10% ITC was an overly severe drain on federal revenues, and caused misallocations of private investment. See generally S. REP. NO. 97-494, 97th Cong., 2d Sess. 122, reprinted in 1982 U.S. CODE CONG. & AD NEWS 109 (Sept. 1982).

Fig. 1-1

	Section A*					Section B*				
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Income	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Expenses (assuming none except depreciation)	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Deduction For Cap. Con. Fund	100	100	100	100	100	-0-	-0-	-0-	-0-	-0-
Taxable Income	900	900	900	900	900	1,000	1,000	1,000	1,000	1,000
Tax Paid [assume 50% tax rate]	450	450	450	450	450	500	500	500	500	500
Net Income For Tax Accounting Purposes	450	450	450	450	450	500	500	500	500	500

Thus the taxes saved amounted under Section A to a total of:
 Avg Tax Rate × Amt of Deduction = Tax Savings .5 × 100,000 = 50,000/yr
 × 5 yrs.
\$250,000 total

* In thousands

Fig. 1-2

[Assumption: The tax benefit accrues to the taxpayer on the last day of the year]

"Loan"—Years 1 through 5

Deferred Taxes (Principle) × (Annuity Discount Factor*) = Present Value
 (50,000) × (3.7907) = 189,535

"Repayment"—Years 6 through 10

Deferred Taxes (Principle) × (Annuity Discount Factor*) × (Pres. Val. Fact*) = P.V.
 (50,000) × (3.7907) × (.6209) = 117,682

Present Value Taxes Deferred Minus Present Value of Taxes Recovered:
 \$189,535 - 117,682 = 71,853

* Rounded

Fig. 1-3

	Section A†					Section B†				
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Income	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Expenses (assuming none except depreciation)	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Deduction For Cap. Con. Fund	74,453	74,453	74,453	74,453	74,453	-0-	-0-	-0-	-0-	-0-
Taxable Inc. Tax Paid (Rounded up)	462,774	462,774	462,774	462,774	462,774	500	500	500	500	500
[assume 50% tax rate]										
Net Inc. For Tax Accounting Purposes*	462,773	462,773	462,773	462,773	462,773	500	500	500	500	500
Thus the value of the tax deferral may be recalculated as follows: Δ										
Deferred Taxes — Years 1 through 5 "Loan"										
PV =	PV (taxes deferred on deposits) +									
	PV (taxes deferred on fund income)									
	≈ (3,7907) [(5)(74,453.40)] + 45,015									
	≈ 186,130									
Deferred Taxes — Years 6 through 10 "Repayment"										
PV =	PV (taxes that were deferred in yrs. 1-5, which are recovered in yrs 6-10 via reduced depreciation deductions)									
	≈ (6209) (186,130)									
	≈ 115,568									
	†In thousands									
ΔCalculation of the "present" value, as of year 6, of the deferred taxes is omitted in order to simplify the presentation										
*Some rounding error involved										
										Present Value of the Tax Deferral
										186,130 - 115,568 = 70,562*

tives. A taxpayer may claim the regular percentage and suffer a reduction in depreciable basis, which converts part of the ITC into a mere tax deferral; or he can choose to take a smaller regular percentage for the ITC without a concomitant reduction in depreciable basis.³¹ Because of its impact on asset cost, the ITC substantially reduces the amount of income the asset must generate to satisfy required rate of return calculations.³² With respect to the American Merchant fleet, the ITC makes investments in American vessels substantially more attrac-

31. See *supra* note 30. Congress passed TEFRA after this Note was prepared for publication; thus, the reader will find in this Note no substantive analysis of TEFRA's impact. It is important to point out, however, that TEFRA changes a few of the numbers involved, but not the fundamental arguments.

Consider, for example, the merchant shipper who purchases a vessel using only capital construction fund (CCF) monies. Such a taxpayer must reduce depreciable basis in the vessel for each dollar of CCF cash used in making the acquisition. See *supra* note 26 and accompanying text. Suppose that a taxpayer purchased an eligible vessel costing \$100x using only CCF cash to finance the purchase. Taxpayer's depreciable basis would be zero. Section 46(g)(2) would treat only \$50x as qualified investment. See *infra* note 37. A taxpayer attempting to use 10% as the regular percentage could claim \$5x as an ITC, but he would be unable to reduce basis by 50% of the credit granted (50% of \$5x = \$2.5x), as required by § 46(q)(1). I.R.C. § 46(q)(1)(West Supp. 1983). The taxpayer could only receive \$2.5x, or 5% of \$50x as an ITC, because use of the other half of the regular percentage (here 10%) requires a basis reduction. The taxpayer could also litigate the status of the other \$50x of investment in an effort to force the I.R.S. to treat it as qualified investment and thus grant an additional \$2.5x of ITC. See I.R.C. § 46(g)(6)(1976). Of course, such litigation would focus on the issues discussed in this Note—the meaning of basis for ITC purposes.

If the taxpayer in the example above were to elect under § 48(q)(4), however, he could claim without litigation 8% of \$50x, or \$4x, as an ITC. I.R.C. § 48(q)(4)(West Supp. 1982). The taxpayer could then litigate the qualified investment issues in an effort to get the remaining \$4x (that is, 8% of the other \$50x of asset cost, the total cost being \$100x, as stated above) that would normally be available to taxpayers using accelerated depreciation methods. The election avoids the basis problem for shipowners who have no basis left to reduce, but requires the litigants to confront again the central issue in this Note—the availability of the ITC to taxpayers who use CCF cash, which reduces depreciable basis but which should not (under the § 48(q)(4) election) reduce basis for ITC purposes.

32. The commonly accepted formula used for determining the required rate of return is denoted as the capital asset pricing model. The model's formula is: $K_e = K_{RF} + (K_M - K_{RF})\beta$, where K_e = the required rate of return, K_{RF} = is the risk free rate of interest, K_M = the required return on the market index, and β = the risk of asset A with respect to the market index, or $\beta = \frac{\text{Cov}_{AM}}{\text{Var}_M}$. See O. JOY, INTRODUCTION TO FINANCIAL MANAGEMENT 71-89 (2d ed.) (1980); J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 60-106 (5th ed. 1980).

Assuming that K_e is the required rate of return, and I is the amount of invested capital, then $(K_e)(I)$ = average required cash return for an investment having simple, uniform cash flows. If the investment credit reduces the cost of the asset acquired, then the average required cash return will fall as well. That is, as I is decreasing, the product of $(K_e)(I)$ declines as well.

tive.³³ Congress declared, in the Revenue Act of 1962, that the ITC should affect all American-made depreciable assets in this way.³⁴ Despite an unusual history of suspensions and reinstatements,³⁵ the ITC's initial policy format remains unchanged. The credit is designed to spur new investment in depreciable assets which are used in a trade or business or for the production of income.³⁶

The Code speaks directly to the relationship between the MMA and the ITC. Section 46(g) permits a taxpayer, who acquires a vessel with cash from a capital construction fund, to take 50% of the maximum credit available under the ITC provisions³⁷ of the Code. That is, the statute entitles the taxpayer to claim up to 5% of cost basis, depending on the asset's useful life, as an investment credit. Yet section 46(g) declares that it raises no inference as to whether any property is or is not depreciable property qualified for the ITC under section 38.³⁸ Thus, if

33. As the investment tax credit reduces the cost of investment in a depreciable asset, it also reduces the cash return required as compared to other alternative investments. This tends to encourage ship owners to purchase the more costly American-made vessels. See Sunley, *The Proper Role of the Investment Tax Credit*, 69 PROC. ANN. CONF. NAT'L TAX ASS'N-TAX INST. AM. 205, 206 (1976).

34. S. REP. NO. 1881, *supra* note 1, at 10-11, reprinted in 1962 U.S. CODE CONG. & AD. NEWS at 3313.

35. See *infra* note 53.

36. I.R.C. § 38 (1976) requires that the assets be depreciable. To be depreciable, I.R.C. § 167(a)(1)-(2) (1976 & West Supp. 1982) requires that the property be used either in a trade or business or held for the production of income.

37. Section 46(g) provides in relevant part:

(2) Amount of Credit

For purposes of paragraph (1), the amount of qualified investment shall be 50 percent of the applicable percentage of the qualified withdrawal referred to in paragraph (1), or the amount of the qualified progress expenditures shall be 50 percent of such withdrawal as the case may be. For purposes of determining the amount of the credit allowable by reason of this subsection for any taxable year, the limitation of subsection (a)(3) shall be determined without regard to subsection (d)(1)A of such section 607 [of the Merchant Marine Act of 1970].

(3) Coordination with Section 38

The amount of the credit allowable by reason of this subsection with respect to any property shall be the minimum amount allowable under Section 38 with respect to such property. If, without regard to this subsection, a greater amount is allowable under Section 38 with respect to such property, then such greater amount shall apply and this subsection shall not apply.

(6) No inference

Nothing in this subsection shall be construed to infer that any property described in this subsection is or is not Section 38 property and any determination of such issue shall be as if this subsection had not been enacted.

I.R.C. § 46(g)(2),(3),(6)(1976).

38. See *supra* note 37 (quoting *id.* § 46(g)(6)).

the taxpayer believes that he is entitled to the full investment credit (10%), section 46(g) leaves him no alternative but to sue for the balance of the credit not expressly granted by section 46(g)(2).³⁹ In sum, section 46(g) simply grants an ITC, up to 5% of cost basis, and invites the taxpayer who wants the full 10% tax credit to seek a judicial declaration of the depreciable nature of the asset.⁴⁰ For those making significant investments in new or reconstructed eligible vessels, the stakes are still quite high. Section 46(g) offers little assistance, for it fails to resolve the dispute over the definition of basis for investment credit purposes.

III. LEGISLATIVE HISTORY

Congress intended the investment tax credit to encourage the rapid modernization and replacement of American productive capacity.⁴¹ Both the Conference and Senate Reports⁴² on the Revenue Act of 1962⁴³ advert to asset cost reduction as the means by which the ITC

39. *Id.* § 46(g)(2) created a floor for tax credits claimed by eligible vessel owners under the Merchant Marine Act of 1970. If the taxpayer believes he is entitled to the ceiling amount, the regular percentage described in *id.* § 46(a)(2)(B) (Supp IV 1980), then he must sue for a court determination as to whether his property is depreciable—a requirement for the ITC. Section 46(g)(6) raises no inference about whether an asset is depreciable. *Id.* § 46(g)(6) (1976). *See infra* notes 142-43 (defining depreciable property).

40. *See supra* note 39. *See generally* Cook, Brodie, & Granwell, *Shipping and Fishing Industries are Affected by Tax Reform Act of 1976*, 46 J. TAX'N 88 (1977); Seago, *supra* note 20. Note that in creating a floor on the investment credits allowable to taxpayers using capital construction funds, Congress overruled, in part, two prior Revenue Rulings on the subject. *See* Rev. Rul. 68-468, 1968-2 C.B. 26; Rev. Rul. 67-395, 1967-2 C.B. 11.

41. S. REP. NO. 1881, *supra* note 1, at 10-11, 18, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS at 3313-14, 3320.

42. The Senate Report states:

Realistic depreciation [through guidelines on tax lives] alone, however, is not enough to provide the essential economic growth. In addition, a specific incentive must be provided if a higher rate of growth is to be achieved. 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.

S. REP. NO. 1881, *supra* note 1, at 11, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS 3314 (emphasis added). The Conference Report reaffirms this view of the purpose of the investment credit:

It is the understanding of the conferees on the part of both the House and the Senate that the *purpose* of the credit for investment in certain depreciable property . . . 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* . . .

CONF. REP. NO. 2508, 87th Cong., 2d Sess. 14, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS 3732, 3734 (emphasis added).

43. The investment tax credit was passed as part of the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (codified in scattered sections of 26 U.S.C.).

was to accomplish this purpose.⁴⁴ President Kennedy expressed a similar view in a report to Congress strongly urging passage of the Revenue Act.⁴⁵ Congress thus regarded the ITC as a means of stimulating the economy by providing an incentive to investment.⁴⁶ This incentive would not only increase the rate of return on new capital assets, but would also increase cash flow available for investment by lowering a business's tax liability.⁴⁷

Congress suspended the ITC in 1967 and again in 1969 in order to cool inflationary pressures.⁴⁸ Countercyclical fiscal policy⁴⁹ and the notion of economic fine tuning⁵⁰ were in vogue. The suspensions were a part of the regnant Keynesian economic policies and were not rejections of the cost reduction approach represented by the ITC. Indeed, when Congress reenacted the ITC at the behest of the Nixon administration,⁵¹ Treasury Secretary Connelly testified favorably on the merits

44. It is interesting to note that, in attempting to calculate the estimated revenue impact of the proposed investment tax credit, the Treasury Department assumed that for purposes of analysis the investment credit should be treated as a reduction in the cost of the asset. The Treasury Department used this assumption in its econometric analysis of the revenue impact of the ITC. S. REP. NO. 1881, *supra* note 1, at 7-10, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS at 3310-12.

45. Economic Report to Congress, 108 CONG. REC. 584 (1962).

46. Many analysts treat the investment tax credit as a cost reduction incentive for new investment. See Brannon, *The Revenue Act of 1971-Do Tax Incentives Have New Life?*, 14 B.C. INDUS. & COM. L. REV. 891 (1973); Brown, *Comments on Tax Credits as Investment Incentives*, 15 NAT'L TAX J. 198 (1962); Taubman, *The Investment Tax Credit, Once More*, 14 B.C. INDUS. & COM. L. REV. 871 (1973); Note, *MAPI Study Shows Investment Incentives of Investment Credit and Depreciation Rules*, 18 J. TAX'N 2 (1963). See also Chase, *Tax Credits for Investment Spending*, 15 NAT'L TAX J. 32 (1962); Johnson & Carey, *The Effect of the Investment Credit on Equipment Replacement Decisions*, 23 NAT'L TAX J. 307 (1970); Johnson & Newton, *Tax Considerations in Equipment Replacement Decisions*, 1967 ACCT. REV. 738; White, *Illusions in the Marginal Investment Subsidy*, 15 NAT'L TAX J. 26 (1962).

47. S. REP. NO. 1881, *supra* note 1, at 10-11, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS at 3313-14. For a discussion of the required rate of return concept and the cash flow implications of asset cost reduction, see *supra* note 31.

48. See *infra* notes 49 & 53.

49. Countercyclical fiscal policy involves use of government expenditure policies to either stimulate or depress the economy, as needed. See R. GORDON, *MACROECONOMICS* 15 (1978). See generally Cook, *The Investment Credit—Investment Incentive and Countercyclical Tool*, 45 TAXES 227 (1967). This policy approach was the motivating force behind the 1967 temporary suspension of the investment credit. S. REP. NO. 1724, 89th Cong., 2d Sess. 4-14, *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 4327, 4331-41. A similar policy view was expressed in support of the "termination" of the credit in 1969. H.R. REP. NO. 413, 91st Cong., 1st Sess. 178, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1832.

50. See, e.g., R. GORDON, *supra* note 49, at 394-416.

51. The investment credit was restored in the Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (codified in scattered sections of 26 U.S.C.).

of the ITC's asset cost reduction approach.⁵² Thus, despite suspensions and subsequent reenactments,⁵³ the intent of the ITC has not changed since 1962. Courts still look to the Revenue Act of 1962 for guidance in determining the congressional intent of sections 38, 46, 47, and 48.⁵⁴ The purpose of the ITC has never really changed despite suspensions motivated by fiscal policy concerns.⁵⁵ Those court decisions that reject

52. *Hearings on the Revenue Act of 1971 Before the Senate Comm. on Finance*, 92nd Cong., 1st Sess. 5 (1971) (statement of Treasury Secretary John Connally).

53. The investment credit was suspended in 1966, Act of Nov. 8, 1966, Pub. L. No. 89-800, 80 Stat. 1508 (codified in scattered sections of 26 U.S.C.), and reinstated shortly thereafter, Act of June 13, 1967, Pub. L. No. 90-26, 81 Stat. 57 (codified in scattered sections of 26 U.S.C.); it was reinstated in 1971, Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (codified in scattered sections of 26 U.S.C.). The suspension merely denied the tax credit for a limited period; it did not change the operational language of the credit. Similarly the restoration of the credit by § 50 simply reactivated the provisions enacted in the Revenue Act of 1962. Section 50 read in part:

Section 50. Restoration of Credit

(a) General Rule

Section 49(a) (relating to termination of credit) shall not apply to property-

- (1) the construction, reconstruction or erection of which-
 - (A) is completed by a taxpayer after August 15, 1971 or
- (2) which is acquired by the taxpayer-
 - (A) after August 15, 1971 or . . .

I.R.C. § 50 (1976). The Revenue Act of 1971 also changed the title of § 49 from "Termination of Credit" to "Termination for Period Beginning April 19, 1969 and Ending During 1971." 26 U.S.C. § 49 (1976 & Supp. IV 1980) (sections 49 and 50 deleted entirely by Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (codified in scattered sections of 26 U.S.C.)).

The investment credit as reenacted is

substantially similar to the investment credit allowed under prior law. The three principal differences are (1) the useful life brackets . . . are to be shortened by one year, (2) the credit is not . . . allowed for foreign produced machinery and equipment and (3) public utility property is to be eligible for a four per cent credit.

S. REP. NO. 437, 92nd Cong., 1st Sess. 25, *reprinted in* 1971 U.S. CODE CONG. & AD. NEWS 1825, 1833-34. Thus the restoration of the investment credit did not involve any fundamental reorientation of the original provisions. Later changes to the investment credit section simply liberalized the credit amounts available. *See, e.g.*, S. REP. NO. 1263, 95th Cong., 2d Sess. 112-13, 1978 U.S. CODE CONG. & AD. NEWS 6761, 6875-76 (making the new 10% figure permanent as the regular percentage in I.R.C. § 46(a)(2)(B) and expanding the limitation on investment tax credit usage in § 46(a)(3)(B) to 90% of tax liability).

Thus, it is reasonable to look to the Congressional Reports of the Revenue Act of 1962 for an explanation of legislative intent. Since 1962 Congress' alterations of the credit have been to its amount or availability and not to the policy undergirding the statute.

54. *See, e.g.*, *Holloman v. Commissioner*, 551 F.2d 987 (5th Cir. 1977); *Farmer's Grain Mktg. Terminal v. United States*, 434 F. Supp. 368 (N.D. Miss. 1977); *Panhandle E. Pipeline Co. v. United States*, 654 F.2d 35 (Ct. Cl. 1981); *Oblebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Cl. 1979); *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976); *States S.S. Co. v. United States*, 428 F.2d 832 (Ct. Cl. 1970); *Zuanich v. Commissioner*, 77 T.C. 428 (1981); *Weirick v. Commissioner*, 62 T.C. 446 (1974).

55. *See supra* note 53.

asset cost reduction as the theory underlying the ITC are thus inconsistent with the legislative history.⁵⁶

Congress contemplated determining the general accounting treatment for the ITC, but ultimately declined to do so for all firms except public utilities.⁵⁷ This decision is significant because the flow-through method adopts a tax reduction approach to the investment credit while the deferral method is based more on an asset cost reduction approach. For financial accounting purposes, the flow-through method uses the entire tax credit to reduce the tax expense for the accounting period.⁵⁸ The deferral method, on the other hand, adopts an asset cost reduction approach by requiring a rough matching of tax credit benefits to the useful life of the asset generating the credit.⁵⁹ Thus a congressional choice of one of these accounting techniques would have represented a substantial policy statement on the legislative intent with respect to the ITC. Congress ultimately adopted a neutral position on the financial accounting issue.⁶⁰ Both the deferral and the flow-through methods,⁶¹

56. *Zuanich v. Commissioner*, 77 T.C. 428 (1981).

57. The Revenue Act of 1971 allowed each taxpayer to choose which method of accounting to use for the investment tax credit. Revenue Act of 1971, Pub. L. No. 92-178, § 101(c), 85 Stat. 497. For public utility investment, however, Congress declared that utilities using the flow-through method for reporting and ratemaking purposes would be ineligible, in general, for the investment credit. *See* I.R.C. § 46(f) (1976 & Supp. IV 1980).

58. ACCOUNTING PRINCIPLES BOARD OPINION No. 4 (1964). *See generally* 3 AICPA, PROFESSIONAL STANDARDS-ACCOUNTING § 4094 (1981); D. KIESO & J. WEYGANDT, INTERMEDIATE ACCOUNTING 534-36 (3rd ed. 1980).

59. ACCOUNTING PRINCIPLES BOARD-OPINION No. 2 (1962). *See generally* 3 AICPA, PROFESSIONAL STANDARDS-ACCOUNTING, *supra* note 58; D. KIESO & J. WEYGANDT, *supra* note 58.

60. *See supra* note 57.

61. The Professional Standards text lists both the deferral and the flow-through methods as acceptable. The text suggests a decided preference for the deferral method, however, because it is more consistent with existing accounting principles and because it reflects more accurately the cost reduction approach of the investment credit. 3 AICPA, PROFESSIONAL STANDARDS-ACCOUNTING § 4094.07-11 (1981). The Accounting Principles Board approved the flow-through method only because it was more popular than the deferral approach. This popularity was a result of its immediate and drastic impact on the income statement. The Accounting Principles Board thus came under substantial pressure to change its ruling in APB No. 2. It did so in APB No. 4, effectively allowing both methods. Both the opinions embodied in APB No. 4 and in § 4094 of the Professional Standards text, however, show substantial uneasiness with respect to the flow-through method. Thus, the Professional Standards text notes in its Conclusion:

.16 However, the authority of Opinions of this Board rests upon their general acceptability. The Board, in the light of events and developments occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the Opinion effective.

therefore, are permitted under generally accepted accounting principles.⁶²

Congress did explicitly define, however, the intent of the ITC as asset cost reduction and the stimulation thereby of additional investment.⁶³ Ambiguity in the financial accounting rules should not inhibit a frank recognition by the courts of the legislative history of the ITC. Furthermore, virtually all analysts treat the ITC, for purposes of financial analysis and decisionmaking as opposed to mere financial accounting conventions, as an asset cost reduction benefit.⁶⁴ Moreover, the Treasury Department itself used the cost reduction approach in preparing its estimates of the ITC's impact on federal tax revenues.⁶⁵

IV. THE MEANING OF BASIS

A. *Statutory Analysis*

Generally, the basis of property equals the cost of that property.⁶⁶ In determining the amount of investment credit that a taxpayer may take under section 46, Regulation 1.46-3(c) provides that the basis of section 38 property shall be found in accordance with the general rule.⁶⁷ Assuming no exceptions⁶⁸ are relevant to the determination of basis for

.17 Under the circumstances the Board believes that, while the method of accounting for the investment credit recommended in paragraph .11 [the deferral method] should be considered to be preferable the alternative [flow through method] . . . is also acceptable.

3 AICPA, PROFESSIONAL STANDARDS-ACCOUNTING § 4094.16-.17 (1981).

62. "Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time." ACCOUNTING PRINCIPLES BOARD, *Statement No. 4-Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, ¶ 138 (1970), in 2 APB ACCOUNTING PRINCIPALS (1972).

63. See *supra* note 42.

64. Some dispute exists over the appropriate financial accounting treatment, see *supra* notes 57-62 and accompanying text. For decisionmaking purposes, the investment credit is obviously a cost reduction factor. See *supra* note 46 (listing analysts, some of whom constructed sophisticated statistical models, using the cost reduction concept).

65. See *supra* note 44.

66. I.R.C. § 1012 (1976) reads in relevant part as follows: "The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C [corporate distributions], K [partnerships], and P [capital gains and losses]." *Id.*

67. Treas. Reg. § 1.46-3(c)(1) (1964) provides in relevant part:

[t]he basis of any new section 38 property shall be determined with the general rules for determining the basis of property. Thus the basis of property would generally be its cost (see section 1012), unreduced by the adjustment to basis provided by section 48(g)(1) . . . and any other adjustment to basis, such as that for depreciation . . .

Id.

68. See *supra* note 66.

ITC purposes, the basis of section 38 property should therefore equal the taxpayer's cost.

The basis reduction provisions of the MMA⁶⁹ are special rules not contained in the Code. Thus, the determination of basis for investment credit purposes should proceed in accordance with the general directives of the Code.⁷⁰ To do otherwise would be to violate the internal symmetry of the Code by injecting the MMA's cost recovery program into the ITC's asset cost reduction system.⁷¹ Normally, one would suggest as a matter of statutory construction that general rules of a statute apply except where preempted by specific portions of that statute.⁷² The MMA, however, is a special system outside the Code. Congress designed the MMA to effectuate a cost recovery concept inherent in a tax deferral system.⁷³ The ITC, on the other hand, is a cost reduction scheme whose basis rules were drafted in contemplation of the Code's own internal system. The Code's general rules, therefore, should be used to determine basis for the ITC, because the specific rules on the subject are contained in a different statute, separate and distinct from the Code's internal system.⁷⁴ This view seems especially plausible because the MMA did not contemplate interaction with the investment tax credit; Congress terminated the ITC in 1969⁷⁵ before enacting the MMA in 1970.

69. 46 U.S.C. § 1177(g) (1976).

70. Treas. Reg. § 1.46-(3)(c)(1) (1964) suggests that the taxpayer follow the "general rules for determining basis." *Id.* See *supra* note 67. The general rule is the cost basis approach given in I.R.C. § 1012 (1976). See *supra* note 66. The general rule, therefore, should apply to those benefiting from the Merchant Marine Act provisions. See *Zuanich v. Commissioner*, 77 T.C. 428 (1981) (Goffe, J., dissenting).

71. See *infra* notes 88-97 and accompanying text. See also *Zuanich v. Commissioner*, 77 T.C. 428 (1981) (Goffe, J., dissenting).

72. See generally 2 C. SANDS, SUTHERLAND STATUTORY CONSTRUCTION Ch. 40 (4th ed. 1973); 3 *id.* Ch. 66 (4th ed. 1974).

73. A tax deferral simply postpones the tax burden eventually incurred by the taxpayer. The Merchant Marine Act's deferral system is closely analogous to accelerated depreciation. See *infra* notes 130-40 and accompanying text. The Treasury Department apparently agreed that the Merchant Marine Act was a deferral system. "Under section 607 [46 U.S.C. § 1177(g)], tax is deferred on deposits in reserve funds of all or any portion of a firm's earnings as well as earnings on prior fund deposits. . . ." Letter from Roy T. Englert, Acting General Counsel of the Treasury, to Hon. Warren G. Magnuson, Chairman Committee on Commerce (April 15, 1970), reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4243, 4244 [hereinafter cited as *Englert Letter*].

74. See *Englert Letter*, *supra* note 73, at 4245 (problems created by enacting tax deferral legislation outside the Internal Revenue Code underscored by General Counsel).

75. For a discussion of the relevant legislative history, see *supra* note 53.

The legislative history⁷⁶ of the ITC buttresses the view that basis for investment credit purposes equals the cost to the taxpayer. The taxpayer's use of tax deferred funds under the capital construction fund program should have no effect upon this determination of basis.⁷⁷ When a taxpayer invests cash from the fund in an eligible vessel, he essentially borrows a portion of those funds from the government.⁷⁸ He repays the "loan" without interest over the asset's life.⁷⁹ Because, under these circumstances, the IRS considers borrowed funds at risk for ITC purposes,⁸⁰ the taxpayer has sustained the full burden of

76. See *supra* notes 41-56 and accompanying text.

77. *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976). In *Pacific*, the court of claims argued that Treas. Reg. § 1.46-3(c) requires that basis be determined in accordance with the general rules, and that I.R.C. § 1012 (1976) and Treas. Reg. § 1.1012-1 (1957) describe the general rule. See *supra* notes 66-67. Accordingly, the court concluded that shippers using tax deferred funds to purchase eligible vessels should receive an investment credit calculated on cost basis, irrespective of the source of the funds. 544 F.2d at 485. The court also observed that "the 'general rules for determining basis of property' referred to by the House and Senate Committees and the Treasury's regulation, have no reference to whether the funds spent as part of the (cost) of the property had their source in untaxed income." *Id.*

78. By depositing cash into a capital construction fund, the taxpayer receives a current deduction that increases his cash inflow by reducing his tax liability. See *supra* note 27. The government "lends" the taxpayer an amount equal to the taxes deferred each year. The loan is recovered without interest over the asset's life in the form of reduced depreciation deductions. This tax deferral system resembles a form of accelerated depreciation because it accelerates the benefits of a portion of future deductions to the current period. The taxpayer using the capital construction fund, however, may accelerated the depreciation deduction benefits to a period prior to asset acquisition, and thus may use part of the increased current income, created by the tax deferral, to finance the purchase of a new vessel.

79. See *supra* note 78.

80. Section 46(c)(8) states in relevant part:

(8) Limitation to Amount at risk.-

(A) In general.-In the case of new or used section 38 property which-

- (i) is placed in service during the taxable year by a taxpayer described in Section 465(a)(1), and
- (ii) is used in connection with an activity with respect to which any loss is subject to limitation under Section 465,

the basis of such property for purposes of paragraph 1 [of Section 46(c)] shall not exceed the amount the taxpayer is at risk with respect to such property as of the close of such taxable year.

(B) Amount at risk.-

- (i) In general.- Except as provided in clause (ii), the term at risk has the same meaning given such term by section 465(b) (without regard to paragraph 5 thereof)
- (ii) Certain financing.- In the case of a taxpayer who at all times is at risk . . . in an amount equal to 20 percent of the basis . . . [then such person shall be considered at risk to the extent of] . . .

purchasing an asset in an arm's length transaction.⁸¹ In accordance with the general rules in the Code, the taxpayer's basis must equal his cost.⁸²

To reduce the basis for ITC purposes by the amount of the capital construction funds used is either to declare that borrowed funds are not at risk, the converse of the interpretations to date or to reduce basis by the amount of the depreciation⁸³ taken in advance of purchase, an action seemingly precluded by the Treasury Regulations.⁸⁴ Under the first view, if a tax deferral is analogous to an interest-free loan, reducing basis by the amount of tax deferred funds used is equivalent to declaring that borrowed funds are not at risk.⁸⁵ Under the second al-

-
- (II) . . . a loan from any Federal, State, or local government or instrumentality thereof, is guaranteed by any Federal, State or local government.

I.R.C. § 46(c)(8) (West Supp. 1982).

Section 46(c)(8) requires that a taxpayer be limited for purposes of § 46(c)(1) (dealing with qualified investment) to amounts at risk. *Id.* § 46(c)(8). The taxpayer has in effect borrowed funds equal to the taxes deferred to help finance new ship purchases. The taxpayer meets the 20% requirement of § 46(c)(8)(B)(ii), as the determination of this issue leads to § 168(d)(1)(A), which finds unadjusted basis under § 1016 without regard to depreciation deductions. *Id.* § 168(d)(1)(A); § 1016 (1976 & West Supp. 1982). Thus, it seems fair to suggest that even if the tax deferral program under the Merchant Marine Act creates a form of loan to the taxpayer, the loan is at risk in the newly purchased vessel and the full investment credit ought to be available. If the taxpayer sells the vessel and does not redeposit the funds into the capital construction fund, the loan is subject to recapture. *See supra* note 25. Of course the investment credit would also be recaptured if the taxpayer disposed of the vessel prior to the end of the applicable useful life described in I.R.C. § 46(c)(2) (West Supp. 1982), or the class life in I.R.C. § 168 (West Supp. 1982). *See id.* § 47 (1976 & West Supp. 1982).

81. If the taxpayer has parted with cash, which is at risk in an investment, and the vessel is purchased in an arm's length transaction, taxpayer must be entitled to the full investment tax credit. *See Oglebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Cl. 1979); *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976). *Cf. Panhandle E. Pipeline Co. v. United States*, 654 F.2d 35 (Ct. Cl. 1981) (taxpayer entitled to full ITC despite basis adjustment, pursuant to I.R.C. § 1017 (1976 & Supp. IV 1980), implying basis adjustment per se does not alter amount at risk).

82. *See supra* notes 66-67 & 81. The asset must be depreciable to be eligible for the investment credit. *See infra* notes 171-90 and accompanying text.

83. The Merchant Marine Act of 1970 simply provides for an acceleration of depreciation deduction benefits to the period in which cash is set aside for new vessel acquisitions, 46 U.S.C. § 1177(d) (1976), and a concomitant reduction in basis in the amount of those deductions after purchase. *Id.* § 1177(g). This is simply an unusual form of depreciation. *Compare Oglebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Cl. 1979) and *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976) with *Zuanich v. Commissioner*, 77 T.C. 428 (1981).

84. *See supra* note 67. Treas. Reg. 1.46-3(c)(1) (1964) indicates that in calculating the investment credit, basis is not to be reduced by the amount of depreciation taken.

85. *See supra* note 80.

ternative, cost basis would be adjusted for depreciation taken despite a stipulation to the contrary contained in the Regulations.⁸⁶ The Commissioner, therefore, should allow a taxpayer, who has parted with cash by virtue of deposits to a capital construction fund and who has subsequently invested in depreciable property, to use the acquisition cost as the basis for calculating the ITC. This is simply an application of the general rule for determining the basis of property for ITC purposes.⁸⁷

B. Basis Used to Measure Two Functions—Cost Recovery and Cost Reduction

The preceding analysis suggests an important concept: asset cost recovery and asset cost reduction differ.⁸⁸ Cost recovery is a process in which the taxpayer recovers the acquisition price, or expense, of an asset through annual depreciation deductions which are subtracted from gross income.⁸⁹ In contrast, asset cost reduction involves an attempt to

86. See *supra* notes 67 & 83-84.

87. See *supra* notes 66-68 and accompanying text.

88. See *Panhandle E. Pipeline Co. v. United States*, 654 F.2d 35 (Ct. Cl. 1981); *Schmidt Barge Lines v. United States*, 610 F.2d 728 (Ct. Cl. 1979); *Oglebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Cl. 1979); *Delta S.S. Lines, Inc. v. United States*, 544 F.2d 496 (Ct. Cl. 1976); *Pacific Transp. Co. v. United States*, 544 F.2d 493 (Ct. Cl. 1976); *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976). See also *Moore McCormack Resources, Inc. v. United States*, 46 A.F.T.R. 2d (P-H) 80-5075 (Ct. Cl. 1980).

89. See *infra* note 125. It is important to note that basis is treated differently under asset cost recovery and asset cost reduction systems. A taxpayer claiming the ITC need not reduce his basis in the asset. See *supra* note 30. In contrast, a taxpayer claiming depreciation deductions under § 167 must reduce his basis in the asset after each depreciation deduction in order to prevent the compounding of depreciation benefits in subsequent periods. I.R.C. § 167 (1976 & West Supp. 1982). See also Treas. Reg. §§ 1.167(b)-(a); 1.167(b)-1; 1.167(b)-2 T.D. 6712, 1964-1 C.B. 106 (1956). Under § 168's class life system, the depreciation deduction allowable is determined by the product of the applicable percentage and the property's unadjusted basis. I.R.C. § 168 (West Supp. 1982). Basis is not adjusted, as under § 167's straight line, double declining balance, or sum of the year's digits methods for the amount of depreciation taken in the prior year. Rather, unadjusted basis is "the excess of the basis of the property determined under part II of subchapter O of chapter 1 for purposes of determining gain . . . over the sum of" any § 167 K benefits and any § 179 bonus depreciation claimed. *Id.* § 167 (1976 & West Supp. 1982); *id.* § 179 (West Supp. 1982). See also *id.* § 168(d)(1)(A) (West Supp. 1982).

Regardless of whether a taxpayer uses the § 167 or the § 168 depreciation deductions, the determination and adjustment of basis is essential for determining the proper deductions and for preventing double deductions. I.R.C. § 167 (1976 & West Supp. 1982); *id.* § 168 (West Supp. 1982). The MMA contains basis reduction rules in order to prevent double deductions: One for deposits to a capital construction fund, and a second when the taxpayer claims a depreciation deduction. See *supra* notes 29-31 and accompanying text. The ITC, of course, does not reduce basis. See *supra* note 29 and accompanying text.

use the Code to decrease the acquisition cost of certain new equipment.⁹⁰ Depreciation deductions lower taxable income and allow the taxpayer to recover the cost of an asset by ultimately reducing taxes payable. Depreciation does not affect the cost of an asset; it merely allocates, or accrues, in accounting terms, that cost over a period of time.⁹¹ The ITC, however, represents a legislative effort to reduce the cost of investment in eligible assets by reducing an investor's tax liability by a portion of the acquisition cost.⁹² Recovering cost through depreciation deductions thus differs from reducing acquisition cost via a reduction in tax liability.

Using the same basis concept for purposes of both cost recovery and cost reduction perverts the intent of Congress. Basis must be adjusted in order to prevent capital construction fund users from obtaining double depreciation deductions.⁹³ The MMA provides for such adjustments to basis by requiring a dollar for dollar basis reduction for all capital construction fund money used to acquire eligible vessels.⁹⁴ To use the adjusted basis as the base amount upon which the ITC is to be calculated, however, produces a contradictory result. A taxpayer who uses capital construction fund cash to purchase a vessel would be denied the ITC to the extent that such money was used in the acquisition.⁹⁵ This result is contrary to the clear legislative intent demonstrated by Congress: namely, to reduce the cost of new investment.⁹⁶ Denying the full ITC to those using capital construction fund money thus confuses the basis concept used to implement a cost recovery program with a basis concept necessary for cost reduction.⁹⁷

90. *Minot Fed. Sav. & Loan Ass'n v. United States*, 435 F.2d 1368 (8th Cir. 1970); *Commissioner v. Schuyler Grain Co.*, 411 F.2d 649 (7th Cir. 1969); *Texas Instruments v. United States*, 407 F. Supp. 1326 (N.D. Texas 1976); *Norfolk Shipping & Drydock Corp. v. United States*, 321 F. Supp. 222 (E.D. Va. 1971). See also *supra* notes 40-46 and accompanying text.

91. See generally S. DAVIDSON, C. STICKNEY, & R. WEIL, *FINANCIAL ACCOUNTING* 76 (2nd ed. 1979).

92. See *supra* notes 41-65 and accompanying text.

93. See *supra* note 89.

94. See *supra* note 26.

95. See *supra* note 89.

96. See *supra* notes 41-65 and accompanying text.

97. This is a fairly subtle point, and judges occasionally fail to grasp its significance. See *Pacific Far E. Lines, Inc. v. United States*, 544 F.2d 478 (Ct. Cl. 1976) (Cowen, J., dissenting); *Pacific Transp. Co. v. United States*, 544 F.2d 493 (Ct. Cl. 1976) (Skelton, J., dissenting). In *Pacific Far East Lines*, Judge Cowen argued that basis is the same for all taxation issues, thereby failing to distinguish between cost recovery and cost reduction. 544 F.2d at 491. In *Pacific Transport*, Judge Skelton argued that the allowance of an investment tax credit on the cost of an asset would

Recently, the court of claims rejected an overly restrictive, literal view of the concept of basis in *Panhandle Eastern Pipeline Co. v. United States*.⁹⁸ The taxpayer-corporation had repurchased its bonds at a discount, thereby receiving discharge of indebtedness income. Taxpayer elected under section 108⁹⁹ to defer recognition of this income by taking a section 1017¹⁰⁰ adjustment to the basis of depreciable assets. The IRS claimed that because of the reduction in basis, section 47(a) mandated a proportionate recapture of the investment credit.¹⁰¹ The tax-

permit a double deduction; once upon the taking of a deduction for a capital construction fund deposit, and again when the tax credit is allowed. 544 F.2d at 493. Judge Skelton failed to recognize, however, that his argument would deny the investment credit to any taxpayer, because the investment credit is generally permitted in tandem with full depreciation deductions calculated on the full acquisition price of the asset. Because deposits to a capital construction fund are a kind of accelerated depreciation, the investment credit should be granted, as it permits cost reduction while the basis reduction provisions of 46 U.S.C. § 1177(g) (1977) satisfy the cost recovery problems. Judge Skelton thus confused cost recovery and cost reduction in his arguments.

98. 654 F.2d 35 (Ct. Cl. 1981).

99. Section 108(a)(1)(c) allows an exclusion from gross income for discharge of qualified business indebtedness income. I.R.C. § 108(a)(1)(C) (Supp. IV 1980). Section 108(c) requires that taxpayers who claim the § 108(a)(1)(C) exclusion must "reduce the basis of depreciable property" by "the amount excluded from gross income." I.R.S. § 108(c) (Supp. IV 1980). For a summary of the basis reduction provision, see *infra* note 100.

100. Section 1017(a) requires that "amounts excluded from gross income under subsection (a) of section 108 . . . shall be applied in reduction of the basis of any [depreciable] property held by the taxpayer." I.R.C. § 1017 (Supp. IV 1981). The effect of the § 108/§ 1017 interaction is to defer recognition of the income from the discharge of indebtedness. The government recovers the taxes so deferred over the life of the asset by virtue of the reduced depreciation deductions. A similar outcome obtains if the asset whose basis is reduced is sold before the end of its useful life, or class life under I.R.C. § 168 (West Supp. 1982), because the reduced basis results in a larger gain for tax purposes. This system of deferral and recovery uses the same conceptual approach employed in the creation of the Merchant Marine Act's system.

101. The case arose under the jurisdiction of the old § 1017 Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3, 301, amended by Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389, 3394. Section 1017, prior to amendment, was unclear with respect to the impact of a basis reduction on the recapture provisions of I.R.C. § 47(a) (1976 & West Supp. 1982). The IRS took the position that in the event of such a reduction in basis, recapture under § 47(a) was required. Section 47 in relevant part requires that:

If during any taxable year any property is disposed of, or otherwise ceases to be Section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit . . . then the tax . . . for such . . . year shall be increased by an amount equal to the aggregate decrease in the credits allowed under Section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed into service . . . and ending with the time such property ceased to be Section 38 property.

Id. See Rev. Rul. 74-184, 1974-1 C.B. 8 (amplifying Rev. Rul. 72-248, 1972-1 C.B. 16). This position was overruled by the addition of I.R.C. § 1017(c) (Supp. IV 1980) in the Bankruptcy Tax

payer, on the other hand, argued that recapture should occur only when a price rebate or a disposition decreased the taxpayer's investment, or cost basis, in the asset.¹⁰² The court found the taxpayer's position consistent with the purposes of the ITC¹⁰³ as well as with the Regulations¹⁰⁴ promulgated by the IRS.¹⁰⁵ It rejected the IRS's literal interpretation of the Code.

The *Panhandle* court viewed basis as both the embodiment of acquisition costs¹⁰⁶ and as a reservoir of cost to be recovered by depreciation.

Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389, 3394 (codified in scattered sections of 26 U.S.C.). See *infra* note 110.

102. *Panhandle E. Pipeline Co. v. United States*, 654 F.2d 35, 38 (Ct. Cl. 1981).

103. *Id.* at 40.

104. Treas. Reg. 1.1017-1(a) (1956) suggests that a § 1017 adjustment to basis is for purposes of determining gain or loss on disposition of the property and not necessarily as a § 1012 reduction in cost basis.

105. 654 F.2d at 41. Because taxpayer's investment cost serves as basis for ITC purposes, the IRS should recapture ITC benefits only upon the occurrence of an event which reduces the cost of taxpayer's investment in depreciable property; alterations in basis for depreciation purposes should not affect the ITC.

106. Examples of events which reduce a taxpayer's investment cost are given under Treas. Reg. 1.47-2(a), (d), (e), T.D. 6931, 1967-2 C.B. 12, as amended by T.D. 7203, 1972-2 C.B. 12. A taxpayer's cost basis decreases when he removes § 38 property partially or entirely from business use. The IRS provides an illustration of this point:

Example (1). A, an individual who makes his returns on the basis of the calendar year, on January 1, 1962, acquired and placed in service in his trade or business an item of Section 38 property with an estimated useful life of eight years. On January 1, 1965, A removes the item of Section 38 property from use in his trade or business by converting such item to personal use. Therefore no deduction for depreciation with respect to such item of property is allowable to A for the taxable year 1965. On January 1, 1965, such item of property ceases to be Section 38 property with respect to A.

Treas. Reg. 1.47-2(a)(2)(iii), ex. 1, T.D. 6931, 1967-2 C.B. 12, as amended by T.D. 7203, 1972-2 C.B. 12. If a taxpayer, however, depreciates an asset to zero using an accepted method of depreciation under § 167, and does so before the end of the asset's useful life, that asset does not cease to be § 38 property. Treas. Reg. 1.47-2(a)(2)(iii) (1967), example 2, illustrates this point:

On January 1, 1965, A placed in service an item of Section 38 property with a basis of \$10,000 and an estimated useful life of 4 years. A depreciates such item, which has a salvage value of \$2,000 (after taking into account Section 167(F)), on the declining balance method at a rate of 50 percent (that is twice the straight line rate of 25 percent). With respect to such item, A is allowed deductions for depreciation of \$5,000 for 1965, \$2,500 for 1966, and \$500 for 1967. A is not allowed a deduction for depreciation in 1968 although he continues to use such item in his trade or business. Such item does not cease to be section 38 property with respect to A in 1968.

Id.

Thus, the IRS admits, however subtly, that cost recovery and cost reduction may require different analyses of basis. Example 2 shows that while the amount of the depreciation deduction may be affected, the status of the asset as § 38 property need not be affected. See *infra* notes 156-82 and accompanying text. The issue of whether a reduction in basis for depreciation necessarily meant a reduction in basis for purposes of the investment tax credit recapture provisions also faced the court in *Panhandle Eastern*.

The court declared, in effect, that the basis concept can serve two roles, both of which need not be identical at all times. The court's ruling implies that cost basis serves as a reservoir for historical cost, which is recovered by the taxpayer using periodic depreciation deductions which eventually drain off that reservoir. The court's decision also suggests, however, that basis embodies the asset's acquisition costs, which are used to determine investment tax credits. By permitting the taxpayer to defer section 108 gain through a section 1017 basis reduction without pro rata ITC recapture, the court recognized that all changes in depreciable basis do not necessarily affect cost basis for ITC purposes.

The *Panhandle* court's decision underscores an important notion: a cost recovery scheme¹⁰⁷ and a cost reduction system are unique and distinguishable. Congress reaffirmed this view in 1980 by implying that all changes in basis do not necessarily effect a recapture of ITC benefits.¹⁰⁸ The Bankruptcy Tax Act of 1980¹⁰⁹ amends section 1017 and declares that a reduction in basis under section 108 should not be construed as a disposition.¹¹⁰

A number of other cases also suggest that a taxpayer's basis for investment credit purposes should equal his outlay of funds.¹¹¹ If the taxpayer fails to expend his own funds, however, he acquires a zero

107. For a discussion of the use of the cost recovery system to effect a recapture of certain deferred taxes, see *infra* note 110. For a general discussion of the differences between cost recovery and cost reduction, see *supra* notes 88-97.

108. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (codified in scattered Sections of 26 U.S.C.)

109. Pub. L. No. 96-589, 94 Stat. 3389 (codified in scattered sections of 26 U.S.C.). This legislation makes § 1017(c) applicable to debt discharges occurring after Jan. 1, 1981. I.R.C. § 1017(c) (Supp. IV 1980).

110. Section 1017(c)(2) states that a "reduction in basis under this section shall not be treated as a disposition." I.R.C. § 1017(c) (Supp. IV 1980). The effect of this amendment is to prohibit the IRS from imposing a recapture tax under § 47(a) in the event of a § 108/§ 1017 adjustment to basis, as such adjustments are not to be considered dispositions. S. REP. No. 1035, 96th Cong., 2d Sess. 20, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 7017, 7035. The current position of the IRS, in accordance with § 1017(c) as amended, is given in Rev. Rul. 81-206, 1981-2 C.B. 9.

111. *Panhandle E. Pipeline Co. v. United States*, 654 F.2d 35 (Ct. Cl. 1981); *Moore McCormack Resources, Inc. v. United States*, 46 A.F.T.R. 2d (P-H) 80-5075 (Ct. Cl. 1980) (unreported order); *Ness v. United States*, 45 A.F.T.R. 2d (P-H) 80-784 (Ct. Cl. 1980) (unreported case); *Gilman v. United States*, 45 A.F.T.R. 2d (P-H) 80-782 (Ct. Cl. 1980) (unreported case); *Schmidt Barge Lines v. United States*, 610 F.2d 728 (Ct. Cl. 1979); *Oglebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Cl. 1979); *Delta S.S. Lines, Inc. v. United States*, 544 F.2d 496 (Ct. Cl. 1976); *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976); *Pacific Transp. Co. v. United States*, 544 F.2d 493 (Ct. Cl. 1976). See also *Charbonnet v. United States*, 455 F.2d 1195 (5th Cir. 1972). But see *Zuanich v. Commissioner*, 77 T.C. 428 (1981).

basis for ITC purposes.¹¹² In one line of cases, which can be denoted third party payments cases, a taxpayer who uses a third party's invested capital to acquire section 38 property does not receive the investment credit.¹¹³ The ITC rewards the investor whose funds are actually at risk, but is unavailable to third parties whose capital is not at risk.¹¹⁴

The tax court in *Zuanich v. Commissioner*¹¹⁵ relied on a similar line of cases¹¹⁶ and rejected the notion that a cash outlay from a capital construction fund for a depreciable asset is eligible for ITC benefits. Using the third party payments cases as the *Zuanich* court did, however, misapprehends the nature of third party payments situations; that is, a taxpayer who uses another's funds may not claim an investment credit, not because he fails to demonstrate a cost basis in the property itself, but because basis for ITC purposes is held by another.¹¹⁷ Tax-

112. *See infra* note 113.

113. *See, e.g.,* Wolfers v. Commissioner, 69 T.C. 975 (1978) (payments under the Uniform Property Relocation Assistance Act not treated as investment for purposes of § 38); Anderson v. Commissioner, 54 T.C. 1035 (1970) (no investment on part of claimant found where taxpayer used payments from sale of oil and gas production interests). *See also* Zuanich v. Commissioner, 77 T.C. 428 (1981) (Goffe, J., dissenting).

114. *See supra* notes 80, 83-86 and accompanying text (discussion of the at-risk rules).

115. 77 T.C. 428 (1981).

116. *See supra* note 113. The tax court viewed the third party payments cases as analogous to the MMA problem. MMA beneficiaries might be said to use the cash of another, such as the cash that would have been paid to the federal government as taxes, when they invest in eligible vessels. This cash, however, is merely a loan to the taxpayer, which the federal government will recover during the useful life of the vessel. *See supra* notes 26-28 and accompanying text. Furthermore, it would appear that such funds are at risk when invested in eligible vessels. *See supra* note 80. The third party payments cases recognize that a taxpayer whose funds are not at risk and who is merely a conduit for the capital of another, is not eligible for ITC benefits. MMA beneficiaries, however, invest capital which is at risk. The analogy between MMA beneficiaries and the third party payments cases thus seems ill-conceived at best.

117. *Zuanich v. Commissioner*, 77 T.C. 428 (1981) (Goffe, J., dissenting). The Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (codified in scattered sections of 26 U.S.C.), provides further support for the notion that cost basis is the standard Congress intended to use for investment credit purposes. The Act changed the recapture rules in § 47, extending them to property that is the subject of casualty, theft, or disposition. Thus a taxpayer whose § 38 property is destroyed by fire is subject to the recapture tax of § 47(a), and is also eligible for an additional tax credit if he reinvests his cash or his insurance payments in new § 38 property. I.R.C. § 47(a) (1976 & Supp. IV 1980 & West Supp. 1982); I.R.C. § 38 (1976). H.R. REP. NO. 533, 92nd Cong., 1st Sess. 28, reprinted in 1971 U.S. CODE CONG. & AD. NEWS 1825, 1843. This change in the law, while relatively minor, suggests an analysis based on the rewarding of those who invest cash and, thus, incur cost in an asset, as opposed to merely rewarding *new* investment in new or used property. Under the investment credit provisions prior to the 1969 termination, there was no recapture tax imposed on disposition of an asset via casualty, but no credit was granted upon reinvestment of insurance money for replacement purposes either.

payers who use cash from a capital construction fund do have a cost basis in the vessel so acquired, and the analogy to third party payments cases is inapposite.

Congress intended taxpayers to calculate the ITC as a percentage of cost basis.¹¹⁸ The preceding analysis demonstrates that this concept is essential to the implementation of a cost reduction approach. The result of this conceptualization of the relationship between cost recovery and cost reduction produces a bifurcated basis standard: one standard for depreciation, and a second standard for the ITC.¹¹⁹ Usually, the two standards will be the same. In situations similar to the MMA, however, in which the timing of cost recovery and cost reduction is not synchronized,¹²⁰ failure to recognize a bifurcated basis standard frustrates the legislative purposes expressed in the ITC.¹²¹ It is illogical to argue against the bifurcated basis standard simply because Congress failed to explicitly state one when it created the MMA's special depreciation scheme. Congress had no reason to explore the basis issues raised by the MMA because the MMA was enacted more than a year before the investment tax credit was reenacted.¹²² Congress did, however,

Given this additional support for the cost basis concept, and given further the lack of any cost basis on the hands of the taxpayers in *Wolfers* and *Anderson*, see *supra* note 113, it should be apparent that it is the lack of a cost basis in an asset that will force a taxpayer to fail in a claim for the investment credit.

118. See *supra* notes 76-97 and accompanying text.

119. In other words, an adjusted basis standard under § 1016 is used to facilitate a cost recovery program, while a cost basis standard is used to effect the intent of Congress inherent in a cost reduction program. I.R.C. § 1016 (1976 & West Supp. 1982).

120. Cost is recovered prior to the purchase of the vessel, when deposits are made to a capital construction fund. Cost is reduced by the investment credit, however, at the end of the year of acquisition. See *supra* note 27.

121. See *supra* notes 76-97.

122. See *supra* note 53. Congress did enact a bifurcated basis provision in § 48(4) with respect to investment credits for movie and television films. One might argue that having consciously chosen a bifurcated basis standard in § 48(4), Congress would have enacted a similar standard for the MMA if it had so desired. See *Zuanich v. Commissioner*, 77 T.C. 428 (1981). I.R.C. § 48(4) (1976) was designed, however, to split the basis standard depending on the locus of production costs; that is, § 48(4) creates a bifurcated basis standard not to effect some special cost recovery scheme, but rather to provide an incentive for additional film production in the United States:

[T]he amount of the investment credit in the case of movie films is to depend on the place of production of the film (i.e., United States or foreign), rather than on the place where the revenues are [earned]. Thus, the foreign use test [§ 48(a)(2)] will not apply to movie films for the future.

H.R. REP. NO. 658, 94th Cong., 2d Sess. 188-89, reprinted in 1976 U.S. CODE CONG. & AD. NEWS 2897, 3083. This splitting of the basis standard with respect to movie and television films was also

make its intent quite clear with respect to the ITC.¹²³ To effect the intent of Congress one must color the words of the statute with the policies declared by the legislature. Words and phrases taken summarily from the Code cannot substitute for the judicious application of legislative intent.¹²⁴ A bifurcated basis standard is essential to the proper application of the MMA provisions and the policies expressed in the ITC.

V. DEPRECIATION: ALLOWED VS. ALLOWABLE IN SECTION 48(a)

A. *The Depreciation Concept*

In general, depreciation represents the allocation of the cost of an asset to each period of an asset's life.¹²⁵ Courts have embraced two theories in deciding depreciation disputes. One, the tax free fund concept,¹²⁶ suggests that a taxpayer should be able to recover the cost of

done in order to deal with the foreign use obstacle in § 48(a)(2) to producers claiming the investment credit. I.R.C. § 48(a)(2) (1976). This act of Congress, however, is not analogous to the proposed bifurcated basis standard for vessel owners covered by the Merchant Marine Act. The latter requires a bifurcated standard in order to harmonize the special cost recovery system with the legislative intent of the investment credit. The movie and television provision splits the basis standard for completely different reasons, and produces a rather different outcome. The *Zuanich* court erroneously concluded that since Congress chose to enact a bifurcated basis standard in § 48, the lack of such an explicit enactment in the ITC must conclusively demonstrate that the standard is not appropriate for judicial injection into the Internal Revenue Code. I.R.C. § 48 (1976). But Congress enacted this standard in § 48 to solve a problem relating to ITC eligibility and foreign made goods. *Id.* The MMA, however, requires some bifurcation of the basis concept in order to harmonize the goals of the Merchant Marine Act, a statute outside the Internal Revenue Code, with the ITC.

123. See *supra* notes 44-56 and accompanying text.

124. *Helvering v. Stockholm Enskilda Bank*, 293 U.S. 84, 93-94 (1934) (dicta). The Tax Court, in *Zuanich v. Commissioner*, 77 T.C. 428 (1981), argued that Congress failed to make its intent clear. The court observed that in the absence of legislative intent to the contrary, the Code must be read literally. Of course if read literally, one would reduce basis by the amount of depreciation taken. See *supra* note 26 and accompanying text. A taxpayer using a capital construction fund under the MMA would thus be unable to claim an ITC to the full extent of capital construction fund money used to acquire an eligible vessel. See *supra* note 37.

125. "[T]he depreciation charge is not a measurement of value changes; it is an allocation of the cost of the asset." D. KIESO & J. WEYGANDT, *supra* note 58, at 520 (emphasis in original). It is the estimation and allocation of the cost of a capital investment to each of the succeeding periods of an asset's life in order to match costs with earnings. See *Coca-Cola Bottling Co. v. United States*, 487 F.2d 528 (Ct. Cl. 1973).

126. *Massey Motors v. United States*, 364 U.S. 92 (1960); *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943); *United States v. Lunday*, 274 U.S. 295 (1927); *City of Knoxville v. Knoxville Water Co.*, 212 U.S. 1 (1907); *Reisinger v. Commissioner*, 144 F.2d 475 (2d Cir. 1944). See 1975 WIS. L. REV. 230, 234-35.

the asset periodically as consumption and further usage effect a decline in value. The other theory, the matching approach,¹²⁷ received official sanction by the Supreme Court in *Commissioner v. Idaho Power Co.*¹²⁸ The matching theory suggests that depreciation is merely a matching of the expenses of asset acquisition with the income produced by that asset.¹²⁹

Accelerated depreciation systems represent attempts by the government to permit taxpayers to match the real cost of an asset against the revenues produced by that asset.¹³⁰ Accelerated depreciation thus implies a frank recognition of the inherent weakness of an historical cost system during a period of prolonged and intense inflation.¹³¹ Accelerated depreciation, however, is still consistent with the matching approach laid out by the Supreme Court in *Commissioner v. Idaho Power*,¹³² because it represents an attempt to match the true cost of an asset against current revenues without entering the quagmire of inflation-adjusted accounting.¹³³

The MMA permits a system of tax deferral which effectively accelerates the benefits of depreciation deductions to periods prior to asset acquisition. This results in a deferral of the tax burden to the years of actual use of the vessel.¹³⁴ More conventional accelerated depreciation systems have virtually the same impact in that they create greater tax deductions in early years while deferring a portion of tax liability to

127. The matching principle expresses the concept that "asset expirations, or expenses, directly associated with particular types of revenue are recognized as expenses in the period in which the revenues are recognized." S. DAVIDSON, C. STICKNEY, & R. WEIL, *supra* note 91, at 76.

128. 418 U.S. 1 (1974).

129. *See supra* notes 127-28.

130. Section 167 permits the taxpayer to use, among other methods, the sum of the year's digits and the double-declining balance systems. I.R.C. § 167 (1976 & West Supp. 1982). Both are accelerated depreciation methods. Section 168 creates a new class life system, which is also an accelerated depreciation system. I.R.C. § 168 (West Supp. 1982). *See* Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance For Measuring Net Income?*, 78 MICH. L. REV. 1 (1979). *See also* Disclosure of Certain Replacement Cost Data-SEC Accounting Series Release No. 190, 17 C.F.R. § 210.3-17 (1976); 3 AICPA PROFESSIONAL STANDARDS-ACCOUNTING, *Financial Reporting and Changing Prices* § 1072 (1981). *See generally* E. BRIGHAM & J. PAPPAS, *LIBERALIZED DEPRECIATION AND THE COST OF CAPITAL* (1970); G. TERBORGH, *UNDERDEPRECIATION FROM INFLATION, A GHOST RETURNS* (1969).

131. *See supra* note 130 (statements by the Securities Exchange Commission and the Financial Accounting Standards Board).

132. 418 U.S. 1 (1974).

133. *See* D. KIESO & J. WEYGANDT, *supra* note 57, at 1116-58.

134. *See supra* note 27.

later years of the asset's life.¹³⁵ The basis concepts in cost recovery, however, should not be confused with those inherent in cost reduction.¹³⁶ Basis is adjusted for cost recovery purposes, just as in the MMA,¹³⁷ in order to ensure that depreciation deductions are not taken on elements of cost which have already been recovered.¹³⁸ Furthermore, adjustments made to basis which are designed to ensure that elements of cost are deducted only once are irrelevant to the purpose of the investment credit; namely, to reduce the initial cost.¹³⁹ Basis is adjusted to prevent double depreciation deductions and to facilitate the calculation of depreciation recapture.¹⁴⁰ These adjustments relate to cost recovery not cost reduction; thus, their effects should be confined accordingly.

B. Basis Recovery Through a Method of Depreciation

Treasury Regulation 1.48-1(b)¹⁴¹ provides tests for determining whether property is depreciable. It requires that the taxpayer recover

135. This concept can be illustrated using a simple, if somewhat unrealistic, example. Assume Roe Corporation earns, and will continue to earn gross revenues of \$1 million per year for the next 20 years, and that it has no deductions except for depreciation. Assume further that on January 1 of years one and six Roe buys a \$500,000 asset, and the corporation uses the straight line method in years one through five, but then decides to use the 200% double-declining balance (DDB) method of depreciation under I.R.C. § 167 (1976 & West Supp. 1982) in years six through ten. Assume also a five-year useful life, no salvage value, a 10% discount rate, and a switch to straight line in year four of the second asset's life to depreciate the remaining adjusted basis to zero. Finally, assume taxes are paid and revenue is earned on the last day of each year. Upon comparing Figure A with Figure B, it is apparent that the 200% DDB method defers some tax liability from years six and seven to the last years of the asset's useful life. Figure C shows that if one ignores the time value of money, all of the deferred taxes are recaptured. Of course, money has a time value, and Figure D indicates that an accelerated depreciation system gives the taxpayer an added benefit never recovered by the government. The conventional accelerated depreciation system noted here resembles the more unusual depreciation system outlined *supra* note 26. In each case, the timing of the deductions yielded a subsidy to the taxpayer in the form of the time value of the deferred taxes.

136. See *supra* notes 88-97 and accompanying text.

137. 46 U.S.C. § 1177(g) (1976). See *supra* note 26.

138. *Pacific Far E. Lines v. United States*, 544 F.2d 478, 488 (Ct. Cl. 1976).

139. *Id.*

140. See Treas. Reg. § 1.167(b)-1 (1956), as amended by Treas. Reg. 1.167(b)-2, T.D. 6712, 1964-1 C.B. 106 (basis reduction for salvage value to prevent double depreciation deductions); Treas. Reg. § 1.167(a)(8)(C)(1956) (basis calculation for depreciation recapture).

141. Treas. Reg. § 1.48-1(b) (1964) states in relevant part:

(1) Property is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a charac-

Fig. B (in 1,000s) [DDB]

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Income	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Depreciation Deduction	100	100	100	100	100	200	120	72	54	54
Taxable Inc. Tax (50% rate)	900	900	900	900	900	800	880	928	946	946
After tax Inc.	450	450	450	450	450	400	440	464	473	473
	450	450	450	450	450	400	440	464	473	473

Fig. C—Value of the Deferral (assume no time value of money)

	Yr. 1	Yr. 2	Yr. 3 (Repmt)	Yr. 4 (Repmt)	Yr. 5 (Repmt)
Amount Taxes Deferred	450-400 = 50	450-440 = 10	450-464 = -14	450-473 = -23	450-473 = -23
Total Taxes Deferred: 50+10 = 60	60	10	14+23+23 = 60		

Fig. D—Value of the Deferral Using Discounting Techniques (assume 10% interest rate):

	Yr. 1	Yr. 2	Yr. 3 (Repmt)	Yr. 4 (Repmt)	Yr. 5 (Repmt)
1) Taxes Deferred:	50,000	10,000	-14,000	-23,000	-23,000
2) Add Present Value of Tax Deferred From Prior Yr.	0	55,000	71,500	63,250	44,275
3) Total	50,000	65,000	57,500	40,250	21,275

Note: \$21,275 "left" in the hands of taxpayer.

the basis, or cost, of the property through a method of depreciation, and that the depreciation deduction be "allowable," that is, property "of a character subject to the allowance for depreciation under section 167."¹⁴² The de minimis standards for determining whether property is depreciable are part of those standards used for determining ITC eligibility. Under the Code, only depreciable property may receive the ITC.¹⁴³ Section 167 indicates that property, having a useful life of three years or more, which is used in a trade or business, may be depreciated using an accelerated method.¹⁴⁴ A vessel must be used in merchant activity in foreign or domestic commerce in order for the shipowner to use a capital construction fund.¹⁴⁵ Obviously, such vessels have a useful life in excess of three years. Thus, those who use capital construction funds satisfy the de minimis standards for ITC eligibility.

Beyond these de minimis standards, the threshold question is whether a fleet owner, electing under the MMA to acquire a new or reconstructed vessel using only capital construction fund money, ever recovers the cost of the vessel through "a method of depreciation."¹⁴⁶ When a vessel owner takes current deductions for deposits to the capital construction fund, the owner is in effect taking depreciation deductions in advance of the acquisition of the asset. This constitutes nothing more than a rather unusual form of accelerated depreciation, through which the federal government grants a subsidy equal to the

ter subject to the allowance for depreciation under section 167 and the basis (or cost) of the property is recovered through a method of depreciation . . .

Id.

142. Treas. Reg. § 1.48-(1)(b) amplifies the flush language immediately following § 48(a)(1) which states, in relevant part, that § 38 property "includes only recovery property (within the meaning of § 168 without regard to any useful life) and any other property with respect to which depreciation (or amortization in lieu of depreciation) is allowable. . . ." *Id.*

143. Section 48 indicates the minimum three year life standard in the flush language following § 48(a)(1). *See* I.R.C. § 48 (West Supp. 1982). The property must be tangible personalty according to the first sentence of § 48(a). *Id.* Finally, the property must be depreciable. *See supra* note 128. To be depreciable, property must be used in a trade, or business, or held for the production of income. *See* I.R.C. § 167(a) (1976 & West Supp. 1982).

144. I.R.C. § 167(a)(1), -(2) & (c) (1976 & West Supp. 1982). To use the ACRS, § 168(c) requires that the property being depreciated must be "tangible property of a character subject to the allowance for depreciation [which is] used in a trader or business, or held for the production of income." *Id.* § 168(c)(1) (West Supp. 1982). By implication, § 168(c)(2) suggests that recovery property must have a useful life in excess of three years. *Id.* § 168(c)(2). Thus, the requirements under § 168 closely resemble those under § 167.

145. *See supra* note 19.

146. *See supra* note 141.

time value of the deferred taxes to the fleet owner.¹⁴⁷ The taxpayer receives large tax deductions during the early part of the useful life of the asset, but by the end of the useful life the government recovers the taxes so deferred.¹⁴⁸ With the exception of a timing difference, this does not differ from conventional accelerated depreciation; the MMA simply allows the taxpayer to take the deduction prematurely, as opposed to sometime during the life of the asset. Because the deduction approach under the MMA is closely analogous to more conventional accelerated depreciation, it would appear that the taxpayer recovers cost through "a method of depreciation." Therefore, insofar as the first part of the test¹⁴⁹ is concerned, vessels covered by the MMA should be eligible for the ITC.¹⁵⁰

The IRS might argue that this line of analysis destroys the distinction between accelerated depreciation and current expensing. Current expensing is the recognition, for tax accounting purposes, of an expenditure in the same tax period in which the expense is incurred. The IRS has nothing to fear on this score, however, because the concepts presented above do not open the ITC to all taxpayers owning nominally eligible¹⁵¹ assets. If the cost of any asset is expensed entirely in one period,¹⁵² then the property can never be eligible for the investment credit because ITC eligibility requires that cost be recovered by some method of depreciation.¹⁵³ A taxpayer who has a cost basis in the asset, but fails to use a recognized method of cost recovery, cannot qualify under section 38. Therefore, acceptance of the accelerated depreciation analogy, as applied to the MMA, need not force the IRS to treat all assets having a positive cost basis as eligible for the ITC. That is, not all assets having a cost basis for ITC purposes and a zero basis for depreciation purposes should be treated as qualifying for the invest-

147. *See supra* notes 27 & 135.

148. *See supra* note 135.

149. *See supra* notes 141-42 and accompanying text.

150. *But see infra* notes 171-90 and accompanying text (analyzing the "amount allowable" requirement for ITC eligibility).

151. Nominally eligible assets might be described as those meeting the de minimis standards for ITC eligibility. *See supra* note 143 and accompanying text.

152. *See, e.g.,* Coca-Cola Bottling Co. v. United States, 487 F.2d 528 (Ct. Cl. 1973); Wagenson v. Commissioner, 74 T.C. 653 (1980).

153. Current expensing is not a method of depreciation. *See* I.R.C. § 167 (1976 & Supp. IV 1980); I.R.C. § 168 (1976 & Supp. IV 1980); *supra* note 136. *See also* Treas. Reg. 1.48-(b)(3) (1964).

ment credit. Only those assets whose cost is recovered by some method of depreciation should be considered eligible for the ITC.¹⁵⁴ Vessel owners using capital construction funds to acquire new ships employ a special cost recovery system analogous to accelerated depreciation. This differs from mere current expensing, and the IRS need not view the above analysis as a threat to its general asset eligibility standards under section 48.¹⁵⁵

At one time, several exceptions applied to the general rule that taxpayers using accelerated depreciation are ITC-eligible.¹⁵⁶ These exception sections granted certain taxpayers an election between either five-year amortization or the investment tax credit in tandem with any section 167 depreciation method.¹⁵⁷ Congress first enacted the five-year amortization provisions for selected taxpayers in order to provide some tax expenditure substitute following the repeal of the ITC in 1970.¹⁵⁸ The Tax Court, in a recent decision, declared that the existence of these

154. See *supra* note 142.

155. See *supra* notes 141-42.

156. I.R.C. § 48(a)(8) (1970 & Supp. II) rendered the 60-month amortization provisions ITC-ineligible by placing them outside the § 38 definition of property. Congress originally intended these provisions—§§ 167(k), 169, 184, 187 & 188—to serve as a replacement for the investment credit. See *infra* note 158. These sections were exceptions to the general rule that taxpayers using accelerated depreciation under § 167, and now § 168 as well, could also claim the ITC. Each of these 60-month amortization provisions has since been repealed, scheduled for termination, or had its ITC ineligibility removed. See I.R.C. § 167(k) (1976 & West Supp. 1982) (rehabilitation expenditures for low income housing—section inapplicable to property placed in service after 1 Jan. 1984); I.R.C. § 188 (1977 & Supp. IV 1980) (child care facilities—section inapplicable to property placed in service after Jan. 1, 1982); I.R.C. § 184(e)(1) (1976) (railroad rolling stock—section applicable to property placed in service between 1969 and 1976); I.R.C. § 169 (1976) (pollution control equipment—ITC-ineligibility removed, see I.R.C. § 169(h) (1976)); I.R.C. § 187 (1970) (coal mine safety equipment—section repealed by Tax Reform Act of 1976, 90 Stat. 1905 (codified in scattered sections of 26 U.S.C.)).

Only one 60-month amortization provision was not intended as a substitute for the ITC. See I.R.C. § 191 (1976) (historic structure rehabilitation). This section was the only exception to the general rule which was not enacted as a substitute for the ITC and it has since been repealed. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34 (codified in scattered sections of 26 U.S.C.). Upon repealing § 191, congressional policy became consistent: those using *any* method of accelerated depreciation could claim the ITC as well.

157. Property that qualified under § 167(a) for depreciation will also generally qualify for accelerated cost recovery under § 168. See I.R.C. § 167 (1976 & West Supp. 1982); I.R.C. § 168 (West Supp. 1982).

158. S. REP. NO. 437, 92nd Cong., 1st Sess. 33, reprinted in 1971 U.S. CODE CONG. & AD. NEWS 1918, 1940. H.R. REP. NO. 533, 92nd Cong., 1st Sess. 21, reprinted in 1971 U.S. CODE CONG. & AD. NEWS 1836. Following the repeal of the investment credit in 1969, Congress created the 60-month amortization provisions to replace the investment credit in certain selected investment activities. When Congress reenacted the investment tax credit in 1971, see *supra* note 51, it

exceptions indicates an historically inconsistent policy with respect to those using accelerated depreciation and those claiming the ITC.¹⁵⁹

This alleged lack of consistency could be important. If a taxpayer indicates that he uses a form of accelerated depreciation, but the IRS can show that use of a form of accelerated depreciation does not uniformly satisfy Regulation 1.48-(1)(b),¹⁶⁰ a court could¹⁶¹ deny ITC eligibility. The Tax Court did just this in *Zuanich v. Commissioner*.¹⁶² In effect, the Tax Court concluded that use of a form of accelerated depreciation does not per se qualify a taxpayer for the ITC. The MMA, of course, provides for a form of accelerated depreciation. The Tax Court has compared the MMA to the sixty-month amortization provisions to show that there is no consistent congressional policy toward those who use accelerated depreciation and claim the ITC.¹⁶³ Generally, a taxpayer must carry the burden of proof in claiming a tax credit or deduction.¹⁶⁴ Because there appears to be no consistent policy toward those using accelerated depreciation forms and claiming the ITC,¹⁶⁵ a court could argue that use of a form of accelerated depreciation does not, in itself, qualify a taxpayer for ITC benefits.

declared that, in view of the reasons for the creation of the special 60-month amortization, it would be inconsistent to permit the use of both five year amortization and the investment tax credit. Consequently, Congress mandated that taxpayers choose between either five-year amortization or the investment tax credit in combination with a § 167 depreciation method. *See generally* 71-26 TAX MGMT. MEM. 3, 9 (1971).

159. *Zuanich v. Commissioner*, 77 T.C. 428, 441-43 (1981). The Tax Court suggested that the availability of an election between either five-year amortization or accelerated depreciation, plus the investment credit, indicates a lack of consistent willingness to grant the investment credit to those using accelerated depreciation. This reasoning implies that an analogy between accelerated depreciation and the Merchant Marine Act's depreciation system is worthless and that the lack of a consistent policy makes the analogy inconsequential. This characterization is unfair as well as misleading. *See supra* notes 156-58 and accompanying text.

160. *See supra* note 141.

161. Of course, such a decision would be inconsistent with the legislative history of the ITC. *See supra* notes 41-56 and accompanying text. The Tax Court justified its decision in *Zuanich v. Commissioner*, 77 T.C. 428 (1981), by attempting to show that the legislative history did not clearly demonstrate congressional intent. The Tax Court erred, however, in its interpretation of the legislative history. *See supra* notes 41-56 and accompanying text.

162. 77 T.C. 428 (1981).

163. *Id.* at 438, 442.

164. *E.g.*, *Landerman v. Commissioner*, 454 F.2d 338 (7th Cir. 1971); *Kirk v. Commissioner*, 425 F.2d 492 (D.C. Cir. 1970); *Mayrath v. Commissioner*, 357 F.2d 209 (5th Cir. 1966); *Standard Oil Co. (N.J.) v. United States*, 338 F.2d 4 (2nd Cir. 1964); *Schubert v. Commissioner*, 286 F.2d 573 (4th Cir. 1961); *Weir v. Commissioner*, 283 F.2d 675 (6th Cir. 1960).

165. *But see* notes 164-70 and accompanying text (indicating that a congressional policy can be discerned, and that the five-year amortization provisions can be distinguished).

The MMA, however, differs from the five-year amortization provisions because Congress did not design the MMA's cost recovery scheme to replace investment credit benefits, while it designed the sixty-month amortization rules for exactly that purpose.¹⁶⁶ To argue that the MMA's cost recovery system is analogous to the five-year amortization provision, however, is to treat the intent of these two pieces of legislation identically. Congress designed the five-year amortization provisions as substitutes for the ITC. Thus, these provisions were to be outside the regular section 167 depreciation schemes. Congress did not intend the MMA, however, to replace ITC benefits.¹⁶⁷ Denying the full ITC to beneficiaries of the MMA on the basis of an analogy to the amortization provisions implies that the purposes of the two sets of provisions were the same. The legislative histories clearly indicate otherwise.¹⁶⁸ Furthermore, in all instances Congress has either phased out the five-year amortization provisions or has lifted their ITC ineligibility.¹⁶⁹ Congressional policy towards the relationship between ITC eligibility and the use of accelerated depreciation forms is therefore not inconsistent. Thus, the use of a form of accelerated depreciation, such as the MMA's capital construction fund system, should satisfy the ITC eligibility rules.¹⁷⁰

C. *"Allowed" vs. "Allowable" in Section 48(a)*

Only depreciable property is eligible for the investment tax credit.¹⁷¹ Section 48(a)(1), in the flush language following subpart (G), adds that section 38 property "includes only recovery property . . . and any other property with respect to which depreciation is allowable."¹⁷² Clearly, eligible property consists of property that is subject to the accelerated cost recovery system, or property against which depreciation is "allowable." Thus, the question becomes whether an asset is depreciable, such that depreciation is allowable, without concurrently having

166. See *supra* note 158. I.R.C. § 191 (1976) was not intended as a substitute for the investment credit. It has since been repealed. See *supra* note 156.

167. See *supra* notes 16-25 & 41-56 and accompanying text.

168. See *supra* note 158.

169. See *supra* note 156.

170. See *supra* notes 141-43 and accompanying text.

171. I.R.C. § 48(a) (West Supp. 1982) (flush language). See *supra* notes 141-42 and accompanying text.

172. See *supra* note 142.

some amount greater than zero "allowed" as a depreciation deduction.¹⁷³ A close examination of Regulation 1.48-1(b) indicates that the IRS envisions at least one situation in which it is possible to hold depreciable property, which fulfills the allowable requirement, without such property being eligible for any depreciation deduction—an amount "allowed."¹⁷⁴ For example, if a taxpayer uses property which is to be depreciated only in periods subsequent to the current tax year, such property is still considered depreciable during that tax period even though the taxpayer does not claim a deduction.¹⁷⁵ Therefore, the general presumption that depreciation is allowable only when there is an amount allowed need not be considered universal.

A taxpayer taking advantage of the MMA tax deferral scheme is in an analogous position, for there might be a zero basis for depreciation purposes¹⁷⁶ on property which is depreciable in nature. The IRS has argued¹⁷⁷ that the use of capital construction fund money decreases¹⁷⁸ the depreciable basis of property dollar for dollar. It maintains that, to the extent of the decrease in basis, the property is not depreciable and is

173. See *supra* note 141. Having demonstrated that the Merchant Marine Act system is simply a special form of depreciation, see *supra* notes 124-68 and accompanying text, it is necessary to establish that a deduction is "allowable" in order to meet the eligibility test laid out in I.R.C. § 48(a) (West Supp. 1982) and in Treas. Reg. § 1.48-1(b)(1) (1964). See *Pacific Far E. Lines v. United States*, 544 F.2d 478, 486-87 (Ct. Cl. 1976); *supra* note 127. See also 10 VAND. J. TRANS-NAT'L L. 341 (1977).

174. Treas. Reg. § 1.48-1(b)(1) (1964) suggests, for example, that:

"If property is placed in service . . . but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins in a taxable year subsequent to the taxable year in which such property is placed in service, then a deduction for depreciation shall be treated as allowable . . ."

Id. See *infra* note 181.

175. See *supra* note 174.

176. A zero basis for depreciation purposes could occur where a taxpayer uses the balance of his capital construction fund to finance the total cost of a new vessel. If all of the cash came from the ordinary income account of the capital construction fund, see *supra* note 20; 46 U.S.C. § 1177(g)(2) (1976), basis would be reduced dollar for dollar to zero.

177. Rev. Rul. 68-468, 1968-2 C.B. 26; Rev. Rul. 67-359, 1967-2 C.B. 11.

178. The IRS does not explicitly distinguish between cost recovery and cost reduction. Consequently, it reads the basis reduction provisions of the Merchant Marine Act as applicable to investment credit determinations. The Court of Claims rejects this argument. See *Moore McCormack Resources, Inc. v. United States*, 46 A.F.T.R. 2d (P-H) 80-5075 (Ct. Cl. 19890); *Ness v. United States*, 45 A.F.T.R. 2d (P-H) 80-784 (Ct. Cl. 1980); *Gilman v. United States*, 45 A.F.T.R. 2d 80-782 (Ct. Cl. 1980); *Schmidt Barge Lines v. United States*, 610 F.2d 728 (Ct. Cl. 1979); *Oglebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Cl. 1979); *Delta S.S. Lines, Inc. v. United States*, 544 F.2d 496 (Ct. Cl. 1976); *Pacific Far E. Lines v. United States*, 544 F.2d 478 (Ct. Cl. 1976); *Pacific Transp. Co. v. United States*, 544 F.2d 493 (Ct. Cl. 1976). The Tax Court agrees with the position taken by the IRS. *Zuanich v. Commissioner*, 77 T.C. 428 (1981).

thus ineligible for the ITC.¹⁷⁹ The MMA system, however, is merely a tax deferral concept akin to accelerated depreciation. Thus, a denial of the ITC constitutes an inconsistent treatment of vessel owners who are lawfully using the MMA provisions.¹⁸⁰ The Regulations¹⁸¹ envision situations in which, as a result of accelerated depreciation methods, property might be considered depreciable while no deduction is currently allowed. For example, when a taxpayer has depreciated an asset to zero before its useful life is over, the IRS still considers the property depreciable, and no recapture of the ITC occurs merely because the taxpayer can take no further deductions, or amounts allowed.¹⁸² Because the MMA merely provides for a form of accelerated depreciation,¹⁸³ *quod erat demonstrandum*¹⁸⁴ the IRS should consider the vessels depreciable to the full extent of their cost basis.

It seems illogical to contend that depreciable property can somehow be converted into nondepreciable property as the result of an adjustment to basis resulting from cost recovery concerns.¹⁸⁵ Congress mandated basis reduction concurrently with qualified withdrawals from a capital construction fund in order to complete the tax deferral system.¹⁸⁶ Although the basis reductions certainly affect the amount allowed as a depreciation deduction, they should not affect the amount allowable, for Congress declared in the Revenue Act of 1962 that the ITC's aim is cost reduction.¹⁸⁷ Therefore, cost basis or cash outlay must be the sum upon which the tax credit is calculated.¹⁸⁸ Because adjustments to basis under the MMA are made to prevent more than one deduction for cost recovery,¹⁸⁹ such adjustments should not effect

179. See *supra* notes 177-78. I.R.C. § 46(g) (1976) somewhat modifies the amounts in question, but not the arguments themselves. See *supra* notes 36-38 and accompanying text.

180. Compare *supra* note 27 with *supra* note 135.

181. Treas. Reg. § 1.47-2(a)(ii) states in relevant part that:

Section 38 property does not cease to be section 38 property with respect to the taxpayer in any taxable year subsequent to the credit year merely because under the taxpayer's depreciation practice no deduction for depreciation with respect to such property is allowable to the taxpayer for the taxable year provided that the property continues to be used [in business] and otherwise qualifies as section 38 property. . . .

Id. See *supra* note 106. See also Treas. Reg. § 1.47-2(a)(2)(iii) (1967) (examples 1 & 2).

182. See *supra* note 181.

183. See *supra* note 27.

184. Literally, "therefore it has been shown."

185. See *supra* notes 88-97 and accompanying text.

186. See *supra* notes 26-28 and accompanying text.

187. See *supra* notes 41-47.

188. See *supra* notes 78-86 and accompanying text.

189. 46 U.S.C. 1177(g) (1976). See *supra* notes 26-28 and accompanying text.

the amount of investment credit granted because the purposes of basis for depreciation, and for the ITC, differ.¹⁹⁰

VI. CONCLUSION

Congress intended that the investment credit be used to spur new investment in plant and equipment by reducing the acquisition cost of depreciable assets.¹⁹¹ Congress designed the depreciation requirement to ensure that the type of property taxpayers purchased would meet the fiscal policy goals of the ITC.¹⁹² Because cost reduction was the goal of the investment tax credit, basis for depreciation should be distinguished from cost basis for ITC purposes.¹⁹³

The MMA provides for a system of deductions that is analogous to accelerated depreciation. Even if a vessel has a zero basis for depreciation purposes¹⁹⁴ upon the date of purchase, the property is still depreciable. Although no amount is allowed as a further deduction, depreciation is still allowable within the meaning of the Code.¹⁹⁵ Property does not cease to be depreciable merely because the depreciation convention used by the taxpayer reduces basis to zero before the end of the asset's useful life.¹⁹⁶ Thus, when a taxpayer acquires an asset using tax deferred funds accumulated under the MMA provisions, an investment credit calculated upon the full cost basis in the asset should be granted. To do otherwise is to frustrate the intent of Congress with respect to the ITC, as well as to confuse a cost recovery scheme with a cost reduction system.¹⁹⁷ The investment tax credit should be liberally construed in keeping with its stated purposes.¹⁹⁸ Taxpayers who build or reconstruct vessels using tax deferred funds under the MMA per-

190. *See supra* notes 88-97 and accompanying text.

191. *See supra* notes 41-47 and accompanying text.

192. Congress wished to encourage investment in plant and equipment to increase the productivity of American industry. *See supra* notes 41-46 and accompanying text. To ensure that the credit was granted only for investments that would accomplish this purpose, Congress created the de minimis standards for investment credit eligibility. *See supra* notes 142-43.

193. *See supra* notes 88-97 and accompanying text.

194. *See supra* note 176 and accompanying text.

195. *See supra* notes 171-90 and accompanying text.

196. *See supra* notes 176-83 and accompanying text.

197. *See supra* notes 88-97 and accompanying text.

198. *Minot Fed. Sav. & Loan Ass'n v. United States*, 435 F.2d 1368 (8th Cir. 1970); *Cameron Iron Works v. United States*, 621 F.2d 406 (Ct. Cl. 1980); *Lykes Bros. S.S. Co. v. United States*, 513 F.2d 1342 (Ct. Cl. 1975); *Alabama Displays, Inc. v. United States*, 507 F.2d 844 (Ct. Cl. 1974);

form the investment function Congress designed the ITC to reward.¹⁹⁹ Statutes constitute nothing more than codified expressions of the intent of Congress and must be read in a manner designed to effectuate that intent.²⁰⁰

Joshua P. Agrons

Northville Dock Corp. v. Commissioner, 52 T.C. 68 (1969). *See also* King Radio Corp. v. United States, 486 F.2d 1091 (10th Cir. 1973); Weirick v. Commissioner, 62 T.C. 446 (1974).

199. *See supra* notes 41-42.

200. *See* Helvering v. Stockholm Enskilda Bank, 293 U.S. 84 (1934); Sacramento Navigation Co. v. Salz, 273 U.S. 326 (1926); United States v. Corbett, 215 U.S. 233 (1909); United States v. Hartwell, 73 U.S. (6 Wall.) 385 (1867). *See generally* 2A C. SANDS, *supra* note 72 at ch. 45, §§ 45.01-15.

