

UIC John Marshall Journal of Information Technology & Privacy Law

Volume 5
Issue 3 *Computer/Law Journal - Winter 1985*

Article 3

Winter 1985

Computer Software and the Investment Tax Credit, 5 Computer L.J. 347 (1984)

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COMPUTER SOFTWARE AND THE INVESTMENT TAX CREDIT

by ROBERT W. MCGEE*

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By cutting the effective cost of developing and manufacturing new computer products, the Investment Tax Credit has played a significant role in the computer revolution. As computer software assumes a predominant role in the second wave of the computer revolution, the Investment Tax Credit will again assume an important role as software manufacturers try to cut their manufacturing costs in order to compete in this fiercely competitive industry.

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I. AVAILABILITY OF THE INVESTMENT TAX CREDIT

In general, the Investment Tax Credit (ITC) is applicable only to a "qualified investment,"¹ which is defined in Internal Revenue Code section 46(c) as the basis of "section 38 property." Section 38 property is primarily tangible personal property.² Therefore, the primary consideration when determining whether or not computer software³ qualifies for the Investment Tax Credit should be whether computer software is tangible or intangible personal property.

Over the years, however, the Service has developed a two-prong test to determine whether or not an investment in computer software qualifies for the ITC. If the software exists independently of the hardware, it is treated as intangible property⁴ and therefore is ineligible for the ITC. If, however, software costs are included in the price of the hardware and are not separately stated, the Service permits the ITC with respect to the cost of the entire system.⁵

By focusing on whether or not the price of the software is included in the price of the hardware in determining the applicability of the ITC, the Service has completely ignored the more substantive question of whether or not the software qualifies as tangible personal property.⁶ One of the difficulties facing the Service and the courts when making this tangibility determination is that computer software contains both an intangible intellectual component and a tangible physical component. The intangible component consists of the set of machine-readable instructions which are encoded on a physical medium. The tangible physical component on which the software program is usually recorded typically takes the form of a floppy disk, tape, or paper.

1. I.R.S. § 46(a) (1982). Unless otherwise noted, all sections refer to the Internal Revenue Code, 1982 edition, before amendment by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified at scattered sections of I.R.C.).

2. I.R.C. § 46(c) (1982). Congressional Records indicate that the term "tangible personal property" is to be broadly construed. See S. REP. NO. 1881, 87th Cong., 2d Sess. 16, reprinted in 1962 U.S. CODE CONG. & AD NEWS 3304, 3318.

3. Revenue Procedure 69-21 defines computer software as:

all programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers, and translators, assembly routines, and utility programs as well as application programs are included. "Computer software" does not include procedures which are external to computer operations, such as instructions to transcription and external control procedures.

Rev. Proc. 69-21, 1969-2 C.B. 303.

4. See *id.*

5. See Rev. Rul. 71-177, 1971-1 C.B. 5.

6. The Internal Revenue Service is currently examining whether certain types of property, such as computer software and master motion picture negatives, constitute intangible property. See 49 Fed. Reg. 5939-41 (1984).

As might be expected, the courts have been inconsistent in their determination of whether computer software should be treated as tangible or intangible personal property. The courts have been inconsistent both when making the determination in different areas of the law, such as criminal and tax law, and even when making a determination within the same area of law, such as sales or use taxes.⁷ For example, a Texas case has held that software is tangible for criminal law purposes.⁸ In that case, an employee was accused of stealing several computer programs from his employer. The employee maintained that he had committed petty rather than grand larceny because the only tangible property he stole was the paper on which the programs were printed and these tapes had a value of less than fifty dollars. The court disagreed, holding that the programs had a value in excess of the value of the paper upon which they were printed and that the programs were tangible personal property for purposes of the criminal statute. In *Computer Sciences Corp. v. Commissioner*,⁹ the Tax Court faced the question whether computer software constitutes tangible property for collapsible corporation¹⁰ purposes. In *Computer Sciences*, Computax, a wholly owned subsidiary of Computer Sciences Corporation, developed a software program for the computer preparation of income tax returns. The corporation took the position that its software program for the preparation of tax returns was intangible property and that the term "property" as used in Internal Revenue Code section 341 only applied to tangible property.¹¹ The Tax Court held that the computer software programs were intangible property developed by the corporation, and that intangible property should be considered property within the meaning of section 341.¹²

When trying to make the determination whether or not computer

7. For state court cases holding that computer software constitutes *tangible* personal property for state sales or use tax purposes, see *Comptroller of the Treasury v. Equitable Trust Co.*, 296 Md. 459, 464 A.2d 248 (1983); *Citizens and Southern Systems, Inc. v. South Carolina Tax Comm'n*, 280 S.C. 138, 311 S.E.2d 717 (1984); *Chittenden Trust Co. v. King*, 143 Vt. 271, 465 A.2d 1100 (1983). In contrast, for state courts cases holding that computer software constitutes *intangible* personal property for state sales or use tax purposes, see *State v. Central Computer Servs., Inc.*, 349 So. 2d 1160 (Ala. 1977); *Honeywell Info. Sys. v. Board of Assessment Appeals*, 7 Computer L. Serv. Rep. (Callaghan) 486 (Colo. Dist. Ct. 1975).

8. *Hancock v. State of Texas*, 402 S.W.2d 906 (Tex. Crim. App. 1966).

9. 63 T.C. 327 (1974).

10. A collapsible corporation is defined as a corporation formed or availed of principally for the production of property with a view to the sale or exchange of the corporate stock by its shareholders before the realization by the corporation producing the property of a substantial part of the taxable income to be derived from such property. I.R.C. § 341(b)(1) (1982).

11. See 63 T.C. at 346.

12. See *id.*

software is a tangible or intangible asset, it may prove helpful to examine the rationale courts have used when addressing the tangibility issue with respect to motion picture film negatives and computer tapes. In the first of a series of Walt Disney cases, *Walt Disney Productions v. United States (Disney I)*,¹³ the court was called upon to decide whether motion picture film negatives are tangible personal property for federal tax purposes and whether such negatives qualify for the ITC. In *Disney I* the Service argued that the costs incurred with respect to script development, costumes, casting, and set design were attributable to the copyrighted film rather than part of the cost of the negatives. Furthermore, the Service took the position that Disney Productions should be permitted to take the ITC only with respect to the cost of the actual film used in producing the negatives. The district court, however, held that the master motion picture film negatives were tangible personal property and thus eligible for the ITC.¹⁴ The court maintained that, in the absence of any indication to the contrary, Congress intended application of the ordinary meaning of tangibility. Since the motion picture negatives weighed between twenty-seven and fifty-one pounds, measured between 5,000 and 11,800 feet in length, and were capable of being seen and touched, they fell within the ordinary meaning of tangibility.¹⁵ Additionally, the court placed more significance on the fact that negatives are physically used in the manufacture of prints, which are Disney's stock in trade to its customers.¹⁶

On appeal in *Walt Disney Productions v. United States (Disney II)*,¹⁷ the Ninth Circuit agreed with the district court's finding that the film negatives constituted tangible property. The appellate court reasoned that film negatives, like production machinery, are standardized units of depreciable property which Disney used to produce other products (*i.e.*, the positive prints).¹⁸ The court concluded that the attribu-

13. 327 F. Supp. 189 (C.D. Cal. 1971), *modified*, 480 F.2d 66 (9th Cir. 1973), *cert. denied*, 415 U.S. 934 (1974).

14. *See id.* at 192. This finding by the court was a direct repudiation of Treasury Regulation § 1.48-1(f), which provides:

Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape.

Treas. Reg. § 1.48-1(f), T.D. 6731, [1] 1964-1 C.B. 11, 38.

15. 327 F. Supp. at 192.

16. *See id.*

17. 480 F.2d 66 (9th Cir. 1973), *cert. denied*, 415 U.S. 934 (1974).

18. *See id.* at 68.

tion of all the value of the film to the copyright, like the attribution of all the value of a machine used in production to a patent that was eventually procured on the machine, was unwarranted.¹⁹

Thus, both the district court and the court of appeals based their holdings on the fact that, like a machine used in production, the film negative was a tool used to manufacture inventory. This analogy may be extended to computer software, since the original computer software program is used to produce duplicate computer software programs.

In *Texas Instruments, Inc. v. United States*,²⁰ the court addressed the issue whether computer tapes, including the data contained therein, constitute tangible personal property for investment tax credit and depreciation purposes. During 1968 and 1969, a subsidiary of Texas Instruments was engaged in the business of collecting, processing, and selling or licensing offshore seismic information. This information was used by customers to explore for oil and gas. While the information was furnished to the customer in the form of pictures depicting the contours of the earth's different strata, the actual collection and editing process involved a complicated computer process. Seismic data were transmitted by electronic impulses and transcribed onto magnetic computer tapes known as "field" tapes. These field tapes were used to produce a "final" or "output" tape which then became the source of the pictures.

When a customer placed an order for the information, he received a copy of the original picture produced by the process, a map locating the points where the sound waves were introduced into the earth, and a report outlining the conditions under which the tests were conducted. The Texas Instruments subsidiary company retained all field and output tapes as well as the original analog film. Information furnished by the picture to customers was licensed on a non-exclusive basis, and customers were generally not permitted to make the data available to others.

Costs incurred in connection with the production of the seismic tapes during 1968 and 1969 were in excess of \$3,000,000, and were deducted by the taxpayer as ordinary and necessary business expenses. The Service disallowed these deductions and determined that the costs should be capitalized and amortized over a seven year period. Texas Instruments did not dispute this determination, but insisted that it was entitled to an ITC on the total capitalized costs of the field tapes, output tapes, and analog film. The Service contended that these tax benefits were applicable only to the cost of the raw tape and film itself, and not to the full cost of producing the tapes and the film.²¹

19. *See id.*

20. 551 F.2d 599 (5th Cir. 1977).

21. *See id.* at 609.

The district court sustained the government's position on two grounds. First, when a taxpayer places tangible personal property that he produced himself into service, the investment tax credit may be taken only for the costs of the tangible inputs used. Labor and other intangible costs must be excluded. Since Texas Instruments failed to allocate its costs between the tangible and intangible input, no investment tax credit could be claimed. Second, the costs incurred in producing and processing the seismic data on the tapes and film did not constitute an investment in tangible property, but rather intangible information.²²

On appeal, the government conceded that the district court's analysis on the first ground was erroneous, but sought to preserve the district court's judgment on the second ground. The Service argued that if the capital asset in which the taxpayer's costs are invested is essentially intangible, then all costs of acquiring or producing that asset constitute the basis of an intangible asset and therefore the ITC is unavailable.²³

The Fifth Circuit Court of Appeals held for Texas Instruments. In reaching its decision, the court considered the definition of intangible property found in the Treasury Regulations:

Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape.²⁴

Treasury regulations are ordinarily entitled to considerable weight in construing statutory language. The court pointed out, however, that the Ninth Circuit Court of Appeals had previously ruled that the regulation was not all encompassing and was inapplicable with respect to film.²⁵ The appellate court agreed with the Ninth Circuit's rationale

22. *Texas Instruments, Inc. v. United States*, 407 F. Supp. 1326, 1340-41 (N.D. Tex. 1976), *rev'd*, 551 F.2d 599 (5th Cir. 1977).

23. *See Texas Instruments, Inc. v. United States*, 551 F.2d 599, 609 (5th Cir. 1977).

24. *Treas. Reg. § 1.48-1(f)*, T.D. 6731, [1] 1964-1 C.B. 11, 38.

25. *See Walt Disney Productions v. United States*, 327 F. Supp. 189 (C.D. Cal. 1971), *modified*, 480 F.2d 66 (9th Cir. 1973), *cert. denied*, 415 U.S. 934 (1974).

When Congress reenacted the investment tax credit in 1971, it expressly indicated its agreement with the *Disney* holding that motion pictures and television films are tangible personal property, eligible for the investment credit. S. REP. NO. 92-437, 92d Cong., 1st Sess. 34, *reprinted in* 1971 U.S. CODE CONG. & AD. NEWS 1918, 1941. Furthermore, the Tax Reform Act of 1976, Pub. L. No. 94-455, § 804(a),(c)-(e), 90 Stat. 1520, added section 48(k) to the Internal Revenue Code, and treats motion picture and television films as tangible personal property eligible for the investment tax credit.

and held that the computer tapes were tangible personal property eligible for the ITC. The court concluded that it could not accurately separate the value of the information recorded on the tapes from the value of the tapes because, "[t]he value of the seismic data is entirely dependent upon existence of the tapes and film. If the tapes were destroyed prior to any reproduction . . . , nothing would remain. An investment in the data simply does not exist without recording of the data on tangible property."²⁶

II. RULES FOR CALCULATING THE INVESTMENT TAX CREDIT

A. QUALIFYING PROPERTY

1. *In General*

In order to qualify for the investment tax credit, property must fall within section 38,²⁷ which includes:

1. property depreciable as recovery property²⁸ under the accelerated cost recovery system (ACRS), or as nonrecovery property;²⁹
2. tangible personal property,³⁰ other than an airconditioning or heating unit; and
3. other tangible property, except buildings or their structural components, used as an integral part of manufacturing, production, extraction, research, or storage of fungible commodities.

Such property must be placed in service during the year in a trade or business or for the production of income,³¹ and must be used primarily in the United States.

26. 551 F.2d at 611.

27. "Section 38 property" is defined in I.R.C. § 48(a) (1982).

28. In general, recovery property includes new or used property acquired after 1980 for use in a trade or business or for the production of income. All recovery property is depreciable under the Accelerated Cost Recovery System (ACRS). I.R.C. § 168(c) (1982).

29. Nonrecovery property is tangible depreciable property. It includes property that does not qualify for ACRS, such as property placed in service before 1981, and property a taxpayer elects to exclude from ACRS.

30. In general, tangible personal property is property other than real estate that can be seen and touched. Principal examples include machinery, equipment, and computers. Land and land improvements, such as buildings and other permanent structures and their components, do not qualify as tangible personal property. Air-conditioning or space-heating units placed in service after September 1978 also are not included unless the units are acquired under a contract that was binding on and after October 1, 1978. In addition, swimming pools, paved parking areas, wharves and docks, bridges and fences, and similar property are not tangible personal property.

31. Property is considered placed in service in the earlier of (i) the tax year in which the period for depreciation of the property begins, or (ii) the tax year in which the property is placed in a condition or state of readiness and availability for service.

2. *Partially Depreciable Property*

If a depreciation deduction is allowed for only a part of the property placed in service during the year, only the part of the property for which depreciation is allowable qualifies for the credit. Thus if a computer is used eighty percent for business and twenty percent for personal purposes, only eighty percent of the computer's basis (or cost) qualifies for the credit.

3. *Leased Property*

A lessee may be able to take an investment tax credit on property that is leased rather than purchased if certain conditions are met. First, the owner must elect to pass the credit through to the lessee. Second, the property must be considered as qualifying new property with respect to both the lessor and lessee.³² The lessee is treated as if it acquired the property for an amount equal to the property's fair market value and is allowed to compute the credit based on this amount.³³ This amount, however, will be reduced if the term of the lease does not equal the class life of the leased property.³⁴

B. AMOUNT ELIGIBLE

The amount of the investment in qualifying property that is eligible for the credit depends on the class of property for recovery property under ACRS, or on the useful life of nonrecovery property.

1. *Recovery Property*

In general, the total investment in five-year or ten-year class recovery property is eligible for the credit.³⁵ If the recovery property is three-year class property, then only sixty percent of the investment is eligible.³⁶ In addition, if the section 179 expense deduction is elected, the investment in qualifying recovery property is first reduced by that amount.³⁷

32. I.R.C. § 48(d) (1982).

33. *Id.* § 48(d)(1)(A).

34. *Id.* § 48(d)(2)(B). The class life of an asset is determined under section 167.

35. *Id.* § 46(c)(7).

36. *Id.* § 46(c)(7)(B).

37. *Id.* § 179(d)(9). Section 179 allows the taxpayer the opportunity to immediately expense up to \$7,500 of section 38 property placed in service during the year. Without the section 179 election, the total amount of the cost of the section 38 property must be capitalized and expensed using ACRS. *Id.* § 179(a).

Example One: A company purchases computer equipment for \$25,000 in 1984. The property qualifies as five-year recovery property, and the company elects the section 179 expense deduction. The allowable investment tax credit would be \$1,750, determined as follows:

Cost	\$25,000
Less section 179 expense deduction	<u>7,500</u>
	17,500
Multiplied by tax credit percentage ³⁸	<u>10%</u>
Investment tax credit	<u>\$ 1,750</u>

Example Two: A company purchased computer equipment for \$18,000 in 1984. The property qualifies as three-year recovery property, and the company elects the Section 179 expense deduction. The allowable investment tax credit would be \$630, determined as follows:

Cost	\$18,000
Less section 179 expense deduction	<u>7,500</u>
	<u>\$10,500</u>
Amount qualifying for the credit (60% of \$10,500)	\$ 6,300
Multiplied by tax credit percentage	<u>10%</u>
Investment tax credit	<u>\$ 630</u>

2. Nonrecovery Property

None of the investment in nonrecovery property with a useful life of less than three years is eligible for the credit.³⁹ Only one-third of the investment in qualifying nonrecovery property with a useful life of at least three years but less than five years is eligible for the credit.⁴⁰ Two-thirds of the amount invested is eligible for the credit if the property has a useful life of at least five years but less than seven years. The full investment is eligible for the credit if the property has a useful life of at least seven years.⁴¹

38. The regular investment tax credit percentage is ten percent. *Id.* § 46(b)(1). Since computer equipment does not qualify for the additional energy or rehabilitation percentage, the investment credit will be determined using only the regular percentage.

39. *Id.* § 46(c)(2).

40. *Id.*

41. *Id.*

Example: A company acquires nonrecovery property qualifying for the investment tax credit for \$12,000.

- (a) If the property had a useful life of at least three years but less than five years, the amount of the allowable investment tax credit would be \$400 ($\$12,000 \times 33 \frac{1}{3}\% \times 10\%$).
- (b) If the property had a useful life of at least five years but less than seven years, the amount of the allowable investment tax credit would be \$800 ($\$12,000 \times 66 \frac{2}{3}\% \times 10\%$).
- (c) If the property had a useful life of at least seven years, the amount of the allowable investment tax credit would be \$1,200 ($\$12,000 \times 100\% \times 10\%$).

C. REDUCED CREDIT IN LIEU OF BASIS ADJUSTMENT FOR REGULAR PERCENTAGE

Normally, the basis of the property upon which the investment tax credit is taken must be reduced by fifty percent of the allowable investment tax credit.⁴² This adjustment, however, may be ignored with respect to recovery property if the taxpayer elects to calculate the investment tax credit using a lower percentage than that which would otherwise be allowable.⁴³

Example One: Five-year recovery property is acquired in 1983 at a cost of \$40,000. The allowable investment tax credit is \$4,000, determined as follows:

Cost	\$40,000
Multiplied by tax credit percentage	10%
Investment tax credit	<u>\$ 4,000</u>

The basis of the property for depreciation purposes must be reduced by fifty percent of the investment credit.

Cost	\$40,000
Less 50% of \$4,000	<u>2,000</u>
Depreciable basis	<u>\$38,000</u>

42. *Id.* § 48(q)(1).

43. *Id.* § 48(q)(4). The taxpayer may elect to use four percent if the recovery property is only 3-year property, or eight percent if the recovery property is greater than 3-year property.

Example Two: Five-year recovery property is acquired in 1983 at a cost of \$40,000. The company elects to take an investment credit that is two percentage points less than the maximum allowable in order to prevent the property's depreciable basis from being reduced. The investment tax credit taken will be \$3,200.

Cost	\$40,000
Multiplied by tax credit percentage	8%
Investment tax credit	<u>\$ 3,200</u>
Depreciable basis	<u>\$40,000</u>

D. USED PROPERTY LIMITATION

The cost of used property that may be considered in investment tax credit calculations is limited to \$125,000 a year for property placed in service in tax years 1982, 1983, or 1984, and \$150,000 per year thereafter.⁴⁴

Example: A calendar year taxpayer acquires computer equipment qualifying as five-year recovery property in 1985 at a cost of \$400,000. Of this amount, \$170,000 represents used property. The amount of the purchase that is eligible for the investment tax credit is \$380,000 (\$230,000 of new property and \$150,000 of used property).

E. AT RISK LIMITATION

The investment tax credit may only be taken on the amount of qualified property that is at risk.⁴⁵ Thus, when computing the investment tax credit, the credit base⁴⁶ shall be reduced by the nonqualified nonrecourse financing that applies to it as of the end of the tax year in which the property is placed in service.⁴⁷ A taxpayer is considered at risk for property to the extent of the total cash paid, the adjusted basis of property given up, and amounts borrowed to acquire the property if the taxpayer is personally liable for the repayments or if the borrowings are secured by property other than property used in the activity.⁴⁸

44. *Id.* § 48(c).

45. *Id.* § 46(c)(8)(B).

46. For the purposes of section 46(c)(8), "credit base" is defined as the basis of the property in the case of new section 38 property, or the cost of the property in the case of used section 38 property. *Id.* § 46(c)(8)(C).

47. *Id.* § 46(c)(8)(A).

48. *Id.* § 465(b)(1).

F. ALLOWABLE CREDIT

The credit allowable is the sum of the following: (i) the investment credit carryovers; (ii) the current year's regular investment credit; (iii) the current year's business energy credit; and (iv) the investment credit carrybacks to the current year.⁴⁹

The regular investment credit is limited to the lesser of the tax liability or \$25,000 plus eighty-five percent of the tax liability over \$25,000.⁵⁰

Example One: Tax liability for 1983, before credits, is \$100,000. The maximum investment credit is \$88,750, determined as follows:

Tax liability before credit	\$100,000
Less	<u>25,000</u>
	<u>\$ 75,000</u>

$$\$25,000 + 85\% (\$75,000) = \$88,750$$

Example Two: Tax liability for 1983, before credits, is \$21,463. The maximum investment tax credit that can be taken is \$21,463, the amount of the tax liability.

Married persons filing separate returns are each allowed to calculate the limit separately. The regular credit is limited for each spouse to the lesser of the adjusted income tax liability, or \$12,500 plus eighty-five percent of the tax over \$12,500. If one spouse does not have a qualifying investment or an unused credit, however, the spouse with the investment or unused credit may determine his or her limit by using the entire \$25,000 plus eighty-five percent of the tax over \$25,000.⁵¹

A controlled group of corporations may annually divide the \$25,000 among its members in any way the members choose.⁵²

G. UNUSED CREDIT CARRYBACKS AND CARRYOVERS

An unused credit exists when the sum of the investment credit carryovers to the tax year and the credit allowable for the tax year is greater than the overall limit. The unused credit, to the extent it is from the credit allowable for the current tax year, may be carried back to the three prior tax years, and the unused balance in those years may be carried over to the seven following tax years.⁵³ The unused credit must be used in the earliest of these years and is used to the extent al-

49. *Id.* § 46(a)(1).

50. *Id.* § 46(a)(3).

51. *Id.* § 46(a)(5).

52. *Id.* § 46(a)(6).

53. Treas. Reg. § 1.46-2(d), T.D. 7751, 1981-1 C.B. 10, 14.

lowed as a carryback to prior years or as a carryover to later years.⁵⁴

1. Carrybacks

An unused credit carried back to a prior tax year is used to the extent that the limit for the prior year exceeds the sum of (i) the investment credit carryovers to that year, (ii) the credit earned for the year, and (iii) the investment credit carrybacks from years prior to the year from which the credit is being carried.

Example: A calendar year taxpayer has \$3,000 of unused investment credits for 1985 available as a carryback to 1982. His income tax for 1982 was \$2,500, the investment credit for 1982 was \$1,000, and the unused credit carryback from 1984 was \$1,000. The unused credits for 1985 that can be used in 1982 are limited to \$500, the amount by which the 1982 income tax (\$2,500) exceeds the sum of the 1982 investment credit (\$1,000) and the 1984 investment credit carryback (\$1,000).

2. Carryovers

In general, carryovers from an unused credit year are applied before carryovers from a later unused credit year.⁵⁵ An unused credit carried over to 1985 is used before a credit for 1985 to the extent the unused credit does not exceed the overall limit. Credits earned for 1985 are then applied in the amount that the limit exceeds the carryovers from 1984 and prior years.

Example: A calendar year taxpayer has an investment tax credit of \$1,200 for 1985. His income tax is \$1,500 for 1985, and there is \$500 of investment credit carried over from 1984. The unused credit from 1984 is first used to the extent of the 1985 tax. Then the 1985 credit is used to the extent of the \$1,000 excess (\$1,500—\$500).

H. INVESTMENT CREDIT RECAPTURE

If the investment tax credit is taken on property in an earlier year, and then the property is disposed of during a later year, some or all of the credit may have to be recaptured.⁵⁶ The recapture of the investment credit taken on recovery property is computed by multiplying a recapture percentage by the original investment credit that was previously taken. The following table provides percentages for calculating the investment credit recapture amount for recovery property.⁵⁷

54. *Id.*

55. *Id.* § 1.46-2(g)(1), 1981-1 C.B. at 15.

56. I.R.C. § 47(a)(1) (1982).

57. *Id.* § 47(a)(5).

Recovery property disposed of or ceasing to qualify within the:	<i>The recapture percentage:</i>	
	For 5-, 10- or 15-year property	For 3-year property
First full year	100	100
Second full year	80	66
Third full year	60	33
Fourth full year	40	0
Fifth full year	20	0

If an investment tax credit is taken on nonrecovery property and that property is later disposed of or ceases to be qualifying property before the end of the estimated useful life used in computing the credit, some of the credit may have to be recaptured. In order to determine how much of the credit should be recaptured, the credit must be recomputed using an applicable percentage based on the actual useful life of the property.⁵⁸

Both recovery and nonrecovery property carryover amounts may be affected by the investment credit recapture rules. The carryover credits must be recomputed based on the actual amount of time the property was used in service. If the recomputed credit is less than the credit that actually decreased the tax liability for the year the asset was placed in service, the tax must be increased in the year of disposal by the excess of the credit allowed for all affected years over the recomputed credit.

Example One: In May 1981 two new machines were purchased for \$6,000 and \$5,000. The machines are five-year recovery property. The 1981 tax return showed an investment credit of \$1,100 against an income tax liability, as adjusted, of \$1,500. In December 1982 the \$6,000 machine was sold.

Since the machine was sold within the second full year after it was placed in service, \$480 (80% of \$600) of the original investment credit must be recaptured. The allowable investment credit is only \$120, and since \$600 was originally taken (10% of \$6,000), the tax liability increases by \$480.

Example Two: On September 1, 1979, three new machines were acquired at costs of \$2,000, \$3,000, and \$5,000. Each machine had an estimated useful life of ten years, and each was placed in service immediately. In the 1979 tax return the full \$1,000 tax credit (10% of \$10,000) was claimed against a tax of \$1,300.

58. Treas. Reg. § 1.47-1(a), T.D. 6931, 1967-2 C.B. 12, 16, amended by T.D. 7203, 1972-2 C.B. 12, 19-21.

On October 1, 1982, the \$3,000 machine was sold. Since that machine was held more than three years but less than five years, the recomputed investment eligible for the credit is \$1,000 (1/3 of \$3,000) and the recomputed credit for that machine is \$100 (10% of \$1,000). The tax liability resulting from the sale of the machine increases by \$200—the excess of the \$300 originally claimed (10% of \$3,000) over the recomputed \$100 (10% of \$1,000) allowable.

Example Three:

The facts are the same as in Example 2, except that the income tax for 1979 was only \$100. There was no income tax for 1976-1978, but there was a \$500 tax each year for 1980 and 1981. The original credit for 1979 (\$1,000) was claimed as follows: \$100 for 1979; \$500 for 1980; and \$400 for 1981.

Had the actual life rather than the estimated useful life been used to compute the credit, the amount of the investment eligible for the credit would have been \$8,000, and the credit for 1979 would have been \$800. The amount that must be added to the 1982 tax—the \$200 excess of the credit claimed over the recomputed credit—is determined as follows:

Year	Credit Allowed	Recomputed Credit	Excess Credit
1979	\$ 100	\$ 100	\$ -0-
1980	500	500	-0-
1981	400	200	200
	\$ 1,000	\$ 800	\$ 200

Example Four:

The facts are the same as in Example 3, except that in February 1982, a new machine qualifying as five-year recovery property and costing \$10,000 was placed in service. The income tax for 1982 is \$900. The excess for 1982 of the credit earned over the tax, \$100 (\$1,000 - \$900), is an unused credit carryback to 1979.

If the actual life, instead of estimated useful life, had been used to compute the investment credit, the investment credit for 1979 would have been \$800. The amount carried to 1980 is \$800 (\$700 carried over from 1979 and \$100 carried back from 1982). The amount carried to 1981 is \$300 (\$200 carryover from 1980 and \$100 carryback from 1982). The amount that must be added to the 1982 tax, the \$100 excess of the credit claimed over the recomputed credit, is determined as follows:

<u>Year</u>	<u>Credit Allowed</u>	<u>Recomputed Credit</u>	<u>Excess Credit</u>
1979	\$ 100	\$ 100	\$ -0-
1980	500	500	-0-
1981	400	300	100
	<u>\$ 1,000</u>	<u>\$ 900</u>	<u>\$ 100</u>

CONCLUSION

Until the Service, or more likely Congress, confronts the issue of whether or not software qualifies as tangible personal property, the availability of the Investment Tax Credit will remain surrounded by uncertainty. The courts have been unable or unwilling to decide the issue and have provided their own degree of confusion in the matter with the *Disney* and *Texas Instruments* cases.