TAXES APPLYING TO CAPITAL INVESTMENT ACQUISITION

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Abstract
In this workpaper we discussed about tax implications of a capital outlay at the time of acquisition depend on the type of investment being acquired. Many capital outlays, such as introduction of a new product, are combinations of a variety of smaller investments. Governments periodically introduce investment tax credit programs to spur investment. We also discussed about the adjustments that need to be made for corporate taxes at the capital acquisition stage, the operating or asset usage stage and the disposal stage.

Key words: capital investments, innovative products, assets depreciation, tax credits, tax policy

JEL classification: M41, H25, E62

INTRODUCTION

All entities have and use assets, independently from their size and character of activity. The fixed assets make the major part of the assets at disposition of the majority of entities, thus its depreciation values, which are attributed to expenditure, affect the amount of profit before taxes (taxable profit) significantly. It is important to compute these assets especially accurately and correctly, because even the smallest changes or inaccuracies in such accounting affect the work results of the organization a lot. Fixed assets participate in the manufacturing process and depreciate in pieces. This is included into expenditure when depreciation is calculated. As the depreciation expenditure reduces taxable profit, and the organization saves circulating assets by paying smaller entity income tax, it is very important to have the correct accounting of fixed assets. It becomes an important element of entities' management.

Net (new) investments represent expenditure for construction, installations and assembly works, for equipment and transport means purchasing, other expenditure for creating new fixed assets, for developing, modernizing, rebuilding the existing ones, as well as the value of services related to ownership transfer of existing fixed assets and lands paid from other units (notary duties, commissions, transport, loading - unloading expenditure) a.s.o. Volume of net (new) investments does not include value of lands and fixed assets from the country which were used before (bought from other units).

EXPENSES TREATED AS INVESTMENTS

Capital expenses involving the acquisition of actual assets-land, building, machinery, inventory, securities, and so on are generally not treated as expenses for tax purposes. The same treatment is applied for certain intangible assets, such as licenses, patent rights, and purchased goodwill. Most of these assets are used un or wear out over time, and the use or wearing out is recognized as a depreciation or amortization expense.
that reduces taxes. The acquisition cost itself, though, is simply viewed as a change from one type of asset to another, such as from cash to fixed asset, and has no immediate tax implication.

On overhaul extends the life of an existing asset. The overhaul is treated as a capital expenditure for tax purposes and depreciated accordingly. A repair, on the other hand, is treated as an expense for tax purposes.

Governments periodically introduce investment tax credit programs to spur investment. An investment tax credit reduces the company’s tax liability by some percent of the cost of the capital investment. The investment tax credit has come and gone several times in the United States. It was repealed again in 1986.

Some capital investments are treated in the tax code as expenses that reduce taxable income in the period of expenditure even if benefits are anticipated over several years. Training programs and advertising expenses fall in this category, as do many research and development expenses. For example, an established retail store that is starting a new department spends €12,000 on training and €18,000 on advertising. If the company faces a marginal tax rate of 34 percent, these costs will result in a tax savings of $(€12,000 + €18,000)34 = €10,200$, and the after tax expenditure will be €19,800.

When a business first starts, the original costs of establishing the business, such as legal fees, cost of permits, registration, advertising, and training, are capitalized as organizational cost. The IRS then allows the business to amortize or write these off against income equally over the first 60 months of operation.

**TAXES APPLYING TO THE OPERATING STAGE**

During the operating stage years of a capital project, income tax is affected. Tax rules are similar whether income is being taxed is corporate income or the income of the owner, but there are differences. The treatment of income under corporate tax rules is treated here. Differences on tax treatment when income is taxed as the income of the owner are discussed later in this chapter.

The accrual tax basis approach to measuring taxable income was explained earlier in this chapter and applies to taxation during the operating stage of the capital project. If the investment results in increased revenue, the taxable income from the investment each period is the increase in revenue, minus any increase in expenses. Some capital investments result in no new revenue but result in a net decrease in expenses. The reduction of expenses also increases taxable income, in most cases.

**Depreciation**

Depreciation is a particularly important expense for capital investment analysis. Assets that wear out over time and are not bought or sold on the normal course of business are depreciated. Depreciation is a process of recognizing this wearing out, and the resultant loss of value, as an expense each period. This expense reduces taxable income. Depreciation has been a part of the tax law since 1913, with each type of asset assigned a life and then depreciated over that life using one of several approved formulas. Depreciation rates for most assets are currently governed by the Modified Accelerated Cost Recovery System (MACRS) that was introduced and discussed.

**Choosing a Depreciation Method**

When there is a choice between depreciation methods, you will prefer the method that maximizes the present value of depreciation tax savings. If the tax rate is expected to be the same each year, MACRS depreciation will be preferred over straight line because the MACRS method provides the depreciation tax savings sooner. If the tax rate is expected to increase in the future, the depreciation method should be compared on a present value basis.
Operating Loss Carry-Back and Carry-Forward

If a company experiences negative ordinary income some year, the loss can be carried back 2 years and the carried forward for up to 20 years or just carried forward for 20 years to offset taxable income.

TAXES APPLING TO THE DISPOZITION STAGE

The final stage in the life cycle of a capital investment is the liquidation or sale of assets. Like every other stage in the life cycle, taxes are an important part of the picture and must be taken into account. Taxes differ somewhat between disposition under corporate taxation and disposition if the business income is treated as personal income of the owners, partners, and corporation shareholders.

Capital Gains and Losses
The major types of capital gains and losses are summarized in Table 1.

<table>
<thead>
<tr>
<th>GAINS</th>
<th>LOSSES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess of sale price over cost for non depreciable assets</td>
<td>Amount by which sale prices of these same assets fall below cost</td>
</tr>
<tr>
<td>not regularly bought or sold in the course of business, such as stock</td>
<td></td>
</tr>
<tr>
<td>bonds, and land</td>
<td></td>
</tr>
<tr>
<td>GAINS</td>
<td>LOSSES</td>
</tr>
<tr>
<td>Excess of sale price over remaining basis for real estate</td>
<td>Amount by which the sale price falls below cost for real estate used</td>
</tr>
<tr>
<td></td>
<td>in the business</td>
</tr>
<tr>
<td>GAINS</td>
<td>LOSSES</td>
</tr>
<tr>
<td>Excess of sale price over original basis for depreciable</td>
<td>Amount by which the sale price falls below cost for depreciable</td>
</tr>
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<td>assets other than real estate used in the business</td>
<td>assets other than real estate used in the business</td>
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When an asset is traded in a like-kind exchange rather than being sold at the end of its life, no taxable gains or losses are created. If capital losses exceed capital gains in any year, the excess must be carried back 3 years to offset past capital gains. If there are not enough prior capital gains in the prior 3 years, the excess capital loss can be carried forward for a maximum of 5 years.

When an asset is traded in on a like-kind new asset rather than being sold and no additional debt is involved in the trade-in, no immediate tax consequences occur. The basis of the new asset is the remaining basis (original cost-depreciation) of the asset traded in, plus the additional amount paid.

REPLACEMENT DECISIONS IN THE PRESENCE OF TAXES

Replacement decisions must be treated carefully because of their unique cash-flow implication. Replacement decision falls in three general categories:

a. Replacement of a worn-out asset that has a sale value
b. Replacement of a worn-out that has a trade-in value different from the sale value
c. Replacement of a usable asset with another asset.
Decisions in category (a) present no new problems. If an asset can no longer be used, but can be sold, that sale price is available whether or not a new asset is acquired, and therefore does not meet the definition of a relevant cash flow. Categories (b) and (c) are discussed in the following sections.

Replacement with a Trade-in Value Different from the Sale Value

In some cases, though, there is an opportunity to trade in the asset for a higher value than would be available with a simple sale. The difference between the trade-in value and the sale value, adjusted for tax implications, would be a reduction in the relevant cost of the new asset.

Replacement of One Usable Asset with a New Asset

Replacement of a usable asset with a new asset can present complications, particularly if the new asset has a life different from the remaining life of the existing usable asset. The trick in solving these problems is not in identifying marginal cash costs, but in deciding which alternatives should be assigned which costs. Errors often occur when the sale price of the old asset is deducted from the cost of the new asset, rather than being treated as an opportunity cost of using the old asset.

CONCLUSIONS

According to Markovic (2008), the successful entities in the future will be the ones, which are wise enough to harness the full potential of the entire organization in the rapidly changing business environment. Entities face many opportunities to control their tax expense. Based on expected income patterns, they can choose between Accelerated Cost Recovery System and Straight-line depreciation. Entities can choose between being taxed as entities or having income treated as if it were income of the owners. Entities can also control the timing of asset sales and therefore the year in which gains or losses are recognized. The loss carry-back and carry-forward is another tool used for tax management. Generally this involves recognizing expenses in high tax jurisdiction and profits in low tax jurisdictions. The general objective of a value maximizing business is to choose the set of tax treatments that maximizes net present value.

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