Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515–6453

APR 1 8 2016

MEMORANDUM

FROM: Thomas A. Barthold T.A.B.

SUBJECT: Revenue Estimate of Cost Recovery Proposal

This memorandum is a partial response to a request dated September 17, 2015, for a revenue estimate of the pooled asset cost recovery system contained in discussion draft MCG16058 (the "discussion draft").

Under present law, for Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. Under the modified accelerated cost recovery system ("MACRS") adopted in 1986, the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight-line depreciation method is required for the aforementioned real property.

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention. Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month. All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year to reflect the assumption that assets are placed in service ratably throughout the year. However, if substantial property is placed in service

during the last three months of a taxable year, a special rule requires use of the mid-quarter convention, designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

The alternative depreciation system ("ADS") is required to be used for property used predominantly outside the United States, tax-exempt bond financed property, and certain tax-exempt use property. An election to use ADS is available to taxpayers for any class of property for any taxable year. Under ADS, all property is depreciated using the straight-line method, over recovery periods which generally are equal to the class life of the property, with certain exceptions.

Section 2 of the discussion draft repeals present-law depreciation rules under section 168 and replaces such rules with a pooling cost recovery system for "pooled property" (*e.g.*, most tangible property and computer software) and a straight-line cost recovery system for "straight-line property" (*i.e.*, real property, water utility property, and railroad grading or tunnel bore) (collectively, "section 168 property," not including motion picture films, video tapes, or sound recordings).

In the case of pooled property, costs are recovered by multiplying the applicable recovery rate for each pool by the associated pool balance at year-end. "Pooled property" is defined as any tangible property which is not straight line property and any computer software (as defined in section 197(e)(3)(B) that is not an amortizable section 197 intangible) assigned to any one of the six pools. Your proposal would map each of the current section 168(e) 3-,5-,7-,10-,15-, and 20-year property classes to one of the six new pools on a revenue neutral basis.

To determine an asset pool balance as of the close of the taxable year, a taxpayer generally must take in to account additions to and subtractions from the pool as well as any depreciation deduction or negative pool balance adjustment.

The proposal provides special rules for pool balances that are less than zero at year-end ("negative pool balances"), a pool with no assets remaining at year-end, and *de minimis* pool balances. Special rules are also provided for leasebacks and dispositions to related parties and tax shelters.

In the case of straight-line property, costs are recovered ratably (without regard to salvage value) over the applicable recovery period using the applicable convention.

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You requested that we determine pool recovery rates that would maintain revenue neutrality over the budget window. The proposal applies to taxable years beginning after December 31, 2016. We estimate that the following recovery rates would make your proposal approximately revenue neutral over the 2016 – 2026 budget window:

- Pool 1: 49 percent;
- Pool 2: 34 percent;
- Pool 3: 25 percent;
- Pool 4: 18 percent;
- Pool 5: 11 percent; and
- Pool 6: eight percent.