CAPITOL TAX PARTNERS

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Updating Depreciable Lives: Is there Salvage Value in the Current System?

The Subcommittee should be commended for holding a hearing on the depreciation system under the present-law Federal income tax. Depreciation is one of the most significant deductions found on business tax returns. Expenditures for capital investments are among the most significant factors influencing the U.S. economy. The recovery of these costs through the tax depreciation system, in turn, influences the level of investment. Current law presents issues of competitiveness, currency, equity, and tax complexity. This hearing represents an important step in addressing and resolving these issues.

Cost Recovery, in General

The tax treatment of capital expenditures such as machinery, equipment, and buildings used in the production of income depends upon the base of the underlying tax system. Consumption-based taxes generally do not tax the return on investment and under such systems the cost of capital investments is immediately expensed and deducted. Because the cost of a capital investment is the present value of the expected income to be generated from such asset over time, expensing the cost of the asset is equivalent to exempting from tax the expected return from the investment.

An income tax system generally does not allow an immediate deduction for expenditures for capital investments. Instead, such expenditures must be capitalized and the cost of the property is recovered over a period of time through a system of depreciation or amortization deductions. Depreciation deductions generally are allowed for a taxable year under an income tax to reflect the decrease in the value of underlying property and to match the income produced by, with the cost of, the property for the year.

A cost recovery system that computes an allowance for depreciation with respect to the actual decrease in the value of an asset over time often is referred to as "economic depreciation." Although perhaps theoretically appropriate, economic depreciation has at least one significant practical flaw. The requirement to annually ascertain the value of an asset is costly, time consuming, and subject to disputes between taxpayers and tax authorities. Thus, almost all

income tax depreciation systems developed to date have employed conventions and assumptions to be used in the determination of depreciation. These conventions include a placed-in-service date (when depreciation begins), a useful life or recovery period (the time period over which depreciation is calculated and allowed), the depreciation method (the formula used to calculate the annual allowance), and the salvage value (the non-depreciable portion of the cost of the property).

The most significant conventions that influence the determination of annual depreciation deductions are the useful life and the depreciation method. Useful lives generally are assigned to various types of property by statute or administrative guidance and often correlate to the expected economic useful lives of the subject property. In some instances, a useful life shorter than the expected economic useful life of an asset will be allowed by policymakers in order to encourage investment in the underlying property or to compensate the investor for social benefits provided by the property.

The straight-line depreciation method determines annual depreciation allowances by dividing the cost of property by its useful life. Straight-line depreciation recovers the cost of property ratably over the property's useful life. For example, for an asset that originally cost $1,000 and that has a five-year useful life, the straight-line depreciation allowance would be $200 ($1,000/5) for each of the five years. The straight-line method often is used for financial reporting purposes.

Accelerated depreciation methods (such as the declining balance methods) provide relatively larger depreciation deductions in the early years of a property's useful life. A declining balance method calculates depreciation each year by dividing the unrecovered cost of an asset by its useful life and then multiplying by a factor. For example, depreciation under the 200-percent declining balance method for an asset that originally cost $1,000 and has a five-year useful life would be $400 ($1,000/5x2) in the first year, $240 (($1,000-$400)/5x2) in the second year, $144 (($1,000-$400-$240)/5x2) in the third year, and so on. Accelerated methods of depreciation are appropriate in instances where an asset can be expected to lose value more rapidly earlier in its useful life or to encourage investment in particular assets. Accelerated methods have been the predominant methods for recovering the cost of personal property (e.g., machinery and equipment) for Federal income tax purposes for the past several decades.

Depreciation under Present Law

Depreciation is allowed with respect to tangible real and personal property that is used in a trade or business or held for the production of income and that by its nature is subject to wear, tear, obsolescence or otherwise loses value from natural causes. Specifically, section 167 of the Internal Revenue Code of 1986 (Code) generally allows a depreciation deduction for a "reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business, or of property held for the production of income." Depreciation is not allowed with respect to tangible real or personal property that is

expected to retain or increase in value. Thus, for example, depreciation generally is not allowed with respect to land and certain works of artwork.

Depreciation begins in the taxable year the property is placed in service in the taxpayer's trade or business or used in the production of income. For this purpose, an asset is placed in service if it is in a condition or state of readiness with respect to its intended use.

A taxpayer computes gain or loss with respect to depreciable property that is disposed of in a taxable transaction before the end of its useful life. The amount of gain or loss is determined by comparing the proceeds realized upon the disposition of the property with the property's adjusted basis (i.e., its uncovered cost). Gain with respect to personal property is treated as ordinary income to the extent of prior depreciation claimed with respect to the property. Any excess is treated as capital gain. Gain with respect to the disposition of depreciable real property generally is treated as capital gain. In the case of an individual, a special 25-percent tax rate generally applies to real estate gains that do not exceed the amount of prior depreciation claimed with respect to the property.

The Modified Accelerated Cost Recovery System

In general

The depreciation deductions for most tangible property placed in service after 1986 are determined under rules specified in Code section 168, known as the Modified Accelerated Cost Recovery System, (MACRS). Less beneficial depreciation allowances generally are used for purposes of computing alternative minimum taxable income.

Under MACRS, property is assigned to various recovery periods (i.e., useful lives) and each recovery period is assigned a recovery method (i.e., a depreciation method). The recovery periods are three, five, seven, ten, 15, 25, 27.5, 39 and 50 years. (These periods are reduced for qualified property used on an Indian reservation.) The recovery methods are the 200-percent declining balance method (for three-, five-, seven-, and ten-year property), the 150-percent declining balance method (for most 15- and 20-year property, certain property used in farming, and property for which the taxpayer elects) and the straight-line method (for all other property, generally buildings and other long-lived property). The MACRS accelerated methods switch to straight-line depreciation at the point in the recovery period that maximizes depreciation deductions.

No distinction is made between new or used property—both are subject to the same recovery periods and the same depreciation rules when placed in service by the taxpayer.

Recovery periods

Property is assigned to a MACRS recovery period in one of two ways. Code section 168 directly assigns certain property to a specific recovery period. For example, Code section 168(e)(3) classifies automobiles and light general-purpose trucks as five-year property. Other property is assigned to a recovery period based on the property's "class life." Class lives for most assets are listed in Revenue Procedure 87-56 and were developed by the Treasury Department pursuant to studies conducted in the mid-20th century and occasionally revised. Certain types of property (such as office equipment) are assigned class lives regardless of the industry in which they are utilized. Most property, however, are assigned class lives depending upon industry classifications. For example, assets used in the production of cement are assigned to the 20-year class life.

Property is assigned to the MACRS recovery periods are as follows:

Three-year property is property with a class life of four years or less; certain horses; and certain "rent to own" consumer durable property.

Five-year property generally is property with a class life of more than four years and less than 10 years; automobiles and light general purpose trucks; semi-conductor manufacturing equipment; computer-based telephone central office switching equipment; qualified technological equipment, including computers and peripheral equipment; property used in the conduct of research and experimentation; and geothermal, solar, wind and biomass energy property.

Seven-year property is property with a class life of 10 years or more but less than16 years; any railroad track; motorsports entertainment complexes; any Alaskan natural gas pipeline; and any property that does not have a class life and is not otherwise classified.

Ten-year property is property with a class life of 16 years or more but less than 20 years; single purpose agricultural and horticultural structures; and any tree or vine bearing fruits or nuts.

15-year property is property with a class life of 20 years or more but less than 25 years; municipal wastewater treatment plants; telephone distribution plants and other comparable equipment used for the two-way exchange of voice and data communications; retail motor fuels outlets; certain leasehold and restaurant improvements placed in service before January 1, 2006; and initial clearing and grading land improvements with respect to gas utility property.

20-year property is property with a class life of 25 years or more, other than certain structures with a recovery period of 27.5 years or more; water utility property and municipal sewers placed in service before June 13, 1996; and initial clearing and grading land improvements with respect to electric utility property.

25-year property is water utility property and municipal sewers placed in service after June 12, 1996.

27.5-year property is residential rental property.

39-year property is nonresidential rental property.

50-year property is railroad grading or tunnel bores.

Other rules

MACRS contains conventions that specify when during the year the asset is deemed placed in service. For most tangible personal property, the half-year convention effectively provides that depreciation begins in the middle of the taxable year of acquisition. If 40 percent or more of property additions for the taxable year are place in service in the last quarter of the year, a mid-quarter convention applies for the year. A mid-month convention applies to real property. Present-law placed-in-service conventions spread the cost of MACRS property over one additional taxable year than indicated by the recovery period (e.g., five-year property is recovered over six taxable years).

No depreciation is allowed in the year of disposition of MACRS property. In addition, MACRS assumes that the salvage value of property is zero, allowing the entire cost of the property to be depreciated.

Depreciation for MACRS property generally is determined on an item-by-item basis. In certain limited instances, special rules allow taxpayers to depreciate all property with the same recovery period and of the same vintage as one asset in a general asset account. The proceeds realized on any disposition of property in a general asset account are included in income as ordinary income rather than offset by the basis of the property.

When originally enacted in 1986, MACRS provided authority to the Secretary of the Treasury to adjust the class lives applicable to any type of property. This authority was repealed in 1988 before it was invoked. From time to time, Congress has instructed the Treasury Department to study the depreciation allowances applicable to specific types of property (e.g., horses, fruit and nut trees, scientific equipment, rental tuxedos, and vehicles) and report their findings to the tax-writing committees.

MACRS does not apply to all tangible property. Motion picture films and videotapes and sound recordings are excluded from MACRS and are depreciated under the income forecast method. The income forecast method generally attempts to match the cost to produce such property with the income generated by the property. MACRS also does not apply to public utility property if the taxpayer does not use a normalization method of accounting. A

normalization method of accounting attempts to spread the benefits of MACRS depreciation among the utility ratepayers serviced by the property.

Alternative Depreciation System

Section 168 also provides an "alternative depreciation system" for property used outside the United States, tax-exempt use property, tax-exempt bond-financed property, and certain imported property. It also may be elected by other taxpayers and is used to calculate corporate earnings and profits. The alternative depreciation system generally uses the straight-line method and longer recovery periods (generally, the property's class life) than regular MACRS and is therefore less beneficial than regular MACRS.

The alternative depreciation system also applies to "listed property" that is not used more than 50 percent in a trade or business. Listed property includes passenger automobiles; other transportation property; property generally used for entertainment, recreation or amusement; computers and peripheral equipment; and cellular phones. Other rules limit the amount of depreciation that may be claimed annually with respect to a passenger automobile regardless of the business use percentage.

Alternative Minimum Tax

The alternative minimum tax (AMT) originally was enacted, and subsequently significantly modified by the Tax Reform Act of 1986, to ensure that taxpayers with significant economic income did not escape taxation on such items of income. To accomplish this goal, the AMT disallows the use of certain permanent items of tax preference (such as tax-exempt interest on certain private activity bonds) and negates the benefit inherent in certain timing items (such as accelerated depreciation under MACRS). Depreciation allowances under the AMT historically have been less beneficial than those allowed under the regular tax.

Under present law, the recovery periods for tangible personal property are the same for AMT and regular tax purposes. However, the 200-percent declining balance method is not allowed; rather, the 150-percent declining balance method is used under the AMT. Depreciation for real property is determined using the alternative depreciation system under the AMT.

Expensing under Section 179 and Other Provisions

Under Code section 179, a taxpayer with sufficiently small annual capital investment may elect, in lieu of claiming depreciation, to expense immediately up to $100,000 of the cost of property acquired in taxable years beginning before 2008 (indexed for inflation and dropping to $25,000 in 2008 and thereafter). The amount eligible to be expensed phases out as the cost of a taxpayer's property additions for the year exceeds $400,000 ($200,000 in 2008 and thereafter). Property eligible for the expensing election under section 179 generally is tangible personal property (and certain computer software for taxable years beginning before 2008).

In addition to section 179, other Code provisions allow full or partial expensing for certain specific types of property (e.g., clean-fuel burning vehicles, tertiary injections, investments in empowerment zones, and certain environmental remediation costs).

Bonus Depreciation

Special rules contained in economic stimulus bills following the events of September 11, 2001, provided additional first-year depreciation ("bonus depreciation") for acquisitions of new property. Pursuant to the Job Creation and Worker Assistance Act of 2002, taxpayers could immediately deduct 30 percent of the cost of qualified property (generally, new tangible personal property) that was acquired after September 10, 2001, and placed in service before January 1, 2005. This "bonus depreciation" was in lieu of depreciation a taxpayer would otherwise claim over the life of the property. Bonus depreciation did not apply if the property was acquired pursuant to a binding contract in existence before September 11, 2001. Self-constructed property qualified for bonus depreciation if construction began after September 10, 2001, and was placed in service by the applicable date.

A special rule applied to property that had a longer production period. Such property was eligible for bonus depreciation if it was placed in service before January 1, 2006, and the 30-percent bonus applied to costs incurred before January 1, 2005.

A provision in the Jobs and Growth Tax Relief Reconciliation Tax Act of 2003 increased and extended the bonus depreciation rules. Under the Act, a taxpayer was allowed to immediately deduct 50 percent of the cost of qualified property acquired after May 5, 2003, and before January 1, 2005 (unless a binding contract was in existence before May 5, 2003), and placed in service before January 1, 2005 (January 1, 2006 for longer production period property). Self-constructed property qualified for the 50-percent bonus depreciation if construction began after May 5, 2003, and before January 1, 2005, and was placed in service by the applicable date.

Prior Law

The Accelerated Cost Recovery System

As the name suggests, MACRS is the successor depreciation system to the Accelerated Cost Recovery System (ACRS). ACRS had been adopted in 1981; the Tax Reform Act of 1986 modified ACRS to produce MACRS.

In format, ACRS was similar to MACRS. Under both systems, property is assigned to a discrete number of recovery periods and a specific accelerated depreciation method applies to each recovery period. However, ACRS utilized less recovery periods than does MACRS and the length of the ACRS periods generally were shorter than the MACRS periods for the same types of property. The recovery periods for ACRS were three, five, ten and 15 years. Most tangible personal property fell into the three- and five- year classifications. Ten-year property generally

consisted of public utility property and 15-year property generally consisted of real property. The recovery period for real property was lengthened to 18 and then 19 years by subsequent revenue acts.

ACRS was enacted as an incentive to invest in depreciable property. The lives and methods provided by ACRS allowed taxpayers to recover the cost of capital investments much more rapidly than would be indicated by the use of economic depreciation. The staff of the Joint Committee on Taxation estimated that the replacement of ACRS with MACRS by the Tax Reform Act of 1986 increased Federal revenues by over $12 billion over a five-year budgetary period.

Facts and Circumstances Determinations

The enactment of the ACRS in 1981 ended the ability of a taxpayer to determine its depreciation deductions on a taxpayer-specific facts and circumstances basis. Under prior depreciation systems, taxpayers were allowed certain leeway in determining useful lives, depreciation methods, salvage value and other conventions for various types of property based on the property's characteristics and the taxpayer's use of the property.

Depreciation deductions have been allowed since the inception of the income tax in 1913. From 1913 to 1934, taxpayers were provided considerable latitude in determining appropriate allowance for depreciation based on their facts and circumstances. In 1934, in order to provide revenue for New Deal public works projects and to offset declines in tax receipts because of the Great Depression, the Treasury Department promulgated rules regarding the burden of proof required for taxpayers to support their depreciation deductions. These rules generally reduced depreciation deductions claimed by taxpayers.

In 1942, Treasury promulgated Bulletin F, which provided guidelines for the useful lives for various types of property. Although taxpayers could still show that shorter lives were appropriate, the effect of Bulletin F was to further slow depreciation.

In 1962, Treasury revoked Bulletin F and provided the "class life" system to assist taxpayers and the IRS in agreeing upon acceptable useful lives to be used in the context of a taxpayer facts-and-circumstances depreciation system. Guidelines for useful lives were intended "to provide taxpayers with a greater degree of certainty in determining the amount of their depreciation deductions and to provide greater uniformity in the audit of these deductions by the Internal Revenue Service." Class life guidelines purposely were set at levels shorter than those reported by most industry participants surveyed in a Treasury study. The class lives were also shorter than the lives previously set forth in Bulletin F. A "reserve ratio test" was developed to ensure that taxpayers were not establishing useful lives that were too short. The reserve ratio test was intended as an objective measure by which the taxpayer's asset retirement and replacement policies were taken into account so that the taxpayer and the Internal Revenue Service could judge whether the taxpayer's chosen useful lives were appropriate.

A later Treasury study indicated that many taxpayers continued to compute depreciation allowances based on their own facts and circumstances rather than the new class life guidelines and that the reserve ratio test contained certain flaws. Consequently, in 1971 the Treasury introduced the Class Life Asset Depreciation Range (ADR) System. The ADR system classified assets based on industry groups and provided useful lives for each group. Taxpayers were allowed to elect depreciable lives that ranged anywhere from 80 to 120 percent of the applicable class life for a group of assets.

The ADR system computed depreciation on a mass asset basis and had specific rules with respect to the use of depreciation methods (both straight-line and accelerated methods were allowed), salvage value, used property, and ordinary and extraordinary retirements. The Treasury Department revised the ADR system over the decade it was in existence—categories were added and deleted, some lives were shortened while others were lengthened. In general, ADR provided taxpayers with more beneficial depreciation than the guideline system promulgated in 1962. The ADR system was effectively repealed by Congress with the enactment of ACRS.

Considerations

Experience gained from the practical application of present-law depreciation rules and the lessons learned from prior law provide certain insights that are relevant in the consideration of changes to the current system of income tax depreciation.

Currency and Process

As described above, our current system of depreciation—MACRS—assigns recovery periods and methods to types of property based on the property's class life. These class lives generally were developed by the Treasury Department with respect to guidance issued in the 1960's. Since then, the U.S. economy has undergone significant change. New industries and types of assets have emerged, services once provided by certain industries have merged or converged into other industries (e.g., telecommunications) and the rate of change in some industries (e.g., technology) has been dramatic. These phenomena have created issues under the current depreciation system. New industries find it difficult to "pigeon hole" themselves into the current class system and classification controversies with the Internal Revenue Service often emerge. Other firms believe that the current class lives and assigned recovery periods do not properly reflect the rate of obsolescence and investment turnover within their industry. One oft-cited example relates to computer equipment, which is assigned a five-year recovery period.

Policymakers may wish to consider procedural changes that would facilitate making the depreciation system more current and responsive to change. Legislating changes to depreciable lives and methods can be a cumbersome and piecemeal process. The Treasury Department, when

provided adequate resources and direction, has demonstrated the ability to study depreciation allowances and make appropriate suggestions. Consideration should be given to establishing a process by which Treasury can study the cost recovery system and formulate recommendations. An expedited process, with appropriate Congressional input and oversight, could then bring about needed changes.

Equity

Any depreciation system should promote horizontal equity by providing comparable treatment among different industries and activities and among participant in an industry. This does not mean that the cost of all investment should be recovered in the same manner. Rather, to the extent possible, the relationship between tax depreciation rules applicable to an asset and that asset's economic depreciation should be the same for all property. Thus, for example, comparable cost recovery rules should be available to a type of property whether such property is leased or acquired outright, is acquired new or used, or disposed of before its expected retirement.

The AMT also presents issues of horizontal equity. Under present law, certain industries and certain firms within an industry experience are subject to different depreciation regimes and different costs of capital if the industry or firm is subject to the AMT. Consideration should be given to addressing the implications of the application of the AMT upon discrete segments of the economy.

Complexity

Depreciation deductions are among the most significant items on business tax returns. The calculations and recordkeeping required with respect to depreciation can be significant. Expenditures must be analyzed and characterized as either capital investments or currently deductible costs. Capital investments must be classified to fit into the various depreciation class lives and depreciated accordingly. Different depreciation records must be maintained for financial reporting, regular Federal income tax, AMT, earnings and profits, and State income tax purposes. Dispositions must be tracked and gain and loss computed and characterized based on prior depreciation allowances. Depreciation calculations and the related recordkeeping requirements generally must be done on a property-by-property basis, increasing compliance burdens.

As a result, consideration should be given to simplifying the current depreciation regime and insuring that any contemplated changes do not further increase compliance burdens. Expanding the availability of mass asset accounting is one means by which depreciation compliance can be simplified.