

TAX REDUCTION AND REFORM PROPOSALS

3

REAL ESTATE DEPRECIATION

PREPARED FOR THE
COMMITTEE ON WAYS AND MEANS
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION



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CONTENTS

	Page
I. Introduction.....	1
II. Summary of Administration Proposals.....	2
III. Description and Discussion of Real Estate Depreciation Proposals.....	5
A. Accelerated Depreciation Methods.....	5
B. Component Depreciation.....	13
C. Special Treatment for Low-Income and Multi- Family Housing.....	20
D. Useful Lives.....	24
Appendices.....	29
A. Proposed Building Guideline Classes and Depreciation Periods.....	31
B. Useful Lives of Certain Buildings Under Bulletin F..	33

I. INTRODUCTION

This pamphlet is the third in a series prepared by the staff of the Joint Committee on Taxation for use by the Committee on Ways and Means in its consideration of the Administration's tax reduction and reform proposals. A previous pamphlet (dated January 27, 1978) provided a summary of the overall Administration tax proposals.

This pamphlet describes in detail the Administration proposals regarding real estate depreciation. This description includes, for each of the specific proposals, an explanation of present law, the background of the item (including legislative history), a description of the Administration proposal, alternative or additional proposals by Members, and a discussion of issues involved in the various proposals. In addition, the material in this pamphlet includes the estimated revenue effect of the Administration proposals.

A brief summary of the specific Administration proposals (and the related present law) precedes the detailed description of the proposals. The detailed description covers real estate depreciation proposals regarding the following: (1) accelerated depreciation; (2) component depreciation; (3) special treatment for low-income and multi-family housing; and (4) useful lives.

The Administration proposals relating to real estate depreciation were included in its proposals relating to tax shelters. Since the real estate depreciation proposals would affect the tax treatment of real estate generally, these proposals are described in this pamphlet separately from the other proposals relating to tax shelters (in Pamphlet No. 2). In addition, another pamphlet covers proposals relating to simplification of the class life asset depreciation range system (ADR) and depreciation for small business (Pamphlet No. 8).

II. SUMMARY OF ADMINISTRATION PROPOSALS

A. Accelerated Depreciation Methods

Present Law

A depreciation deduction is allowed for the exhaustion, wear and tear of buildings used in a trade or business or held for the production of income. Special rules limit the use of accelerated depreciation methods for real estate. A new residential rental building may be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method used consistently by the taxpayer which does not result in the allowance of greater aggregate depreciation deductions during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method. New nonresidential buildings may be depreciated under the declining balance method at a rate not exceeding 150 percent of the straight-line rate. If used residential rental property has a useful life of 20 years or more, it can be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. Other used properties must be depreciated under the straight-line method.

Rapid 5-year amortization is provided for certain low-income rehabilitation expenditures, pollution control facilities, child care facilities, and rehabilitation expenditures for certified historic structures.

Under special rules, accelerated depreciation on, and rapid amortization of, real property in excess of straight-line depreciation is generally subject to recapture as ordinary income, treated as a tax preference item for minimum tax purposes, and reduces the amount eligible for the 50-percent maximum tax rate on personal service income.

Administration Proposal

Under the Administration proposal, taxpayers would not be permitted to use an accelerated method of depreciation for buildings (other than certain subsidized low-income housing). Generally, real estate depreciation would be limited to either the straight-line method based on useful lives prescribed by the Treasury Department or the actual decline in the fair market value of the building as established under a facts and circumstances test.

As described below, special transitional rules would be provided for low-income and multi-family rental housing. In addition, accelerated depreciation at a reduced rate would continue to be available for new low-income rental housing.

B. Component Depreciation

Present Law

Under present law, a taxpayer may allocate the cost of a building to its component parts and compute depreciation on the basis of the useful lives of the component parts (such as plumbing system, roof, and building shell) instead of on the basis of the useful life of the entire building.

Real estate depreciation computed under the component method and straight-line rates may often approximate or exceed depreciation allowable under an accelerated method based on the useful life of the entire building. Straight-line depreciation under the component method is not treated as a tax preference for minimum tax purposes and generally is not subject to ordinary income recapture for depreciable real property even if the total deductions allowable approximate or exceed the amounts which would be allowable under an accelerated method for the entire building.

Administration Proposal

Under the Administration proposal, the component depreciation method would be prohibited for both new and used buildings.

C. Special Treatment for Low-Income and Multi-Family Housing

Present Law

Under present law, new residential rental property may be depreciated under the declining balance method at a rate of up to 200-percent of the straight-line rate, the sum of the years-digit method, or any other method used consistently by the taxpayer which does not result in the allowance of a greater aggregate amount of depreciation during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method. Used residential rental housing may be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate if the property has a useful life of 20 years or more. Property is treated as residential rental property only if 80 percent or more of the gross rental income from the building or structure for the taxable year is rental income from dwelling units.

Rehabilitation expenditures for subsidized low-income housing may be amortized under the straight-line method using a useful life of 60 months and no salvage value. This provision applies to qualified expenditures incurred with respect to low-income rental housing before January 1, 1979.

For subsidized low-income rental housing, depreciation subject to recapture as ordinary income when the property is sold at a gain is phased out by one percentage point for each month the property is held for more than 100 months.

Administration Proposal

Until 1983, the present depreciation methods would continue to apply to new and used low-income housing. Other new multi-family housing could be depreciated through 1982 using the 150-percent declining balance method. Used low-income rental housing would continue to be eligible for the 125-percent declining balance method through 1982. Other used multi-family housing would be depreciated under the straight-line method.

After 1982, residential rental housing (other than low-income housing) would be limited to the straight-line method. New low-income housing would be eligible for depreciation under the 150-percent declining balance method.

D. Useful Lives

Present Law

Under present law, depreciation for real estate may be determined by estimating useful lives under a facts and circumstances test or under guideline lives prescribed under Revenue Procedure 62-21, as in effect on December 31, 1970. Guideline lives under the class life asset depreciation range system (ADR) generally have not been prescribed for real property.

Administration Proposal

Under the Administration proposal, the useful lives of various kinds of real estate would be established by Treasury guidelines based on industry wide averages of useful lives in actual use.

As an alternative to using the guideline useful lives and the straight-line method, a taxpayer would be able to elect to use a facts and circumstances test that would permit a depreciation deduction in any year sufficient to decrease the basis of the building to its fair market value as of the end of the year.

Once the facts and circumstances test is elected for a structure, the taxpayer would not be permitted to change to the guideline system.

III. DESCRIPTION AND DISCUSSION OF REAL ESTATE DEPRECIATION PROPOSALS

A. Accelerated Depreciation Methods

Present Law

Under present law, a depreciation deduction is allowed for the exhaustion, wear, and tear of buildings used in a trade or business or held for the production of income. New residential rental buildings may be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method if the aggregate depreciation allowable during the first two-thirds of the property's useful life does not exceed the amount allowable under the 200-percent declining balance method. For this purpose, a building or structure is considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income is from the rental of dwelling units. New commercial buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate. Used residential properties with an estimated useful life of 20 years or more can be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. All other used properties must be depreciated under the straight-line method.

Certain rehabilitation expenditures for low-income rental housing may be amortized on a straight-line basis over a period of 60 months. Qualified rehabilitation expenditures for certified historic structures also may be amortized over a 60-month period. Alternatively, the cost of a historic structure, including the rehabilitation expenditures, may be depreciated as a new building, for example, under the 200-percent declining balance method for residential property or the 150-percent declining balance method for nonresidential property.

A 60-month amortization method is also available for certified pollution control facilities and certain expenditures for child care facilities.

Generally, in the case of all real estate other than certain low-income rental housing, depreciation in excess of straight-line depreciation is subject to recapture as ordinary income upon a sale or exchange of the property (rather than being considered long-term capital gain). All of the depreciation allowable, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Any gain in excess of the amount recaptured as ordinary income is treated as gain from the sale or exchange of property used in a trade or business (sec. 1231). This portion of a gain is aggregated with gains and losses from other sales or exchanges of property used in a trade or business. After aggregation, a net gain is eligible for capital gains treatment and a net loss is treated as an ordinary loss.

In the case of rapid 5-year amortization, gain is generally recaptured as ordinary income for the full amount of the amortization allowable in the same manner as recapture for depreciable personal property. However, in the case of low-income housing rehabilitation expenditures, gain is recaptured as ordinary income only to the extent of the amortization allowable in excess of straight-line depreciation in essentially the same manner as for depreciable real property generally. (The Technical Corrections bill (H.R. 6715) would apply the depreciable real property recapture rule to rehabilitation expenditures for certified historic structures.)

Accelerated depreciation on real property in excess of straight-line is treated as a tax preference for minimum tax purposes, reduces the amount of personal service income eligible for the 50-percent maximum tax on personal service income, and is not taken into account in determining the earnings and profits of a corporation.

Background

LEGISLATIVE HISTORY

Depreciation methods

Before 1946, depreciable real estate generally was depreciated under the straight-line method for income tax purposes (that is, a depreciation deduction of an equal prorata amount over the useful life of the property). In 1946, administrative practices began to permit the depreciation of real estate on the 150-percent declining balance method, which had previously been available only for tangible personal property (such as machinery and equipment). Under the Internal Revenue Code of 1954, real property could be depreciated in the same manner as tangible personal property, so that when a building was first placed in service the double-declining balance method or the sum-of-the-years-digits method could be used by the first owner.¹ A subsequent owner was permitted to use the 150-percent declining balance method.²

The Tax Reform Act of 1969 limited the extent to which accelerated depreciation would be allowed with respect to real property. Under the 1969 Act, the use of accelerated methods of depreciation depends upon whether the property is residential rental property, nonresidential property, or low-income residential property. In addition, in the case of residential and nonresidential property, the allowable method also depends upon whether the property is new or used. Also, in the case of used residential property, the useful life must be taken into account, i.e., must have a useful life of 20 years. (The permissible accelerated methods are described above under *Present Law*.

¹ The Code also permits the use by the first owner of "any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the [double declining balance] methods * * *."

² The second owner may be able to approximate, at 1½ times the declining balance, the depreciation deductions available to the first owner, since the second owner often can depreciate the property over a shorter useful life than the first owner. The other benefits (depreciation calculated upon total basis, little recapture, and generally capital gains at disposition) are available to second and subsequent owners, as well as to the first owner.

As passed by the House, the 1976 Act treated accelerated depreciation for real property as an accelerated deduction subject to the limitation on artificial losses (LAL). Under this limitation, accelerated depreciation was to be deductible only against a taxpayer's net related income from real property, i.e., gross real estate income reduced by "ordinary" deductions attributable to real property. The LAL provisions were deleted by the Senate. The Conference Committee on the Tax Reform Act of 1976 agreed to the deletion of LAL, but accepted other changes which dealt with real estate tax shelters in particular or with tax shelters generally.

Depreciation recapture

The provisions relating to depreciation recapture were first enacted in 1962 to prevent deductions for accelerated depreciation from converting ordinary income into capital gain. In general, the 1962 provision (sec. 1245 of the code) provided that gain on a sale of most tangible personal property would be taxed as ordinary income to the extent of all depreciation taken on the property after December 31, 1962. In 1964, the recapture rules were extended to real property (buildings) to provide in general that gain on sale would be taxed as ordinary income to the extent of the depreciation (in most cases only the "excess" accelerated depreciation) taken on that property after December 31, 1963. This provision (sec. 1250 of the code), however, had a gradual phase-out of the recapture rules. If the property had not been held for more than 12 months, all of the depreciation was recaptured. However, if the property had been held over 12 months, only the excess depreciation over straight-line was recaptured and the amount recaptured was reduced after an initial 20-month holding period at the rate of one percent per month. Thus, after 120 months (10 years) there was no recapture of any depreciation.

In the Tax Reform Act of 1969, the recapture rules were further modified as to post-1969 depreciation on real property. Under the Act, in the case of residential real property and property with respect to which the rapid depreciation for rehabilitation expenditures had been allowed, post-1969 depreciation in excess of straight-line was fully recaptured at ordinary income rates if the property had been held for more than 12 months³ but less than 100 months (8 years and 4 months). For each month the property was held over 100 months, there was a one percent per month reduction in the amount of post-1969 depreciation that is recaptured. Thus, there was no recapture of any depreciation if the property was held for 200 months (16 years and 8 months).

In the case of non-residential real property, all post-1969 depreciation in excess of straight-line depreciation is recaptured (to the extent there is gain) regardless of the length of time the property is held.

In addition, in the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, such as the FHA 221(d)(3) and the FHA 236 programs,

³ There was no change in the rule providing for recapture of all depreciation (including straight-line) if the property is not held for more than 12 months.

the pre-1969 recapture rules on real property were retained.⁴ However, if the property is constructed, reconstructed, or acquired after December 31, 1975, the regular post-1969 rules for residential property will apply (i.e., a one percent reduction per month after 100 months).

The Tax Reform Act of 1976 provided for the complete recapture of all post-1975 depreciation in excess of straight-line depreciation for residential rental property other than subsidized low-income rental property. As under prior law, all of the depreciation taken, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months.

Minimum tax

The excess of accelerated depreciation on real property over the amount allowable under the straight-line method has been treated as a tax preference since enactment of the minimum tax provisions under the Tax Reform Act of 1969. Thus, the changes made by the 1976 Act in the minimum tax provisions have had some impact on real estate taxation (e.g., raising the minimum tax rate from 10 to 15 percent and decreasing the exemption to the greater of \$10,000 or one-half the regular taxes paid).

Other provisions

There were also a number of other provisions in the Tax Reform Act of 1976 which directly and indirectly affected the tax treatment of real estate investments. These provisions were added to the Code along with other changes affecting tax shelters in order to deal with tax deferral opportunities provided by tax shelters, as well as the opportunity provided to convert ordinary income into capital gains.

Under the 1976 Act, real property construction period interest and taxes are required to be capitalized in the year in which paid or accrued and amortized over a 10-year period. (Previously, taxpayers could deduct these items currently when paid or accrued or elect to capitalize them as carrying charges.) The 10-year amortization period is being phased-in over a 7-year period. In addition, the effective date of the provision was postponed for residential and low-income rental housing so that it first applies to residential construction period taxes and interest after 1977 and low-income housing construction period taxes and interest after 1981.

The Tax Reform Act of 1976 also provided for a two-year extension, until January 1, 1978, of the special 5-year amortization rule for expenditures to rehabilitate low-income rental housing. That Act also increased the amount of rehabilitation expenditures per dwelling unit that can be taken into account from \$15,000 to \$20,000. The provision was extended to January 1, 1979, by Public Law 95-171.

The 1976 Act also added the rapid amortization and accelerated depreciation provisions for certified historic structures.

The provisions of the 1976 Act which indirectly affect real estate investment include the limitations on the deductibility of prepaid

⁴ That is, with respect to these projects, accelerated depreciation will be fully recaptured at ordinary income rates only if the property has been held for not more than 20 months. If the property is sold within 12 months, all of the depreciation is recaptured. For each month the property is held over 20 months, there is a 1 percent per month reduction in the amount of accelerated depreciation recaptured. Thus, there will be no recapture if the property is held for a period of 100 months (8 years and 4 months).

interest, the changes concerning the deductibility of investment interest, and the rules prescribed for deductibility of partnership organization and syndication expenses.

On the other hand, an exception to the partnership at risk loss limitation provisions was provided for real estate activities.

ECONOMIC BACKGROUND

Housing construction has undergone wide fluctuations in recent years. Overall housing starts rose from a depressed level of 1.4 million in the recession year 1970 to 2.1 million in 1971 and to a record 2.4 million in 1972. This large housing boom resulted from the relatively easy credit conditions prevailing in these years and the large housing subsidy programs enacted in the 1968 Housing Act.

Housing starts declined precipitously, however, in 1974 and 1975 because of the credit crunch which occurred in mid-1974 and the depressed state of the overall economy. Starts were only 1.3 million in 1974 and were less than 1.2 million in 1975. Housing recovered to 1.5 million starts in 1976, and 1977 was the only really good year for housing since 1973, as starts rose to almost 2.0 million.

Real estate depreciation rules only affect housing which is not occupied by the owner. Generally, rental units are multi-family units, and the recovery of multi-family housing starts has not been as great as that of single-family housing starts. Starts of residential structures with 5 or more units were 0.8 million in 1971-73, before falling to 0.4 million in 1974 and to only 0.2 million in 1975. In 1977 multi-family starts were only 0.4 million, less than half the peak attained in 1972.

The tax laws encourage rental housing construction to the extent that allowable depreciation for tax purposes exceeds the actual decline in the value of the structure during the year, what is sometimes called "economic depreciation." Studies indicate that most buildings decline in value much more slowly than is implied by double declining balance depreciation and that actual useful lives are generally longer than lives used for tax purposes. However, it has been argued that in periods of inflation, economic depreciation should be based on the price level prevailing during the year in which the depreciation is claimed, rather than on the actual historical cost of the asset as is the case under present law. The understatement of depreciation resulting from failure to take account of inflation in computing depreciation deductions tends to offset the overstatement of depreciation resulting from use of short lives and the double declining balance method. Whether tax depreciation will exceed economic depreciation under present law will depend on future rates of inflation. Another factor is that in periods of inflation, owners of real estate benefit from a decline in the real value of their mortgage debt unless interest rates have fully adjusted to offset the inflation.

Total private construction, which includes residential, commercial, and industrial structures, has also undergone large fluctuations in recent years. Starting from the depressed level in 1970, private construction expenditures adjusted for inflation rose 29 percent between 1970 and 1973. As a result of the tight credit conditions, the energy crisis and the severe recession, they fell by 25.9 percent between 1973 and 1975. The improvement in the economy and easier credit conditions have caused an improvement in private construction expenditures, which grew by 18.5 percent between 1975 and 1977; but they

are still about 12 percent below the record levels of 1973. Unemployment in the construction industry is now about 11 percent, compared to about 9 percent in 1973. (In 1973, overall unemployment was 4.9 percent, compared to 6.2 percent today. Thus, unemployment in the construction industry presently bears about the same relationship to overall unemployment as it did in 1973.)

Administration Proposal

Under the Administration proposal, taxpayers would not be permitted to use an accelerated method of depreciation for buildings (other than certain subsidized low-income housing). Generally, depreciation of realty would be limited to the straight-line method based on useful lives prescribed by the Treasury Department. An option would be provided for depreciation based on the actual decline in the fair market value of the building. Salvage value would be disregarded if depreciation is computed on the basis of the prescribed useful lives.

Effective date

The Administration proposal generally would be effective for buildings acquired after December 31, 1978. If construction begins before January 1, 1979, the proposed amendments would not apply if original use of a building begins with the taxpayer.

As described later, special transitional rules are to apply to subsidized low-income housing and multi-family housing.

Revenue effect

The Administration's proposals relating to real estate depreciation, including its proposal for the elimination of accelerated depreciation, would increase fiscal year budget receipts as follows:

[In millions of dollars; fiscal years]

1979	1980	1981	1982	1983
28	174	410	649	847

Members' Proposals

Mr. Martin

Mr. Martin proposes to allow rapid 5-year amortization for rehabilitation expenditures of certified historic structures for owner-occupied property which is not used in a trade or business or held for the production of rents.

Issues

The Administration states that accelerated methods of depreciation for real estate result in a much more rapid depreciation pattern than the actual economic depreciation pattern. They have, therefore, concluded that the use of accelerated methods of depreciation for realty is unjustified. The Administration states that accelerated depreciation for real estate is unjustified for several reasons. First, several Treasury studies indicate that accelerated depreciation for

real estate (or even straight-line depreciation) greatly exceeds economic depreciation of real estate.⁵ Second, the Administration states that the inappropriateness of accelerated methods of depreciation for buildings is clearly demonstrated by both the rates of return on equity investments in real property and the disparity between the implied rates of decline in building values and the lending practices of major financial institutions.

The Administration states that the proposed changes would help correct tax abuses without adverse impact on capital formation in real estate. The Administration states that the only projects which would not be built as a result of its proposal are those which are largely predicated on the marketing of tax losses. It is argued that these investments are socially wasteful and adversely affect the long-run health of real estate markets.

Similarly, the Congressional Budget Office has issued a report which concludes that direct subsidies are more efficient in stimulating the production of housing units than tax incentives.⁶ In addition, the Subcommittee on the City of the House Committee on Banking, Finance, and Urban Affairs has recommended more tax neutrality between new rental housing construction and in the preservation and rehabilitation of existing housing.⁷ This report indicates that more neutrality could be achieved if both types of rental housing were limited to straight-line depreciation.

The Joint Committee staff study for the Ways and Means Committee Task Force on Capital Formation (*Tax Policy and Capital Formation*) also concludes that straight-line depreciation is not a very accurate measurement of economic depreciation.⁸ However, this report also indicates that, when there is inflation, depreciation based on historical cost will result in depreciation deductions in dollars which are worth less than when the depreciable asset was purchased. The value of tax deferral through accelerated depreciation will tend to mitigate or offset this adverse effect of inflation on purchasing power if viewed in terms of depreciation funding for investment in new or replacement structures.

The Administration estimated that its proposals on methods of depreciation would result in increasing rents for housing (other than low-income housing) at 1.4 percent through 1982 and an additional 1 percent thereafter. Industry estimates presented to the committee indicate that the increase in rents would be about 2.1 percent at the outset.⁹ It is generally agreed that estimates of this kind are difficult to make.

Another issue that the committee may wish to consider in connection with its deliberation of real estate depreciation methods is the effect such methods may have on capital formation. In this

⁵ The conclusions of these Treasury studies are set forth at pp. 86-87 of the President's 1978 tax program (Jan. 30, 1978).

⁶ Congressional Budget Office, *Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives* (GPO, Washington, May, 1977).

⁷ *Federal Tax Policy and Urban Development*, 95th Cong., 1st Sess. 1977, p. 16.

⁸ Staff of the Joint Comm. on Taxation, *Tax Policy and Capital Formation*, 95th Cong., 1st Sess. (1977), p. 22.

⁹ Statement of the National Realty Committee on the Administration's Proposed Tax Reduction and Reform Act of 1978, submitted to the Committee on Ways and Means (March 15, 1978) p. 19.

connection, it is argued that not only is the aggregate amount of capital available for investment an important factor but so, also, is the capital recovery rate. Thus, one of the many factors that is considered in connection with the decision to invest capital into new capital facilities is the rate of capital recovery. Generally, if all other factors remain the same, capital will flow to that project where capital is recovered more quickly. The use of an accelerated method of depreciation, because it allows for a more rapid recovery of invested capital, will directly affect the decision to commit funds to build new facilities. Additionally, if invested capital is more quickly recovered, the amount of capital available for other opportunities that may be available also is increased.

Under the Administration's proposal, accelerated depreciation methods would be prohibited for industrial structures. It has been argued that inclusion of industrial structures would tend to offset to some extent the incentive effect of extending the investment credit to these structures. However, if accelerated depreciation changes were restricted to real property other than industrial structures it may be argued that definitional complexities could arise in targeting the application of the change only to nonindustrial structures.

Instead of eliminating accelerated depreciation altogether, the committee may wish to consider partially scaling down the accelerated methods available. For example, the committee may wish to consider reducing the 200-percent declining balance method for new residential rental property and the 150-percent declining balance method for other new real property to lower percentages. Such a reduction could be considered in connection with the extension of the investment credit to buildings to maintain the desired incentive for real property construction and investment.

Simplification and administrative aspects

A significant amount of simplification would result from the Administration's proposal in terms of applicability of the indirect methods used to cut down on the overuse or abuse of accelerated depreciation. For example, if accelerated depreciation for real property is eliminated, there would be no "excess" depreciation treated as a tax preference for minimum or maximum tax purposes and there would be no "excess" depreciation subject to the real property depreciation recapture provisions.

The Administration's proposal to eliminate accelerated depreciation methods for most depreciable real property would not result in a significant simplification of the mere computation of the depreciation allowable for a taxable year. Since accelerated depreciation would continue to be available for depreciable personal property, there would be some increased stress on definitional complexities where property had characteristics of both real and personal property.

B. Component Depreciation

Present Law

Under present law, a taxpayer may use the component depreciation method in depreciating a building. Under this depreciation method, a taxpayer allocates the cost of a building to its basic component parts and then assigns separate useful lives to those components. These components would include the basic building shell, plumbing and heating system, roof, and other identifiable components. Each of the component parts is then depreciated as a separate item of property. The component depreciation method may be applied to both new and used property.

Depreciation for a building which is claimed under the component method using straight-line rates may often approximate or exceed depreciation allowable under an accelerated method based on the useful life of the entire building. Straight-line depreciation under the component method is not treated as a tax preference for minimum tax purposes and is not subject to ordinary income recapture for depreciable real property even if the total deductions allowable approximate the amounts which would be allowable under an accelerated method for the entire building.

Background

The Internal Revenue Code does not specifically provide for the component depreciation method for real estate. However, under regulations adopted in 1956 (Treas. Reg. § 1.167(a)-7), assets may be grouped in an account in a variety of ways for depreciation purposes. As examples, the regulations authorize aggregating in a "group account" under which similar assets with approximately the same useful lives are included, a "classified account" under which assets are segregated according to use without regard to useful lives, or a "composite account" under which assets used in a trade or business are included without regard to character or useful lives. Under the regulations, these accounts may be further divided into subaccounts on the basis of cost, location, date of acquisition, character, or use.

In 1959, the Tax Court held that a partnership could compute its depreciation allowance under these Treasury regulations by segregating various items of equipment in new buildings into separate component groups and assigning estimated useful lives ranging from 10 to 40 years to each of the various component groups.¹⁰ The Tax Court held that the taxpayer could choose to use a component grouping method for computing depreciation and that the regulations authorized the component method. In 1960, the Internal Revenue Service acquiesced in the Tax Court case.¹¹

¹⁰ *Herbert Shainberg*, 33 TC 241 (1959).

¹¹ 1960-1 CB 5.

In 1966, the Internal Revenue Service ruled that, in the case of new real property, the taxpayer could allocate cost to the various components of an apartment building and compute depreciation by using the appropriate rate for each of the separate components.¹²

This ruling also stated that ordinarily the basis of used real property cannot be allocated into separate component accounts but an overall useful life for the building must be determined for the building as a whole. However, the courts have permitted the use of the component method for used buildings.¹³ If the component method is elected for used property, the cost of acquisition of the building must be properly allocated to the various components based on the components' value at the time of acquisition. The useful lives assigned to the components must be based on the condition of the components at acquisition (rather than when constructed), and the asset depreciation range class life system may not be elected.¹⁴ In addition, depreciation of the structural components of a used building is limited to the depreciation methods allowed for a used building.

Administration Proposal

Under the Administration proposal, the use of the component depreciation method for real estate would be prohibited for both new and used buildings.

Effective date

The Administration proposal would be effective for buildings acquired after December 31, 1978. In the case of construction begun prior to January 1, 1979, the new rules would not apply if the original use of the building begins with taxpayer.

Revenue effect

The Administration's proposals relating to real estate depreciation, including its proposal for the elimination of component method depreciation, would increase fiscal year budget receipts as follows:

[In millions of dollars; fiscal years]

1979	1980	1981	1982	1983
28	174	410	649	847

¹² Rev. Rul. 66-111, 1966-1 CB 46.

¹³ *Louis Lesser*, 42 TC 688 (1963), *acq.*, 1966-2 CB 5, *aff'd* 352 F. 2d 789 (9th Cir.) *cert. denied* 384 U.S. 927 (1966); Rev. Rul. 73-410, 1973-2 CB 53.

¹⁴ Rev. Rul. 73-410, 1973-2 CB 53.

Issues

The Administration is concerned that taxpayers utilizing the component depreciation method are allocating costs disproportionately to component parts with shorter lives, and then underestimating those useful lives.

For example, they contend that the longest lived component of a building is its structure or "shell." Taxpayers using the component method frequently assign a life to a building shell equal to the life the Treasury previously suggested for that type of building in Revenue Procedure 62-21 (e.g., 45 years for office buildings). However, these lives were composite lives; that is, they were averages of all building components of which the shell was only one. The shell life for the office building was determined to be 67 years (compared with the 45-year composite life). Treasury believes that it is inappropriate to use the shorter composite lives for shells. Since the shell of a building ordinarily accounts for approximately one-half of a building's cost, an underestimation of its useful life greatly accelerates depreciation deductions for a building.

In addition to assigning the lowest possible lives to a building's components, to further accelerate depreciation deductions, the Administration states that some taxpayers allocate disproportionately large portions of a building's cost to the shorter-lived components. For example, the Administration contends that it is common practice for an owner of a *new* building to assign the entire cost of the plumbing contract to a separate component called "plumbing," and then to assign a short life to that account on the ground that the fixtures will be replaced in a few years. However, a large part of the cost of installing plumbing in a building is associated with the permanent piping within the building which will have a useful life equal to the structure itself.

In support of its proposal, the Administration cites a sample of the many cases which have come to the attention of the Internal Revenue Service. (See Table 1.) The IRS sample shows that taxpayers are using component depreciation to claim unrealistically large deductions on the basis of unjustifiably short building lives. In most of these cases, the component depreciation method is much more generous than the statutorily allowed accelerated methods.

TABLE 1.—TREASURY EXAMPLES OF ABUSE OF THE COMPONENT METHOD OF REAL ESTATE DEPRECIATION

[In years]

Type of building	Approximate cost	Normal life estimated by IRS engineer	Composite life claimed by taxpayer under component method
Apartment-----	\$1, 200, 000	40	10
Apartment-----	1, 000, 000	40	15
Apartment-----	1, 000, 000	40	15
Apartment-----	981, 000	40	15
Apartment-----	1, 300, 000	40	15
Apartment-----	800, 000	40	20
Apartment-----	1, 000, 000	40	18
Office-----	635, 000	45	17
Office-----	375, 000	45	17
Industrial-----	130, 000	45	16
Industrial-----	65, 000	45	13
Industrial-----	31, 000	45	16
Industrial-----	31, 000	45	20
20 motels-----	35, 000, 000	35-40	24-27
Shopping center-----	1, 850, 000	40	20
Shopping center:			
1st phase-----	1, 900, 000	35-40	19
2d phase-----	6, 000, 000	35-40	16

Source: Secretary of the Treasury, Office of Tax Analysis, Jan. 24, 1978.

The Administration concludes that these abuses of the component depreciation method for real estate cannot be handled effectively by audit enforcement procedures. In an audit involving the depreciation claimed for a large building, the complexity of examining a very large number of components, frequently in excess of 100 items, makes it virtually impossible for the agent to thoroughly examine the accounts in the limited time available. The Administration states that a related audit problem is that many large buildings are owned by partnerships. A single taxpayer may be a member of several partnerships, which may also be partners in other partnerships. Thus,

examination of one tax return necessitates consideration of complex depreciation schedules for many large buildings.

The committee may wish to consider whether the component depreciation method can be effectively audited by the Internal Revenue Service. It can be argued that the method is too complex for effective audit and requires subjective judgments by both the taxpayer and the IRS engineers which leads to unnecessary disputes. Further, it can be argued that this encourages taxpayers to risk the "audit lottery", that is; to claim depreciation using unrealistically short useful lives in the hope that the return will not be selected for audit. On the other hand, it can be argued that if the component method is economically justified, it should be available.

On the other hand, it may be argued that the component method of depreciation is a proper method of determining the allowance for depreciation. Thus, it is argued that the component method of depreciation recognizes that component items do in fact have different useful lives. It is pointed out that the fact that certain building components depreciate more rapidly than other components has been recognized since 1942 when Bulletin F was promulgated setting forth various useful lives for building components. Further, it is argued that prohibition of the component method of depreciation may have an adverse effect on capital formation.

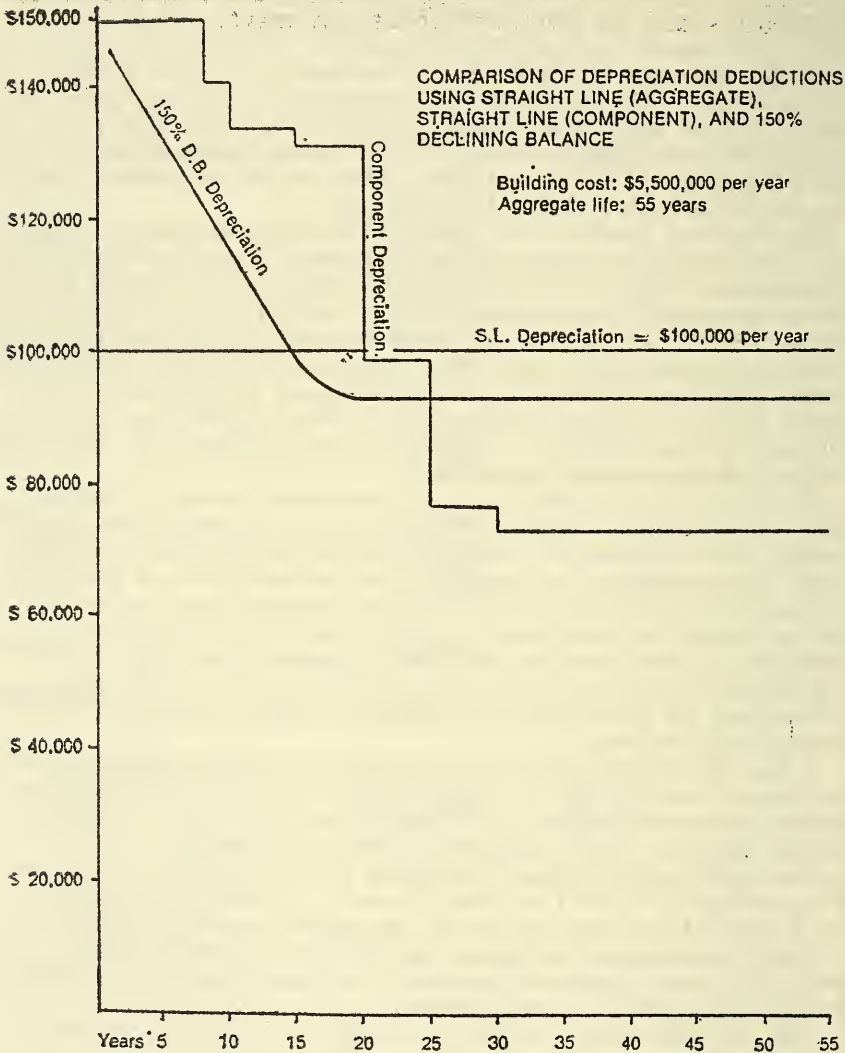
Finally, it can be argued that if the component method of depreciation is a justifiable method of capital recovery, it should not be prohibited merely because it may be somewhat complex and difficult to audit. For example, if a taxpayer does not elect to use the ADR system, but instead accounts for depreciable equipment on an item-by-item basis, the depreciation schedules generally will reflect as many items, if not more, as will be reflected on a depreciation schedule where the taxpayer uses the component method of depreciation. In this case, it is argued the same degree of complexity may be present as well as similar audit problems.

It may be argued that the rules relating to accelerated depreciation in excess of straight-line depreciation can be avoided through the use of the component method of depreciation. In a recent article, one author indicates that component depreciation can be a "cure" for excess depreciation without losing much of the depreciation allowable if an accelerated method had been chosen.¹⁵ If a building is depreciated on a straight-line rate under the component method, there is no "excess" depreciation preference for purposes of the minimum tax, ordinary income recapture, maximum tax provisions, or determining earnings and profits of a corporation.

The following table presents one author's illustration of the advantages of component method depreciation:

¹⁵ Tidwell, "Component Depreciation Can Be a 'Cure' for Excess Depreciation," 55 *Taxes* 116 (Feb. 1977).

TABLE 2. COMPARISON OF COMPONENT METHOD DEPRECIATION WITH 150-PERCENT DECLINING BALANCE METHOD¹



¹ In this example, the following assumptions were made:

Life Groups:	Percent of total cost
55 yr.....	72.9
30 yr.....	2.0
25 yr.....	9.9
20 yr.....	11.9
15 yr.....	0.7
10 yr.....	1.2
8 yr.....	1.4
Total.....	100.0

Source: Tidwell, "Component Depreciation Can Be a 'Cure' for Excess Depreciation," 55 Taxes 116 (Feb 1977).

Simplification and administrative aspects

The Administration's proposal to prohibit component method depreciation would contribute toward tax simplification by eliminating a source of controversy concerning the amounts allocable to various components, and the useful lives of the components.

C. Special Treatment for Low-Income and Multi-Family Housing

Present Law

Under present law, new residential rental property may be depreciated under the declining balance method at a rate of up to 200-percent of the straight-line rate, the sum of the years-digit method, or any other consistent method which does not result in the allowance of a greater aggregate amount during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method. Used residential rental housing may be depreciated under the declining balance at a rate of up to 125 percent of the straight-line rate if the property has a useful life of 20 years or more. Property is treated as residential rental property only if 80 percent or more of the gross rental income from the building or structure for the taxable year is rental income from dwelling units.

Under present law, special depreciation rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(k) of the Code). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income.¹⁶

Under the special depreciation rules for low-income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Under present law, only the aggregate rehabilitation expenditures as to any housing which does not exceed \$20,000 per dwelling unit qualifies for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed \$3,000 per dwelling unit.

For subsidized low-income rental housing, depreciation subject to recapture as ordinary income is phased out by one percentage point for each month the property is held for more than 100 months.

Background

The Tax Reform Act of 1969 for the first time placed certain limitations on the use of accelerated depreciation methods for real estate. Under that Act, depreciation on used residential housing (including multi-family residences) was limited to 125 percent of the straight-line rate. However, new residential housing (including multi-

¹⁶ Under current Treasury regulations, occupants of a dwelling unit are considered families and individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the income limits prescribed by the Secretary of Housing and Urban Development (HUD). The level of eligible income varies according to geographical area. The current income limits prescribed by the Secretary of HUD for family of four are \$22,500 in Washington, D.C., \$19,875 in Chicago, and \$17,375 in Los Angeles. Thus, 80 percent of these limits are \$18,000, \$15,900, and \$13,900, respectively.

family housing) continued to be eligible for declining balance depreciation at twice the straight-line rate.

The Tax Reform Act of 1969 for the first time provided the special 60-month depreciation rule for expenditures to rehabilitate low-income rental housing. Originally, this special rule was provided for a five-year period to terminate on January 1, 1975. Public Law 93-625 extended the termination date by one year, or to January 1, 1976.

The Tax Reform Act of 1976 provided another two-year extension, or until January 1, 1978, of the special 60-month depreciation rule for expenditures to rehabilitate low-income rental housing and increased the amount of rehabilitation expenditures that can be taken into account per dwelling unit from \$15,000 to \$20,000. Under the 1976 Act, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1978, would qualify for the 5-year depreciation rule even though the expenditures are actually made after December 31, 1977. Public Law 95-171 further extended the termination date to January 1, 1979.

In addition, the 1976 Act modified the definition of families and individuals of low and moderate income by providing that the eligible income limits are to be determined in a manner consistent with those presently established for the Leased Housing Program under Section 8 of the United States Housing Act of 1937, as amended.

The new rules under the 1976 Act providing for complete recapture of accelerated depreciation do not apply to four categories of low-income rental housing.¹⁷

Administration Proposal

Under the Administration proposal, low-income and new multi-family rental housing would not be limited to straight-line depreciation for buildings acquired before January 1, 1983. Until 1983, new low-income housing would be allowed a depreciation deduction based on the 200-percent declining balance method (or sum of the years-digits method) and new multi-family rental housing would be allowed a

¹⁷ These categories are (1) Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (specifically housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws); (2) low-income rental housing held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower income families; (3) low-income rental housing with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k) of the Code; and (4) Federally assisted housing with respect to which a loan is made or insured under title V of the Housing Act of 1949. As to these four categories of real property, all depreciation will be recaptured if the property has not been held for more than 12 months. However, if the property has been held for more than 12 months, no more than the excess depreciation over straight-line will be recaptured. For each month the property is held over 100 months, there will be a one percent per month reduction in the amount of accelerated depreciation attributable to periods after December 31, 1975, which is recaptured. Thus, after 200 months (16½ years) there will be no recapture.

Special rules similar to those discussed above are provided for Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws) where a portion of the gain from the sale or exchange of such property is subject to recapture under both the prior recapture rules and the new recapture rules.

depreciation deduction based on the 150-percent declining balance method. Until 1983, used low-income housing would continue to be depreciated on the 125-percent declining balance method.

After 1982, multi-family housing (and used low-income housing) would be limited to the straight-line method, and new low-income housing would be allowed a depreciation deduction based on the 150-percent declining balance method.

For purposes of these rules, low-income housing would be defined as it was most recently by the Congress in applying the special recapture rules (section 1250 of the Code). Rental housing would be defined by reference to section 167(j)(2)(B) of the Code; and multi-family dwellings would be multiple dwelling housing with more than four units.

In addition, taxpayers who own subsidized housing and elect to use the facts and circumstances test would not be permitted a depreciation deduction in any year which would decrease the basis of the property below its current fair market value.

No specific proposal was made by the Administration with respect to the treatment of rehabilitation expenditures for low-income housing.

Effective date

The Administration proposes that, in the case of used low-income and new multi-family housing, the limitation to the straight-line method of depreciation would be effective for buildings acquired after December 31, 1982. The limitation to the 150 percent declining balance method of depreciation for new low-income housing would also be effective for buildings acquired after December 31, 1982.

In the case of construction begun prior to January 1, 1983, the new rules would not apply if original use of the building begins with the taxpayer.

Revenue effect

The Administration's proposals relating to real estate depreciation, including its proposal for the treatment of low-income and multi-family housing, would increase fiscal year budget receipts as follows:

[In millions of dollars; fiscal years]

1979	1980	1981	1982	1983
28	174	410	649	847

Members' Proposals

Mr. Gephardt

Mr. Gephardt proposes to extend the special 5-year amortization provision for low-income rehabilitation expenditures for at least 2 years. If extended for 2 years, the provision would apply to expenditures made before January 1, 1981, or to expenditures made after that date if made pursuant to a binding contract entered into before January 1, 1981.

Issues

The Administration's proposal raises the issue of what special treatment should be provided for low-income and multi-family housing.

The committee also may wish to consider the extension of the special 5-year amortization provision for low-income rehabilitation expenditures. Under present law, the provision will expire on January 1, 1979. During the past few years, the provision has been extended for one or two-year periods and usually in the closing days of a Congressional session when it is about to terminate. Under these circumstances, it has been argued that the incentive effect is diluted and that a greater rehabilitation effort could be stimulated if the provision were either permanent or was effective for a longer period. It is argued that there is a relatively long lead-time involved in planning the purchase and rehabilitation of an existing project. As a result, the imminent termination of the provision every couple of years causes uncertainty in connection with such an undertaking. For this reason, it has been argued that the 5-year amortization provision should be made a permanent part of the tax law or extended for a relatively long period of time. If this is done, it is maintained that the Congress would get a better picture of the provision's effectiveness if reviewed after a longer period of time had elapsed.

D. Useful Lives

Present Law

Under present law, depreciation for real estate may be determined by estimating useful lives under a facts-and-circumstances test or under lives prescribed under Revenue Procedure 62-21, as in effect on December 31, 1970. Guideline lives under the class life asset depreciation range system (ADR) generally have not been prescribed for real property.

Under Revenue Procedure 62-21, the useful lives were prescribed for certain types of buildings. The useful lives were based on a composite account for the structural shell and all integral parts, including air-conditioning, fire prevention, and power requirements, and equipment such as elevators and escalators. The lives exclude special-purpose structures which are an integral part of a production process and are normally replaced when the equipment housed is replaced. The lives are set forth in Table 3.

TABLE 3.—GUIDELINE LIVES FOR CERTAIN BUILDINGS UNDER REVENUE PROCEDURE 62-21

Type of Building:	<i>Useful life (years)</i>
Apartment.....	40
Banks.....	50
Dwellings.....	45
Factories.....	45
Garages.....	45
Grain Elevators.....	60
Hotels.....	40
Loft Buildings.....	50
Machine Shops.....	45
Office Buildings.....	45
Stores.....	50
Theaters.....	40
Warehouses.....	60

Background

Prior to promulgation of Revenue Procedure 62-21, suggested useful lives were set forth in Bulletin F which had been issued in 1942. Bulletin F was superseded by Revenue Procedure 62-21. Appendix B sets forth the percentages recommended for various types of buildings under Bulletin F.

In 1962 the Internal Revenue Service adopted certain guideline lives for real property. (Rev. Proc. 62-21). However, the use of these guideline lives was not mandatory.

The Revenue Act of 1971 provided for a new unified system of class lives for depreciation purposes which may be elected by taxpayers for assets placed in service after 1970. (These new rules are

commonly referred to as the class life asset depreciation range system, or the ADR provisions.) A taxpayer which elects to determine the useful life of assets it acquires during a taxable year under this class life system generally must use this system for all eligible assets acquired during the year.

In the case of real estate, however, Congress in 1971 recognized that under the rules of the 1962 guidelines, taxpayers in many cases were permitted to depreciate real property over shorter lives than the guideline lives because of the particular facts relating to the taxpayer's particular use of property. If these taxpayers were, as a condition of electing the class life system, required to include the real property in the election, they would have been substantially and adversely affected since they would have had to use significantly longer lives for the real property than they had used in the past. In view of this, Congress in the 1971 Act provided a transitional rule for these taxpayers to enable them to elect the class life system for other assets while the Treasury Department studied the general matter of the appropriate lives for real property. As a result, in the case of real property placed in service during the 3-year period beginning on January 1, 1971, taxpayers who elect the class life system may exclude from the election real property in cases where for the first year a life shorter than the initially prescribed class life (which is to be the 1962 guideline life) is justified for the asset under the rules of the 1962 guidelines.

Since this statutory transitional period expired, the application of the class life system to real estate was to apply after 1973. However, the Treasury Department informed the Congress that it had not yet completed its study for providing a system for incorporating real estate into the ADR system and requested that the provision in the 1971 Act which applies the ADR system to real estate after 1973 be repealed. The Congress was concerned that the effect of bringing real estate into the ADR system before devising a satisfactory system would be to unfavorably disturb the remainder of the system. As a result, in 1974, the Congress repealed the provision requiring the application of the ADR system to real estate after 1973 (paragraph (1) of section 109(e) of the Revenue Act of 1971).

In the case of real property placed in service before class lives have been prescribed for real property, a taxpayer who has elected the ADR system may also elect to determine the useful life of depreciable real property under Revenue Procedure 62-21 as in effect on December 31, 1970 (to the extent the provisions of that revenue procedure are applicable to real estate), or on the basis of the facts and circumstances of the particular case.

Administration Proposal

Under the Administration proposal, the useful lives of various kinds of real estate would be established by Treasury guidelines.

As an alternative to using the average useful lives and straight-line method, a taxpayer would be able to elect to use a facts and circumstances test that would permit a depreciation deduction in any year sufficient to decrease the basis of the building to its fair market value as of the end of the year.

Once the facts and circumstances test is elected for a structure, the taxpayer would not be permitted to change to the guideline system.

Effective date

The Administration proposes that the amendments apply to buildings acquired after December 31, 1978. In the case of construction begun before January 1, 1979, the new rules would not apply if original use of the building begins with the taxpayer.

Revenue effect

The Administration's proposals relating to real estate depreciation, including its proposal relating to useful lives, would increase fiscal year budget receipts as follows:

[In millions of dollars; fiscal years]

1979	1980	1981	1982	1983
28	174	410	649	847

Issues

The Administration is concerned that taxpayers have been underestimating the useful lives of their buildings. To the extent a taxpayer underestimates the useful life of a building, the taxpayer overstates the depreciation allowance during the shorter life claimed, producing premature deductions. Moreover, the current procedure for determining useful lives fosters disputes between the Internal Revenue Service and the taxpayer. These disputes, involving basically factual issues, require both the taxpayer and the Government to devote substantial time, effort and expense to the determination of a mutually acceptable useful life. This may be particularly true in the case of a taxpayer using the component depreciation method because each identifiable component must be assigned a separate useful life. In addition, the Administration states that, in the absence of objective useful life guidelines for real estate, many higher income taxpayers are taking aggressive "tax return positions" in claiming useful lives far shorter, and salvage values much lower, than are justified by the facts and circumstances. It is argued that these taxpayers have little to lose by claiming short useful lives and low salvage values because the odds are that the taxpayer's return will not be audited, and even if audited, he can negotiate a mutually acceptable settlement.

A comparison prepared by the Department of Treasury to illustrate the differences in the 1962 Guideline lives and average lives claimed by taxpayers is set forth in Table 4. The proposed building guideline lives are set forth in Appendix A and are summarized in the following table.

TABLE 4.—COMPARISON OF 1962 GUIDELINES AND LIVES CLAIMED FOR CERTAIN BUILDING TYPES

[In years]

Building type	Guideline lives under revenue procedure 62-21	Average lives claimed by taxpayers (new buildings only)	Percentage of taxpayers claiming lives shorter than guideline lives	Selected proposed guideline lives
Retail (including shopping centers)-----	50	36	93	30-35
Warehouse-----	60	37	99	35-40
Factory-----	45	37	77	35
Apartment-----	40	32	78	30-35
Office-----	45	41	91	30-40
Bank-----	50	43	79	30-40

Source: Office of Industrial Economics, Department of the Treasury, *Business Building Statistics* (GPO, Washington, 1975).

The committee may wish to consider whether the proposed changes are flexible enough to provide tax equity. The proposed guidelines do not allow any deviation to take into account factors such as type of construction (frame, brick veneer, masonry, stone, etc.), location (useful lives would be the same for buildings in harsh climatic conditions as for buildings in other areas). It may be argued that depreciable real estate should be brought into the ADR system to provide greater flexibility through the permissible 20-percent deviation from the prescribed guideline life. It might also be argued that the alternative facts and circumstances test will provide any necessary flexibility. Further, it might be argued that the proposed useful lives are so short that there is no need to provide greater flexibility. (See Table 4.)

The committee may wish to consider that the alternative facts and circumstances test proposed by the Administration would represent a significant departure from existing depreciation concepts. Under present law, fluctuations of the fair market value of a building are generally not considered. As such, depreciation is allowable as a form of cost recovery reflecting the exhaustion, wear and tear resulting from the taxpayer's use of the property in his trade or business. Accordingly, the fact that a particular building may have a fair market value greater than the taxpayer's adjusted basis because it may be put to a higher or better use by that taxpayer or some other person is irrelevant under present law (except that it may have some bearing on the rate of obsolescence or the amount of salvage value.)

Simplification and administrative aspects

It would appear that promulgation of mandatory guideline lives for real property would contribute more to simplification than would occur if ADR guideline lives were prescribed under existing regulations

authority because there would be no election to be made in the typical case. The limited availability of the proposed facts and circumstances alternative (i.e., the fair market value limitation) would tend to encourage the use of the guideline lives and thereby minimize audit disputes. However, if the facts and circumstances test for actual decline in value were used, complexities and controversies over valuations asserted by taxpayers and the Internal Revenue Service could be as great as those arising with respect to the appropriate useful life for a building.

APPENDICES

APPENDIX A: TREASURY'S PROPOSED BUILDING GUIDELINE CLASSES
AND DEPRECIATION PERIODS

General

Two groups of classes are provided for buildings. The first group includes complete buildings. The appropriate class for a given building is determined by the predominant use of the building. However, certain types of buildings which are explicitly covered by other asset guideline classes (such as farm buildings, service stations, railroad station and office buildings, and telephone central office buildings) are not included in these classes. For these buildings, their ADR class lives will be used.

The second group of classes includes replacement building components. The appropriate class for a given component is determined by the type of component, without regard to the type of building of which it is a part.

Buildings—Complete

These classes include structural shells of buildings and all original components thereof, such as machinery and equipment that serves heating, plumbing, air-conditioning, illumination, fire prevention and power requirements; machinery and equipment for the movement of passengers and freight within buildings; interior partitions, both fixed and movable; floor and wall coverings, doors, windows, ceilings and other items of interior finish; and associated land improvements. (Land improvements which constitute the principal asset of a taxpayer in a given location, to which buildings are incidental, such as golf courses and race tracks, are not included.) These classes also include structural shells and all original components of building additions which expand the floor space of the existing buildings to which they pertain.

TYPES OF BUILDINGS

	Years
Office buildings (including bank buildings):	
Office buildings—three or fewer floors above ground.....	30
Office buildings—more than three floors above ground.....	40
Industrial buildings:	
Factories.—Includes all buildings directly related to manufacturing processes on contiguous parcels of land....	35
Repair garages and shops.—Includes all buildings housing equipment for repair of industrial machinery or vehicles (except those directly related to manufacturing processes, which are included in the factory building classification). Includes new car dealership buildings.....	30
Storage buildings:	
Warehouses.—Includes all buildings used for storage of consumer goods, machinery, raw materials, foodstuffs (except grain elevators), or finished manufactured goods..	35
Grain elevators.....	40

Retail buildings:

(Includes buildings in which goods, including prepared food, are sold to the public.)

Retail buildings.—Less than 50,000 square feet of indoor floor space on contiguous parcels of land..... 30

Retail buildings.—50,000 or more square feet of indoor floor space on contiguous parcels of land..... 35

Service buildings:

Theater buildings..... 35

Recreational services buildings (except stadiums and arenas)..... 30

Medical services buildings.—Includes nursing homes, hospitals, clinics, and physicians' and dentists' office buildings..... 35

Common carrier passenger terminals (except railroad stations)..... 25

Other service buildings.—Includes buildings in which other services are provided for the public, such as barber shop buildings, appliance repair buildings, laundry and dry cleaning buildings (except central laundry and dry cleaning plants, which are included in the factory classification), and photographic studios..... 30

Residential buildings:

Single-family and two-family dwellings..... 30

Apartment buildings—three or fewer floors above ground.. 30

Apartment buildings—more than three floors above ground.. 35

Hotels and motels—three or fewer floors above ground.... 30

Hotels and motels—more than three floors above ground... 35

Buildings—Replacement Components*General*

Includes all capitalized expenditures for building components for existing buildings (except roof coverings)..... 20

Roof covering

Includes felt and asphalt, corrugated metal, plastic, shingle, or other types of weather-proofing membranes..... 15

Used Property

The depreciation period for used buildings not older than 5 years will be the same as that for new buildings of the same class. The depreciation period for buildings older than 5 years but younger than 22 years will be the guideline life for new buildings of the same class less 1.5 percent of that guideline life for each year of the building's age in excess of 5 years. For buildings 22 years or older at the time of acquisition, the depreciation period will be 75 percent of the life for new buildings in that class. Useful lives computed under these rules will be rounded to the nearest half year. For example, if a taxpayer acquires a 20 year old building that had an original guideline life of 35 years, under the guideline life option the building will have a useful life of 27 years.

APPENDIX B: USEFUL LIVES OF CERTAIN BUILDINGS UNDER BULLETIN F

Buildings

The useful life of a building for business purposes depends to a large extent on the suitability of the structure to its use and location, its architectural quality, the rate of change in population, and the shifting of land values, as well as the extent of maintenance and rehabilitations.

The extent to which the equipment of a building, such as heating, plumbing, electrical wiring and fixtures, elevators, and other improvements, must be replaced is an important factor in determining the over-all rate of depreciation to be applied to the building and its equipment. Such a rate contemplates that the cost of new equipment will be capitalized, and that the cost of the equipment replaced will be charged to the depreciation reserve. In instances, however, where it is not feasible to determine the cost of the old equipment, the cost of the new equipment may be charged to the depreciation reserve. Where this method of accounting is followed and in the absence of special circumstances, the composite rates of depreciation set forth below are considered reasonable:

	Composite rate (percent) type of construction		
	Good	Average	Cheap
Apartments-----	2½	2½	3
Banks-----	2	2	2½
Dwellings-----	2	2½	3
Factories-----	2¼	2½	3
Farm buildings-----	2	2	2½
Garages-----	2	2½	3
Grain elevators-----	1½	2	2½
Hotels-----	2½	2½	3
Loft buildings-----	2	2	3
Machine shops-----	2	2½	3
Office buildings-----	2	2½	3
Stores-----	2	2	2½
Theaters-----	2½	3	3½
Warehouses-----	1½	2	2½

Where, however, the building equipment is set up as a separate account for depreciation purposes, the above composite rates are not applicable and the appropriate rate should be determined by reference to the list of useful lives indicated below, which are considered reasonable for buildings of standard or sound construction:

TOTAL LIFE (YEARS)

Apartments.....	50	Garages.....	60	Office buildings.....	67
Banks.....	67	Grain elevators.....	75	Stores.....	67
Dwellings.....	60	Hotels.....	50	Theaters.....	50
Factories.....	50	Loft buildings.....	67	Warehouses.....	75
Farm buildings.....	60	Machine shops.....	60		

Building Equipment

Useful lives for building equipment ranged from 10 to 25 years. Useful lives for some principal building components were:

	<i>Years</i>
Air conditioning—20 tons.....	20
Boiler.....	20
Asbestos insulation.....	15
Plumbing—	
Lavatories, etc.....	25
Iron cold water pipes.....	25
Iron hot water pipes.....	20
Asphalt roofs.....	15