[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON OCTOBER 22, 1979

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

OCTOBER 18, 1979

U.S. GOVERNMENT PRINTING OFFICE
52-299 O WASHINGTON : 1979 JCS-41-79

CONTENTS

INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on October 22, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

The pamphlet first briefly summarizes the bills. This is followed by a discussion of each bill, setting forth present law, the issues involved, an explanation of the bill provisions, the effective dates, and, where available, the estimated revenue effects. The summary and description of the bills are in the numerical order of the bills listed for the hearing.

The bills described in the pamphlet are:

(1) S. 1021 (relating to optional taxation of interest paid on State and local bonds);

(2) S. 1078 (relating to taxation of artists);

(3) S. 1435 (relating to cost recovery for depreciable assets); and

(4) S. 1467 (relating to method of accounting for railroad track assets).

I. SUMMARY

1. S. 1021—Senator Danforth

Bondholder Taxable Bond Option and Credit

Under present law, interest received on obligations of State and local governments is generally exempt from Federal tax. Special exceptions and limitations apply to industrial development bonds and arbitrage bonds.

Under the bill, a taxpayer could elect to include interest received on a State or local government obligation in gross income. If taxable treatment is elected, the amount includible in gross income would be 167 percent of the interest received and a credit against tax would be allowed for an amount equal to 67 percent of the interest actually received. The rate of the credit generally provides the same benefit as a tax exemption provides for a taxpayer in the 40-percent tax bracket and a greater benefit for a taxpayer in a bracket below the 40-percent bracket.

2. S. 1078—Senators Javits, Goldwater, Domenici, Williams and Pell

Artists Tax Equity Act of 1979

This bill would provide several changes in Federal taxation of income and estates to benefit artists and their heirs.

Present law does not allow in-kind payment of Federal taxes. This bill would provide a credit against artists' estate tax liabilities for certain transfers of artists' work to the Federal Government.

The bill would allow artists to claim a 30-percent income tax credit for contributions of their own works to charitable organizations and certain United States government entities.

The bill also would liberalize the "hobby loss" rules for artists. The bill would double the present law five-year base period, so that artistic activity would be presumed engaged in for profit, if gross income from the creation of artworks exceeds deductions attributable to that activity for two or more of ten consecutive taxable years, unless the Internal Revenue Service can establish the contrary.

In addition, the pre-1976 capital gain treatment on the sale or exchange of certain artworks inherited from the artist would be restored.

3. S. 1435—Senators Nelson, Bentsen, Packwood, and Chafee

Capital Cost Recovery Act of 1979

For most depreciable assets, the Capital Cost Recovery Act of 1979 would replace existing depreciation rules with a system which provides an accelerated method of depreciation and useful lives which are generally substantially shorter than present useful lives for most eligible depreciable real and personal property (although the lives of some items of personal property would be lengthened). The bill would generally permit a 10-year writeoff for plants and buildings (other than residential real estate), a 5-year writeoff for machinery and equipment, and a 3-year writeoff for a limited amount of investment in automobiles and light trucks. In general, the bill would allow accelerated deductions in the early years of the recovery period, roughly equivalent to using double declining balance depreciation for the first few years and then switching to sum-of-the-years'-digits depreciation. This system of accelerated deductions would apply to both new and used property. Also, the period over which the cost of an asset could be recovered would begin with the earlier of the year in which such costs are paid or incurred or the year in which the asset is placed in service (rather than only with the year in which the asset is placed in service, as under current law). The bill contains transitional rules to phase-in the application of the 10-year and 5-year writeoffs (in certain cases) over the period 1980–1983 so that the provisions would not be fully effective until 1984.

The bill also would shorten the useful life requirement for eligibility for the full 10-percent investment credit from 7 years to 5 years and would provide that assets qualifying for a 3-year writeoff would be eligible for a 6-percent investment credit (instead of a 3⅓ percent credit under existing law). The rules for the recapture of investment credit also would be liberalized.

Under the bill, the depreciation recapture rules for real estate covered by the new provisions would be revised to provide for a recapture of all depreciation (rather than only accelerated depreciation) upon sale or other disposition. The bill also would revise the "add-on" minimum tax so that, in the case of real property subject to the new rules, the tax preference for accelerated depreciation on real property would apply only to leased property.

4. S. 1467—Senators Dole and Bentsen

Method of Accounting for Railroad Track Assets

Under present law, the Internal Revenue Service allows the railroad industry to use the retirement-replacement-betterment (RRB) method of accounting for railroad track assets, which is the same method required for these assets by the Interstate Commerce Commission. Under the RRB method, when a new railroad line is laid, the costs (for rail, ties, ballast, fasteners, and labor) are capitalized, and these costs are not depreciated, but when replacements are made to an existing line, the replacement costs are deducted currently.

The RRB method is not codified as part of the Internal Revenue Code, but is recognized as an acceptable method in court decisions and Internal Revenue Service rulings. The bill would codify the RRB method, effective for taxable years ending after December 31, 1953.

II. DESCRIPTION OF BILLS

1. S. 1021—Senator Danforth

Bondholder Taxable Bond Option and Credit

Present law

Present law provides that interest on State and local obligations is generally exempt from Federal tax. However, with certain exceptions, tax-exempt status is denied to industrial development bonds (sec. 103(b) of the Code) and arbitrage bonds (sec. 103(c) of the Code).

Background

From the viewpoint of State and local governments which must attract the individual investor into the tax-exempt market, interest yields on tax-exempt issues must rise until they are equal to the yield after taxes on comparable risk taxable investments, e.g., corporate bonds. Individual taxpayers in the 70-percent marginal tax bracket, for example, would find that a tax-exempt bond yield which is 30 percent of a taxable bond yield is equal to the after-tax yield on the taxable bond. For an individual in the 50-percent marginal tax bracket, the ratio must be at least 50 percent, and the ratio must be 72 percent for a taxpayer in the 28-percent bracket.

Because there are relatively few persons in the highest marginal tax bracket,[1] the increasing volume of tax-exempt issues makes it necessary for State and local governments to increase the yield on tax-exempt issues relative to taxable corporate issues substantially above the 30-percent ratio in order to attract additional investors. The higher yield on tax-exempt bonds, relative to the after-tax yields on taxable issues, attracts some of the more numerous taxpayers in lower marginal tax brackets who then find tax-exempt issues desirable investments at these higher interest rates.

As this happens, the differential between tax-exempt and taxable bonds is reduced, and higher tax-bracket investors can be viewed as receiving a "bonus" return since they would hold tax-exempt bonds even at a lower rate of interest. The amount of the bonus is the difference between the interest yield that would be sufficient to stimulate the purchase of a tax-exempt issue by a high-bracket taxpayer and the higher current market interest yield that is necessary to bring the additional investors from lower tax rate brackets into the tax-exempt bond market. The greater the difference between the current market interest rate and the interest rate which would just induce an investor to purchase tax-exempt issues, the greater is the bonus return to the investor in high marginal tax brackets.

---

[1] The highest marginal tax rate for individuals presently is 70 percent. For corporations, the highest marginal tax rate is 46 percent. The analysis for both tax structures is identical.

As a result of this bonus, it has been argued that the cost to the Federal Government in foregone tax revenue substantially exceeds the resulting reduction in the borrowing costs of State and local governments.

Issue

The issue is whether a bondholder taxable bond option and credit should be enacted to attract investments by taxpayers (whose income is subject to a marginal tax rate of less than 40 percent) and tax-exempt organizations and thereby broaden the tax-exempt bond market.

Explanation of bill

General

Under the bill, holders of certain tax-exempt bonds would be given an election either (1) to exclude from gross income the interest on the empt organizations and thereby broaden the tax-exempt bond market. tax-exempt bonds as under present law, or (2) to include in gross income 167 percent of such interest and claim a tax credit equal to 67 percent of the amount of the tax-exempt interest on the bond. The 67-percent rate for the credit generally provides a bondholder in the 40-percent tax bracket, who elects the credit, the same tax benefit as tax exemption provides.

The bill also makes the election available to shareholders of regulated investment companies with respect to exempt interest dividends attributable to interest on certain tax-exempt obligations.

The bill would not affect the method in which tax-exempt bonds are issued and would not subject issues of tax-exempt bonds to any additional regulation by the Department of the Treasury.

Under the bill, any U.S. person would be eligible to make the bondholder election. Thus, tax-exempt organizations (such as charities and qualified pension and profit sharing plans) also would be eligible for the bondholder election. Generally, the credit would be refundable for organizations exempt from the Federal income tax (such as charities and qualified pension and profit sharing plans) and would be nonrefundable for others.

In general, all obligations issued after the effective date which, under present law, would be exempt from tax under the Internal Revenue Code would be eligible for the bondholder election. This includes general obligation bonds, revenue bonds, and short-term obligations such as tax anticipation notes. However, industrial development bonds, as that term is presently defined in the Internal Revenue Code, are not to be eligible for the election even if those bonds are eligible for tax exemption under the Code.

In addition, any obligation which is held by a related entity if the obligation is not issued pursuant to a public underwriting would not be eligible for the election.

The bill establishes two tests to define a public underwriting. First, competitive bids for the rights to sell the obligation to the general public must be solicited from independent parties, such as underwriters. Second, 25 percent or more of the obligations sold must be acquired by persons which are not related entities.

The bill defines related entities to include, in the case of obligations of either a State or a municipality of that State, that State and any political subdivision of that State. In the case of obligations issued by an instrumentality of two or more States, all of the States involved and political subdivisions within those States are considered to be related entities to the instrumentality. Under this provision, any agency or instrumentality of a State or political subdivision (including any trust or plan for the benefit of the employees of a State or political subdivision) is treated as part of the State or political subdivision. Thus, a municipality's pension fund is a related entity of that municipality, of all other municipalities in that State and of that State government.

Regulated investment companies and certain other entities

Under present law, mutual funds may, under certain circumstances, distribute to their shareholders dividends which are excludible from gross income, but only to the extent of the amount of the mutual fund's interest income which is excluded from gross income under 103(a). The bill provides that mutual funds may elect the credit with respect to qualified tax-exempt interest to the extent that it is not attributable to amounts designated as exempt-interest dividends. The treatment of certain other entities, such as subchapter S corporations, partnerships, estates and trusts is to be determined pursuant to regulations prescribed by the Secretary.

Time and manner of making election

The election to claim the credit is to be made with the Federal income tax return filed for the taxable year in which the interest or dividend is received. The bondholder may make the election to include the tax-exempt interest in gross income for one year and to exclude the interest on the bond for another taxable year. In addition, an election once made for a taxable year may be changed at any time before expiration of the period for making a claim for a credit or refund.

Interest on indebtedness incurred to hold municipal bonds

The bill also provides that interest or expenses paid or incurred in order to purchase or carry any tax-exempt bond for which an election is made remains subject to the interest disallowance rules (sec. 265), and other rules which apply to tax-exempt income.

Effective date

This provision would apply to tax-exempt bonds issued after December 31, 1979. Any refunding of an ineligible obligation will also be ineligible for the election.

Revenue effect

It is estimated that the bill would reduce budget receipts by $6 million in fiscal year 1980, by $74 million in fiscal year 1981, by $244 million in fiscal year 1982, by $403 million in fiscal year 1983, and by $526 million in fiscal year 1984.

Prior Congressional action

The provisions of this bill were included as a Senate Finance Committee amendment to the Revenue Act of 1978 (sec. 336 of H.R. 13511). The amendment was deleted from the bill on the Senate floor to provide additional time to evaluate the proposal.

2. S. 1078—Senators Javits, Goldwater, Domenici, Williams, and Pell

Artists Tax Equity Act of 1979

This bill would amend the Internal Revenue Code to make several changes in Federal taxation of income and estates to benefit artists and their heirs.

A. Artists Estate Tax Credit

Present law

Under present law, the Secretary of the Treasury may accept legal tender checks or money orders in payment of an estate tax liability. There is no provision authorizing the Secretary of the Treasury to accept other forms of payments, such as the conveyance of real or personal property.[1]

Issue

The issue is whether artists' estates should be allowed a credit against the Federal estate tax for the fair market value of artworks transferred to the Federal Government or the Smithsonian Institution.

Explanation of provision

Under the bill, a credit would be allowed against the Federal estate tax liability of an artist's estate for certain transfers of artworks to the Federal Government. Qualifying property would be literary, musical, or artistic property, or similar property, which is included in the gross estate of the artist who created the property. The property would be required to be transferred without restrictions to a Branch or Department of the Federal Government or to the Smithsonian Institution. The bill would require that property be transferred and accepted for the purpose of making it available to the general public.

In order to insure that credit be allowed only for property of artistic merit and that the property be available to the general public, the bill would require the recipient of the property to sign a statement attesting that the property has artistic, musical, or literary significance and that the recipient will make it available to the public.

The amount of the credit allowed under the bill would be equal to the fair market value of the property transferred, determined as of the valuation date used for Federal estate tax purposes. The credit would reduce Federal estate tax liability on a dollar-for-dollar basis. However, no amount of the credit would be refundable. The bill provides that interest would accrue if the property is not transferred expeditiously.

---

[1] Under section 2010 of the Tax Reform Act of 1976, the Secretary of the Treasury was authorized to accept conveyance of real property bordering the Toiyabe National Forest as payment of estate tax imposed on the estate of La Vere Redfield.

The bill also contains an "anti-double dipping" rule to disallow a credit or deduction with respect to the transferred property under any other Code provision, if the estate tax credit is claimed. The bill would allow Governmental units which receive creditable transfers of property to accept the property without making reimbursement or payment to the Treasury for the estate tax liability offset by the transfer.

Revenue effect

It is estimated that this provision will reduce budget receipts by $5 million annually.

B. Artists Income Tax Credit

Present law

Present law allows taxpayers an income tax deduction for contributions of property to charitable organizations. Generally, the amount deductible for contributions of ordinary income property is limited to the donor's adjusted basis. Correspondingly, artists who donate their own works to a charity may claim a deduction equal to the cost of the materials used in the creation of the work. Generally, donors, other than the creators of the donated artwork, may claim an income tax deduction equal to the fair market value of the donated work. However, if the use of the artwork by the charity is unrelated to its exempt function, the amount taken into account as a charitable contribution by an individual donor is reduced by 40 percent of the unrealized appreciation in the artwork. In addition, this reduction is made in the case of contributions of appreciated artwork to certain private foundations. Similiar rules apply to charitable transfers of appreciated property by corporate taxpayers.

Issue

The issue is whether income tax deductions claimed by artists for charitable contributions of their own works should be treated in the same manner as contributions of other ordinary income property, and thus limited to the artists' costs for materials used in the work, or should be treated differently.

Explanation of provision

The bill would provide a nonrefundable income tax credit equal to 30 percent of the fair market value of literary, musical, or artistic compositions which were created by the artist's personal efforts and which the artist contributes to a charitable organization or to Federal, State, or local governments.

No credit would be allowed for contributions in excess of $35,000 in any year. The credit would be limited to 50 percent of the artist's income tax liability for the year, unless the liability is less than $2,500, in which case the credit would be available up to the full amount of the liability. A taxpayer would be allowed to carry forward any credits in excess of these limitations for the 5 years succeeding the taxable year. No credit would be allowed for Federal, State, or local government officials' contributions of official papers, memoranda, or similar property, prepared in connection with the performance of their duties of office.

In order to claim a credit for a contribution, the taxpayer must obtain from the donee a written statement that the donated property represents material of artistic, musical, or literary significance and that the donee's use of the property will be related to the donee's exempt purpose. No income tax deduction would be allowed with respect to any contribution for which this credit is claimed.

Revenue effect

It is estimated that this provision will reduce budget receipts by $10 million annually.

C. Ten-Year Hobby Loss Base

Present law

A taxpayer may not claim deductions for losses arising from activities not engaged in for profit. Under Code section 183(d), a taxpayer is presumed to be engaged in an activity for profit for the current taxable year if, in two or more years of the period of five consecutive taxable years ending with the current taxable year, the activity was carried on at a profit.[2] If the presumption applies, the burden of establishing that the activity was not engaged in for profit shifts to the Internal Revenue Service.

Issue

The issue is whether an artist should be allowed a base period longer than 5 years for establishing that the artist's creation of artworks is engaged in for profit.

Explanation of provision

The bill would liberalize the presumption under Code section 183(d) by doubling the base period. The bill would provide that, if gross income from the creation of literary, musical, or artistic property, or similar property, for 2 or more taxable years during a period of 10 consecutive taxable years exceeds deductions attributable to the activity, the activity would be presumed to be engaged in for profit, unless the Internal Revenue Service can establish to the contrary.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

D. Capital Gain Treatment for Inherited Artworks

Present law

Prior to the estate and gift tax changes made by the Tax Reform Act of 1976, gain from the sale or exchange of a copyright, literary, musical, or artistic composition, letter or memoranda, and similar property which had been inherited from the artist who created the property was taxed as a capital gain. Under the carryover basis rules adopted by the Tax Reform Act of 1976, such inherited property will be excluded from the definition of a "capital asset" because its basis was determined by reference to (carried over from) the decedent's basis.

---

[2] In the case of an activity consisting primarily of breeding, training, showing or racing horses, the test is made on the basis of a 7-year period rather than the 5-year period.

Presently, the carryover basis rules are scheduled to apply to property passing from a decedent dying after December 31, 1979.

Issue

The issue is whether an artwork, which is inherited from the artist who created it and which is carryover basis property, should be treated as capital gain or ordinary income property when held by the artist's heir.

Explanation of provision

The bill would classify copyrights, literary, musical, or artistic compositions, letters or memoranda, and similar property as capital assets if held by a heir of a taxpayer who created the property or in the case of a letter or memorandum or similar property, if held by a heir of the taxpayer for whom the property was prepared or produced.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

E. Effective Date of Bill

All provisions of the bill would apply to taxable years beginning after December 31, 1978. (The amendment relating to capital gain treatment for inherited artworks would only affect property passing from decedents dying after 1979 since the carryover basis rule does not apply before then.)

3. S. 1435—Senators Nelson, Bentsen, Packwood, and Chafee

Capital Cost Recovery Act of 1979

PRESENT LAW

A. Depreciation

Depreciation in general

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, decay or decline from natural causes, exhaustion and obsolescence,[1] the adjusted basis (less salvage value in excess of 10 percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use.[2] This approach to the recovery of the basis of an asset is referred to as depreciation.

Depreciation of personal property

For new tangible personal property with a useful life of 3 years or more, the accelerated methods allowed include the 200-percent declining balance method, 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 (e.g., methods based on units of production, machine time, etc.). Administrative practice has permitted the 150-percent declining balance method to be used for used tangible personal property.[3]

The key factors which determine the amount and the timing of depreciation deductions with respect to any depreciable asset are: (1) the cost of the asset; (2) the salvage value of the asset; (3) the useful life assigned to the asset; and (4) the method of depreciation (e.g., straight line or an accelerated method). Since determinations of the first three of these factors are essentially factual and are based on cir-

---

[1] If the asset is not subject to these factors, depreciation is not allowable. For example, land is not depreciable.

[2] In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, five-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

[3] Rev. Rul. 57-352, 1957-2 C.B. 150; Rev. Rul. 59-389, 1959-2 C.B. 89.

Accelerated methods are not allowed for intangible assets (sec. 167(c)).

cumstances which may be unique to the taxpayer's situation, many controversies arise between taxpayers and the Internal Revenue Service on appropriate useful lives and salvage values. Thus, a major purpose for establishing the ADR system was to reduce the controversies relating to useful lives and salvage values for certain types of property. Similarly, a repair allowance system was provided to reduce controversies over the classification of expenditures as currently deductible repairs or as capital improvements.

ADR System

In general

The regular rules relating to allowable methods of depreciation generally are applicable under the ADR system. However, in the case of new tangible personal property with a useful life of three years or more, a taxpayer who elects ADR may only select the straight-line, declining balance (up to 200 percent), or sum-of-the-years-digits methods. For used depreciable personal property, accelerated depreciation is limited to the 150-percent declining balance method, i.e., 150 percent of the straight-line rate.

Election

A taxpayer must make an irrevocable election to apply the provisions of the ADR system to eligible property placed in service during the taxable year. This election is applicable to all eligible assets placed in service during the taxable year and is effective as to those assets for all subsequent taxable years. This election must be made on Form 4832 and filed with the taxpayer's income tax return for each year that application of the ADR system is elected. If, in a subsequent taxable year, the taxpayer does not elect to apply the ADR system, the regular rules regarding depreciation will be applicable to any depreciable assets placed in service during that taxable year. A valid election to apply the ADR provisions must contain the taxpayer's consent to comply with all of the ADR requirements and must specify certain information (for example, the asset guideline class and the first-year convention adopted by the taxpayer for the taxable year of election). In addition, the taxpayer must maintain books and records from which certain specific information can be drawn (for example, the depreciation period and salvage value for each vintage account established for the taxable year and each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance). Also, taxpayers who elect the ADR provisions must respond to infrequent data surveys conducted by the Treasury Department.[4]

Eligible property

An ADR election applies only to eligible property. Generally, eligible property is new or used depreciable property for which an asset

[4] The information reporting requirements for an electing taxpayer were reduced and simplified by the Treasury Department on January 26, 1979 (Treas. Reg. § 1.167(a)-11, as amended by T.D. 7593, 44 Fed. Reg. 5419). In general, much of the information which was required on IRS form 4832 is no longer automatically required to be submitted. Instead, the books and records of the taxpaper must be maintained so that such information is readily available, and if the Treasury Department surveys the taxpayer, the information called for must be submitted on the survey request.

guideline class and an asset guideline period have been prescribed by the Treasury Department for the taxable year of election. If used property constitutes a significant portion of the property placed in service during a taxable year (10 percent), a taxpayer may elect to apply the ADR system only to new property.

Presently, with certain very limited exceptions, the ADR system does not apply to depreciable real property. Until class lives under the ADR system are prescribed for real estate, a taxpayer who has elected the ADR system may elect to determine the useful life of depreciable real property under Revenue Procedure 62–21 (which reflects the prior general IRS position on useful lives) as in effect on December 31, 1970, or on the basis of the facts and circumstances of the particular case.[5]

Vintage accounts

Under the ADR system, the allowance for depreciation is computed on the adjusted basis of the assets grouped together in a vintage account. The vintage of the account refers to the taxable year during which the eligible property is first placed in service. Each eligible property may be placed in a separate vintage account or, under certain circumstances, assets in the same guideline class may be placed in the same vintage account. However, new and used eligible property may not be combined in a single vintage account. Certain other property also may not be combined in a single vintage account, e.g., property eligible for additional first-year depreciation may not be combined with ineligible property.

Certain special rules have been provided to account for ordinary and extraordinary retirement of assets in a vintage account. Likewise, special rules are provided in connection with the recognition of gain or loss on retirements.

Useful lives and asset guidelines class

In general, the estimated useful life of assets in each asset guideline class is established by the Office of Industrial Economics of the Treasury Department. Each asset guideline class consists of a category of assets that have certain common characteristics or that are utilized in the same or related activities. Generally, a class life is established to reflect the actual asset replacement practices being employed by taxpayers and other factors, such as obsolescence. The taxpayer may use a depreciation life within a range (asset depreciation range) of 20 percent below or above the predetermined life of the asset guideline class. For example, if the asset guideline period for a certain asset guideline class is 10 years, the taxpayer may elect a useful life with respect to assets in that guideline class that is not less than 8 years (20 percent below the asset guideline period) nor more than 12 years (20 percent above the asset guideline period). Under the ADR system, there are 14 asset classes for specific categories of depreciable assets. These categories apply to assets of specific types (e.g., automobiles) regardless of the type of business in which the assets are used. There are also approximately 118 classes (or subclasses) of depreciable assets grouped by the type of activity in which the assets are used. Table 1 illustrates the useful lives of a limited number of asset classes under ADR.

[5] Section 5 of Public Law 93–625.

TABLE 1.—ADR USEFUL LIVES OF VARIOUS ASSETS

Description of assets in guideline class	Asset depreciation range (in years) Lower limit	Asset guideline period	Upper limit
Certain short-lived assets:			
Manufacture of fabricated metal products—special tools	2.5	3	3.5
Manufacture of motor vehicles—special tools	2.5	3	3.5
Breeding hogs	2.5	3	3.5
Manufacture of electrical equipment—special tools	4.0	5	6.0
Certain intermediate-lived assets:			
Data handling equipment except computers	5.0	6	7.0
Assets used in drilling of oil and gas wells	5.0	6	7.0
Manufacture of electronic products	6.5	8	9.5
Certain long-lived assets:			
Railroad cars and locomotives, except those owned by railroad transportation companies	12.0	15	18.0
Vessels, barges, tugs and similar water transportation equipment, except those used in marine contract construction	14.5	18	21.5
Industrial steam and electric generation and/or distribution systems	17.5	22	26.5
Telephone central office equipment	16.0	20	24.0

Source: Revenue Procedure 77–10, 1977–1 C.B. 548, as modified by Rev. Proc. 79–26, 1979–18 I.R.B. 21.

"*Half-year convention*" *rules*

Under the ADR system, two alternative conventions are provided for purposes of determining depreciation for the year during which property is first placed in service. First, the "modified half-year convention" provides that depreciation for a full year is allowed for all eligible property placed in service during the first half of the taxable year. All other eligible property will be treated as being placed in service on the first day of the next taxable year. Second, the "half-year convention" provides that depreciation is allowable for a half-year for all eligible property placed in service during the taxable year. The same convention must be used for all vintage accounts of the same taxable year but may be changed as to vintage accounts of subsequent taxable years.

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to depreciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain. Thus, if salvage value is less than 10 percent, it may be ignored. The salvage value of each vintage account must be estimated by the taxpayer at the time of electing the ADR system for assets placed in service for a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

Treatment of repairs, maintenance, etc.

Under present law, the characterization of certain expenditures for the repair, maintenance, rehabilitation or improvement of property is a factual determination. If these expenditures substantially prolong the life of an asset or are made to increase its value or adapt it to another use, the expenditures are capital in nature and are recoverable in the same manner as the cost of a capital asset. All other expenditures for repair, maintenance, etc., are allowed as a deduction during the taxable year in which paid or incurred.

If a taxpayer elects to apply the ADR provisions, the taxpayer may make a further election to apply the provisions of the asset guideline class "repair allowance." Under these provisions, a taxpayer is allowed a current deduction for amounts paid or incurred for certain repairs, maintenance and similar expenditures to the extent that the expenditures do not exceed, in general, the average unadjusted basis of all repair allowance property multiplied by the repair allowance percentage. "Repair allowance property" is eligible property in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The repair allowance percentage is a predetermined rate established for each asset guideline class. Property improvements (including the amount of repairs, maintenance, etc., in excess of the asset repair allowance) and excluded additions are capitalized in a special basis vintage account, subject to the ADR rules. If a taxpayer does not elect to use the asset guidelines class repair allowance for assets in an asset guideline class, the regular rules regarding the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of property are applicable. If the repair allowance is elected, the taxpayer must maintain books and records to identify repair expenditures relating to specific classes of property, to allocate to specific classes of property the expenditures relating to properties in two or more classes, and to identify expenditures for excluded additions, e.g., expenditures which are clearly for capital items.

Recognition of gain or loss on retirement

In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable personal property. Thus, under normal tax rules, each retirement of depreciable personal property (coupled with a sale, exchange, or abandonment) would result in current recognition of gain or loss.

Under the ADR system, recognition of gain or loss may be postponed for "ordinary retirements" of assets included in a vintage account, i.e., retirements occurring for routine causes during the range of years selected for the account. In this case, the proceeds from the retirement are added to the depreciation reserve of the vintage account. However, in the case of an "extraordinary retirement," any gain or loss resulting from the retirement is recognized. (The characterization of gain or loss is governed by the normal rules relating to depreciation recapture and gain or loss on property used in a trade or business (secs. 1231 and 1245).) For this purpose, an extraordinary retirement would include a retirement attributable to an insured casualty.

Depreciation of real property

Accelerated methods

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, in some cases, the cost of an 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 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 and qualified rehabilitation expenditures for certified historic structures, 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.

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.

Useful lives

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, useful lives are prescribed for certain types of buildings. The useful lives are 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 2.

TABLE 2.—GUIDELINE LIVES FOR THE CERTAIN BUILDINGS UNDER REVENUE PROCEDURE 62–21

Type of Building	Useful life (years)
Apartments	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

Generally, as indicated in Table 3, taxpayers have claimed useful lives that are shorter than those listed in Rev. Proc. 62–21.

TABLE 3.—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
Retail (including shopping centers)	50	36	93
Warehouses	60	37	99
Factories	45	37	77
Office buildings	45	41	91
Banks	50	43	79
Apartments	40	32	78

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

Furthermore, by use of the component depreciation method, some taxpayers have claimed depreciation deductions which approximate the deductions which would be obtained by the use of composite lives of as short as 16–20 years on certain new commercial buildings.[6] However, there is no certainty that these deductions would be allowed by IRS or the courts.

Other rules relating to depreciation

Additional first-year depreciation

Under present law, the provision for additional first-year depreciation (sec. 179) permits an owner of tangible personal property with a useful life of six years or more to elect, for the first year the property is subject to depreciation, a deduction for additional first-year depreciation in an amount not exceeding 20 percent of the cost of the property. The cost of the property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return).[7] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

[6] 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.

[7] In the case of depreciable property owned by a partnership, the $10,000 limitation is applied at both the partnership level and the partner level.

Recapture

Under present law, with certain limited exceptions, gain from the disposition of depreciable personal property (and certain other property—generally property which is eligible for the investment credit) is "recaptured" as ordinary income to the extent of the depreciation taken (sec. 1245). Gain in excess of the depreciation taken may be treated as capital gain under section 1231 (unless the gain is aggregated with losses on sec. 1231 assets).

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.

Accelerated depreciation and the minimum tax

Under present law, a 15-percent minimum tax is imposed on the amount of a taxpayer's tax preferences in excess of the greater of (1) $10,000 ($5,000 in the case of married individuals filing separately), or (2) the amount of the regular income tax in the case of a corporation and one-half of the amount of the regular income tax in the case of an individual.[8]

One of the tax preferences in the minimum tax is accelerated depreciation on leased personal property.[9] The tax preference is the amount by which the income tax deduction for depreciation (or amortization) exceeds the depreciation deduction which would have been allowed if the property had been depreciated under the straight line method of depreciation for each year of its useful life for which the taxpayer owned the property. If the leased property is depreciated under the ADR system and the taxpayer chooses to use a shorter life than the ADR class life established for the asset, any increase in depreciation for the year on account of using a useful life shorter than the class life is included in the amount of the preference. Thus, additional ADR depreciation is a preference even if the straight line method is used rather than an "accelerated" method. This tax preference does not apply to corporations other than personal holding companies and subchapter S corporations.

With respect to real property (sec. 1250 property), accelerated depreciation, i.e., the excess of the deduction for depreciation (or amortization) over straight line depreciation, is a tax preference item.

---

[8] The 15-percent minimum tax is separate and apart from the alternative minimum tax (under sec. 55).

[9] For this purpose, the term "personal property" means property which is subject to depreciation recapture under section 1245.

These tax preference items also reduce the amount of personal service taxable income eligible for the 50-percent maximum tax on personal service taxable income.

Earnings and profits

Generally, a corporate distribution with respect to the corporation's stock is a dividend only if it is made out of the corporation's current or accumulated "earnings and profits." Generally, earnings and profits are computed in a manner similar to the manner in which taxable income is computed. However, a number of adjustments and special rules apply.

Under one of these special rules, for taxable years beginning after straight-line depreciation) is not taken into account for purposes of determining earnings and profits (sec. 312(k)).

B. Investment tax credit

Present law provides a 10-percent regular investment credit and a 10-percent energy investment credit for investments in certain tangible property used in a trade or business or for the production of income. The amount of each credit is generally 10 percent of a taxpayer's eligible cost in acquiring qualifying property. The credits are used to offset the taxpayer's income tax liability.[10]

To be eligible for these credits, property must be depreciable or amortizable with a useful life of three years or more. However, reduced credits are allowed where property has a useful life of less than seven years. Under these rules, if the property has a useful life of three or four years, a credit is allowed on one-third of the cost of the property. Similarly, a credit is allowed on two-thirds of the cost where the property has a useful life of five or six years. This determination is generally made on the basis of the useful life which is used for purposes of depreciation or amortization. These useful life limitation rules are also applied where the credit has been claimed and the property is later disposed of by the taxpayer before the end of its useful life. In such situations, the credit is recomputed on the basis of its actual useful life in the hands of the taxpayer, which may result in a reduction in the allowable credit and a recapture of the excess credit from the taxpayer.

For purposes of the regular investment credit, qualifying property includes tangible personal property (such as motor vehicles, machinery and office equipment) and also other tangible property (such as blast furnaces, pipelines, railroad track and utility poles) used as an integral part of manufacturing, production, extraction or furnishing certain services, including electrical, gas and steam utility services. However, buildings and their structural components are not generally eligible for the regular investment credit. Qualifying property for purposes of the energy investment credit includes boilers, burners and

---

[10] Under certain circumstances, a corporate taxpayer may elect an additional one percent investment tax credit if an amount equal to on percent of the qualified investmtent for the year is contributed to an employee stock ownership plan (ESOP). Further, an additional one-half of one percent investment tax credit is available if (a) an equivalent amount is contributed to the ESOP by the taxpayer and is matched by employee contributions and (b) certain other requirements concerning the operation of the ESOP are met.

related fuel handling and pollution control equipment to burn substances other than oil or natural gas or to convert these alternate substances into a fuel. In addition, energy property includes equipment which uses solar, wind, or geothermal energy, and equipment to produe either natural gas from geopressurized brine or oil from shale. Equipment used to recycle solid waste, as well as certain specially defined equipment (such as heat wheels) added to existing facilities to utilize otherwise wasted heat and gases, also qualifies as energy property. The energy credit is available for buildings and their structural components which otherwise qualify as energy property. However, the energy credit does not extend to energy property used to provide electrical, gas, steam and other public utility services.

Generally, the investment credits are claimed for the taxable year in which qualifying property was placed in service. However, in cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of progress expenditures made during the period of construction before the property is completed and placed in service.

The regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 60 percent for 1979 and will increase by increments of 10 percentage points a year to 90 percent for 1982 and later years. The energy credit applies against all tax liability not offset by the regular credit, and energy credits for solar and wind energy property are fully refundable to the extent they exceed tax liability. Other excess regular and energy credits from a taxable year may be carried over to apply against tax liability for the three preceding and seven succeeding years.

DEPRECIATION AND OTHER INVESTMENT INCENTIVES IN SELECTED FOREIGN COUNTRIES

In general

It is argued that increases in productivity are less in the United States than in other industrialized nations in part because the United States provides lesser tax incentives for capital investment than other industrialized nations. Brief summaries of the depreciation rules (and other tax incentives for investment) of five industrialized nations are set forth below. In general, the nations selected are either major competitors or major trading partners of the United States. These rules are generally the rules in effect as of January 1, 1978.[11] Since these summaries are not exhaustive, in some cases definitive conclusions cannot be drawn as to whether the countries referred to below provide greater tax incentives for capital investment than the United States.

West Germany

Depreciation

In general

The beneficial owner of fixed tangible or intangible assets which have a determinable useful life in excess of one year may deduct a reasonable allowance for depreciation. In general, a taxpayer is required to deduct depreciation only in the year which it is allowable, and the deduction may not be deferred to a later year. However, it appears that depreciation allowances which have been inadvertently unclaimed when allowable may be deductible in later years.

The basis of an asset for purposes of depreciation is the cost of acquisition or manufacturing. Immovable assets can be depreciated only by using the straight-line method. On the other hand, in the case of movable fixed assets, straight-line, 2.5 times declining balance, and the production basis methods are permitted. If the declining balance method is used, the rate may not exceed 25 percent. Additional depreciation may be claimed when assets are subject to heavy use. In these situations, the straight line rates may be increased by 25 percent for two-shift use and by 50 percent for three-shift use.

A change from the declining balance method to the straight-line method is permissible, but not vice versa. Salvage value may be ignored at the taxpayer's election unless the salvage value is expected to be substantial. Because profits on disposal of fixed assets are taxable at the same rates as ordinary commercial profits, this factor has little significance and German companies seldom take it into account in determining their depreciation policy. At any time during the life of a movable asset, the going concern value, if lower than the adjusted cost basis, may be substituted for it. Also, it appears that a deduction for obsolescence resulting from technological or economic

[11] Where depreciation rules are different for individuals and corporations, the rules applicable to corporations are set forth.

factors is allowable. However, on movable fixed assets which are being depreciated on the declining balance method, special depreciation for obsolescence cannot be deducted.

The depreciation taken in the commercial financial statements may exceed the depreciation shown on the tax statements, but not vice versa. This rule appears to require that depreciation claimed for tax purposes must be reflected in earnings statements.

The rates of depreciation permissible for fixed assets other than buildings are not fixed by statute, but the Federal Ministry of Finance publishes a table of recommendations. Since local finance offices can deviate from the tables in individual cases, the actual rates are a matter of negotiation. It appears that the following straight-line rates are generally accepted: machinery, 10–12 percent; automobiles and trucks, 20–25 percent; office equipment, 10–20 percent; computers, 20 percent; industrial buildings, such as factories and warehouses, 2–4 percent; office furniture, 10 percent.

Movable fixed assets can be depreciated under a 250-percent declining balance method at an annual rate not in excess of 25 percent.

In general, the depreciation rate for buildings is fixed by statute at a straight-line rate of 2 percent. However, buildings completed on or after December 1, 1977, can be depreciated under the declining balance method at the following rates:

(1) for the year of completion and each of the 11 subsequent years, 3.5 percent.

(2) for each of the following 20 years, 2 percent; and

(3) for each of the following 18 years, 1 percent.

Expenditures on movable fixed assets which cost DM 800 (about $460, as of October 1, 1979) or less may be written off in full during the year of acquisition.

Special depreciation and amortization for specific types of investment

Among the special rules for the recovery of costs of specific types of investment are the following:

(1) An initial allowance of 60 percent is permitted for depreciable personal and immovable assets serving the purposes of environmental protection (air pollution, water pollution, noise protection, etc.) if such assets are acquired or manufactured after December 31, 1974, but before January 1, 1979. In subsequent years, an annual depreciation rate of 10 percent is permissible until full amortization.

(2) In addition to normal depreciation, an initial allowance of 50 percent of the cost of movable fixed assets and 30 percent of the cost of immovable fixed assets is granted for investments in certain qualifying private hospitals, provided the assets are acquired or manufactured after December 31, 1976.

(3) Enterprises situated on the borders of the Iron Curtain Countries may be allowed a writeoff in the initial five years of 50 percent of the cost of movable fixed assets and 30 percent of the cost of buildings.

(4) An initial allowance of 40 percent is granted for new merchant ships and of 30 percent for aircraft registered in Germany.

This allowance may be spread over five years if (a) the ship or aircraft is acquired or manufactured before January 1, 1979, and (b) the ship is held for a period of not less than eight years (six years in the case of aircraft).

Under general rules for the application of special accelerated depreciation allowances, such allowances may not be used to create or increase a loss.

Other investment incentives

No investment tax credit is provided.

Japan

Depreciation

In general

Depreciation is allowed for all tangible fixed assets such as buildings, machinery, ships, etc. However, leasehold rights are not depreciable assets. The initial value of assets for purposes of depreciation is the acquisition cost of purchased assets, the total costs of manufacture or construction of assets produced internally, or the fair market value of assets acquired by gift, exchange or otherwise. Both the straight line and the declining balance (where allowable) calculations assume residual value of 10 percent of the acquisition cost of almost all tangible assets, but assets may be depreciated or amortized down to a residual value of 5 percent for tangible assets and 0 percent for intangibles. Certain manufacturing plants and the equipment therein are depreciated as a unit.

Depreciation may be deducted for tax purposes as entered on the books of the company and may be charged against profits, up to the limits established by law. Apparently this rule requires that all depreciation deducted for tax purposes be taken into account in computing earnings for financial purposes.[12]

The entire cost of depreciable assets may be deducted currently if the cost is less than 100,000 yen per unit or if the useful life is less than one year.

The Ministry of Finance has established standard useful lives for almost all depreciable assets. If shorter useful lives can be justified to the relevant regional tax bureau, the shorter lives may be used. If a shorter useful life is approved due to obsolescence, depreciation for previous years may be recomputed on the basis of the shorter useful life and the excess of depreciation (as computed over the depreciation actually deducted during such years) may be currently expenses.[13]

"Ordinary depreciation" is allowed for most assets, and the statutory limits on deductibility are calculated to reflect the average actual decline in economic value of the assets, as determined in accordance with generally accepted accounting principles. However, the Special Tax Measures Law allows special accelerated depreciation for certain types of assets.

---

[12] If the depreciation deducted for financial purposes exceeds the statutory limits, the excess may be carried over and, taken together with subsequent book depreciation, deducted up to the statutory limits in subsequent years.

[13] A corporation may make its own reasonable estimate of the remaining useful life of used property.

52-299 O - 79 - 2

Ordinary depreciation

Most assets eligible for ordinary depreciation may be depreciated using the straight-line method, the declining balance method, or another method specifically approved by the relevant regional tax bureau. The unit of production method may be used for assets used in the mining industry. A change in depreciation methods is subject to the prior approval of the relevant local tax office.

Special accelerated depreciation

A corporation meeting certain requirements may accelerate the depreciation of certain specified assets by either of two accelerated methods. In addition to ordinary depreciation, under the "special additional depreciation" method, a corporation may deduct during each year an additional percentage of the ordinary depreciation taken for such year. Examples of the amounts of special additional depreciation allowed for certain eligible assets are as follows:

(*a*) newly constructed rental housing, 100–150 percent of ordinary depreciation (depending on the useful life);

(*b*) qualified crude oil storage tanks, 50 percent of ordinary depreciation; and

(*c*) new machinery, plant, etc. of a small corporation installed as part of an approved modernization plan, 50 percent of ordinary depreciation.

Under the "special initial depreciation" method, a certain percentage of the acquisition costs of eligible assets may be deducted during the year when the assets are first placed in use. Examples of the amounts of special initial depreciation allowed for certain eligible assets are as follows:

(*a*) qualified manufacturing plants installed in the Okinawa free trade zone, 33⅓ percent of acquisition cost;

(*b*) qualified facilities to prevent pollution, 50 percent of acquisition cost;

(*c*) qualified plants equipped with special antipollution devices and qualified energy efficient plants, 25 percent of acquisition cost; and

(*d*) certain machinery using data processing equipment, 25 percent of acquisition cost.

Both the special additional depreciation and the special initial depreciation may be accounted for in the normal way by reducing the basis of the assets, thus reducing the amount of depreciation in future years. Alternatively, these amounts may be credited to a special depreciation reserve account, in which case basis is not reduced and ordinary depreciation may be taken on the remaining basis. If this latter approach is used, the amounts credited to the special depreciation reserve account must be taken back into income in equal installments over the immediately succeeding seven years. (Any allowable special depreciation which was not actually taken during the preceding three years may be credited to this special depreciation reserve account currently.)

Any tangible asset may not be depreciated, either through ordinary or special depreciation, to a residual value of less than 5 percent of original cost.

Investment credit, etc.

No general investment tax credit is provided. However, a special tax credit is allowed for any corporation which has increases in its research and experimental expenses and training costs of programmers and systems engineers for electric computers. This tax credit cannot exceed 10 percent of the corporation tax.

Certain special incentives are also available for overseas investment and reserves for designated percentages of export gross receipts.

France

Depreciation

In general, tangible assets are usually depreciated over the following useful lives—

Industrial buildings	20 years.
Commercial buildings	20 to 50 years.
Equipment and tools	4 to 10 years.
Office furniture	10 years.

Under French tax law, most depreciable assets must be depreciated on the straight-line method. However, new industrial and commercial equipment, plants to be used for conserving raw materials, and certain other assets may be depreciated under the declining balance method. Generally, the rates of depreciation under the declining balance method are obtained by multiplying the straight-line rates by a special co-efficient which is 1.5 for assets with a normal useful life of 3 to 4 years, 2 from 5 to 6 years and 2.5 from 6⅔ to 20 years.

The declining balance method is not allowed for:

(1) buildings (except for hotels and light buildings, the useful life of which does not exceed 15 years);

(2) passenger cars;

(3) pickup trucks;

(4) typewriters, telephone installations, and office furniture; and

(5) used property.

The cumulative depreciation on fixed assets recorded on a company's books as of each year must be at least equal to the normal cumulative straight-line depreciation for each category of fixed assets. If any part of this minimum depreciation is not recorded in a given year, it could not be claimed in the future as a deduction against taxable income. This rule also applies if a company is in a loss position, before or after charging off this minimum depreciation. If a company is in a loss position, the deficit resulting from a properly recorded depreciation charge may be carried forward without time limit. (The rule in the preceding sentence is an exception to the normal five year limitation on net operating loss carryforwards.)

Special depreciation allowances are granted in certain cases where investments are considered particularly fruitful to the French economy. Among these are:

Special accelerated first-year depreciation of 50 percent of the cost of buildings used for technological or scientific research is allowed. A similar rule applies to costs of certain assets used for industrial water purification and pollution control, if they are acquired before December 31, 1980, and are parts of industrial installations existing on December 31, 1976.

An exceptional writeoff during the year of completion is permitted for 25 percent of the cost of buildings erected for industrial and commercial purposes, if the building has been started by December 31, 1977 (subject to Ministerial approval).

United Kingdom

Depreciation

In general, the full cost of all machinery and equipment (other than automobiles not used for public hire or the conveyance of goods or passengers) may be deducted in the year the expenditure is made. This rule applies to both new and used property. Also, it appears that the taxpayer may deduct all or any portion of the amount allowable and carry the rest over to succeeding years in such amounts as he desires.

An industrial building may be depreciated by taking a depreciation deduction of 50 percent in the first year and thereafter writing down the building at a rate of 4 percent per annum.

An alternative means of recovering expenditures for machinery and plant is to write down the undepreciated capital cost at a rate of 25 percent per year (on the declining balance method.) This declining balance method of depreciation at a rate of 25 percent per annum generally applies to automobiles which do not qualify for the full deduction in the year of the expenditure. Depreciation allowances are generally recaptured on the disposal of the assets.

Depreciation may be deducted only with respect to certain specified categories of assets. It appears that the main types of assets for which depreciation is not allowable are nonindustrial buildings (e.g., offices, hotels, showrooms, and retail shops), intangible assets other than patents, and, in certain circumstances, know-how.

Other investment incentives

It appears that development area grants of 20 percent to 22 percent of the capital expenditure on machinery and plant are available for certain expenditures. These grants do not reduce a taxpayer's basis for depreciation purposes. Other incentives may also be available in development areas for certain investments.

Canada

Depreciation

In Canada, depreciation for tax purposes takes the form of a capital cost allowance which is computed on a basis of pools of assets with relatively few separate classes of property. The annual cost recovery allowances are generally determined by applying a prescribed rate to each class on a declining balance method. Thus, for example, the prescribed annual rate on most machinery and equipment is 20 percent; on automotive equipment, 30 percent; on most buildings, 5 percent. A taxpayer may defer a deduction for depreciation by claiming less than the amount allowable. In general, capital cost allowances previously claimed are recaptured where assets are sold for proceeds in excess of the undepreciated cost. However, it appears that the class system operates to deter any recapture of capital cost allowance until such time as the proceeds of disposition of an item of depreciable property exceed the undepreciated capital cost of the entire class of property to which that item belongs.

In addition, a special 2-year writeoff is allowed for machinery and equipment for Canadian manufacturing and processing operations.

Unlike certain other systems described above, tax depreciation is not required to conform to book depreciation.

Other incentives

Certain regional development incentives are available under various Federal and provincial programs. These programs offer substantial incentives to encourage corporations to locate their manufacturing facilities in areas of slow economic growth.

Canada provides an investment tax credit of 5 percent (or 7½ percent or 10 percent, depending upon the region in Canada) of the cost of certain buildings, machinery and equipment if such assets are (1) acquired before July 1, 1980, and (2) are to be used in manufacturing, processing, or other specified activities. This credit reduces capital cost for tax depreciation purposes. The amount of this credit allowable may not exceed the sum of $15,000 plus one-half of the amount by which the Federal income tax otherwise payable exceeds $15,000. Any unused investment credit may be carried forward for up to 5 years.

ISSUES

The bill raises a number of issues. The most general issue is whether additional tax incentives are needed at this time to encourage capital formation or increase productivity. If so, a second issue is whether an approach which focuses mainly on accelerating depreciation allowances would be more appropriate than an approach which would be based primarily on rate reductions or an increased investment tax credit.

If it is appropriate to adopt an approach based on accelerating the deductions for the cost of depreciable property, the specific issues raised by this bill include the following:

(a) Whether the period over which assets are to be written off should be a specified period unrelated to the asset's economic useful life.

(b) Whether asset classes should be limited to a very few classes.

(c) Whether percentages of asset cost should be prescribed for each year of a recovery period (or useful life) in a manner which reflects accelerated methods of cost recovery.

(d) Whether used property should be entitled to the same type of depreciation or cost recovery rules (including accelerated methods) as new property.

(e) Whether cost recovery (or depreciation) should initially be allowable when payment is made rather than when an asset is placed in service (if the payment date precedes the time that the asset is placed in service).

(f) Whether the taxpayer should be permitted to defer any portion of an otherwise allowable deduction for the cost of property until taxpayer chooses to use it.

(g) Whether the types of assets allowed to use a 3-year recovery period should be limited to automobiles and light trucks.

(h) Whether the dollar amount of assets which can be recovered over a 3-year period should be limited to $100,000 of investment per year.

(i) Whether a cost recovery system reflecting relatively short useful lives and accelerated depreciation should apply to depreciable real property.

(j) Whether the cost recovery system should apply to utility property (since utilities are required to normalize depreciation and the investment tax credit for rate-making purposes).

(k) Whether the investment tax credit should be revised to provide eligibility for the full credit for otherwise eligible assets using a 5-year cost recovery period and for a 60-percent credit for otherwise eligible assets using a 3-year recovery period.

(l) Whether investment tax credit recapture should be revised to provide for proportional recapture based on the number of years the asset is actually in service.

(m) Whether the depreciation recapture rules should apply to all depreciation on real property rather than only the accelerated portion of such depreciation.

(n) Whether the item of tax preference for accelerated depreciation on real property should apply to all real property or only to leased property.

Another issue is whether the expected capital formation and productivity gains to be expected from this measure are appropriate taking into account the revenue effects. A further issue is the extent to which budget constraints may limit or delay the implementation of tax revisions such as those suggested by the bill.

EXPLANATION OF THE BILL

A. In general

For most depreciable assets, the bill would replace existing depreciation rules with a system which provides an accelerated method of depreciation and useful lives which are generally substantially shorter than present useful lives for most eligible depreciable real and personal property (although the lives of some items of personal property would be lengthened, e.g., certain machine tools). The bill would generally permit a 10-year writeoff for plants and buildings (other than residential real estate), a 3-year writeoff for a limited amount of investment in automobiles and light trucks, and a 5-year writeoff for all other tangible personal property. In general, the bill would allow accelerated deductions in the early years of the recovery period, roughly equivalent to using double declining balance depreciation for the first few years and then switching to sum-of-the-year's-digits depreciation. This system of accelerated deductions would apply to both new and used property. Also, the period over which the cost of an asset could be recovered would begin with the earlier of the year in which such costs are paid or incurred or the year in which the asset is placed in service (rather than only with the year in which the asset is placed in service, as under current law). The bill contains transitional rules to phase-in the application of the 10-year and 5-year writeoffs (in certain cases) over the period 1980–1983 so that the provisions would not be fully effective until 1984.

The bill would shorten the useful life requirement for eligibility for the full 10-percent investment credit from 7 years to 5 years and would provide that assets qualifying for a 3-year writeoff would be eligible for a 6-percent investment credit (instead of a 3⅓ percent credit under existing law). The rules for the recapture of investment credit also would be liberalized.

Under the bill, the depreciation recapture rules for real estate covered by the new provisions would be revised to provide for a recapture of all depreciation (rather than only accelerated depreciation) upon sale or other disposition. The bill also revises the "add-on" minimum tax so that, in the case of real property subject to the new rules, the tax preference for accelerated depreciation on real property would apply only to leased property.

B. Capital cost recovery deduction

Eligibile property

Most property currently subject to an allowance for depreciation would be covered by the new capital cost recovery system. Eligible property, referred to as "recovery property," would generally include both new and used tangible property (other than land) that is used in a trade or business or held for the production of income. However, recovery property would not include: (1) property placed in service by the taxpayer before January 1, 1980; (2) residential rental property; (3) property which may be amortized (in lieu of depreciated) and for which the taxpayer elects such amortization; (4) property subject to a method of depreciation not expressed in a term of years (such as property depreciated under the units of production or machine-hour methods of depreciation); (5) leasehold improvements properly depreciated over the term of the leasehold, if the taxpayer elects to exclude such property or improvements from the rules of this new provision; and (6) property which is acquired from a person who had used the property before January 1, 1980, if either (a) the property is leased back to the person from whom it was acquired within one year after acquisition, or (b) the taxpayer and the person using the property before January 1, 1980, are related parties (within the meaning of sec. 267(b)).

Computation of recovery deduction

The recovery deduction would be determined by applying a statutory percentage to the capital cost of the recovery property. Recovery property would be separated into three classes, and the applicable percentage would be provided in the following capital cost recovery table.

Capital Cost Recovery Table

	The applicable percentage for the class of property is:		
If the recovery year is—	*Class 1*	*Class 2*	*Class 3*
1	10	20	33
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		

In general, use of this table would result in a deduction which approximates the deduction which would result from using—(1) double declining balance depreciation for the earliest years of the recovery period, (2) sum-of-the-year's-digits depreciation for later years, (3) the half-year convention (under which all capital cost is treated as added to capital account on the first day of the second half of the taxable year), and (4) no salvage value.

Real property

Class 1 would include buildings and their structural components. When fully effective (in 1984), the capital cost of class 1 property would be recovered over a period of ten recovery years and the applicable percentages would range from 10 percent in the first recovery year and 18 percent in the second recovery year to 2 percent in the tenth recovery year.[14]

The bill contains a transitional rule which provides a phase-in for the recovery of costs of class 1 property. For capital costs added to capital account in 1980, 1981, 1982 or 1983, the recovery periods are 18 years, 16 years, 14 years and 12 years, respectively. These transitional rules apparently contemplate the same general type of accelerated recovery as would apply under the general rules.

Tangible personal property

Class 2 would generally include all tangible personal property not included in class 3 (relating to certain automobiles, etc.), and, when fully effective, the capital cost would be recovered over a period of five recovery years. The applicable percentages for class 2 property would range from 20 percent in the first recovery year and 32 percent in the second recovery year to 8 percent in the fifth recovery year. For recovery property included in class 2, transitional recovery periods and recovery percentages are to be provided for recovery property subject to the new recovery allowance rules if the capital cost of the recovery property is paid or incurred prior to 1984. Under these rules, the recovery period of assets for which the shortest permissible useful lives under ADR are more than 5 years but not less than 9 years[15] would be as follows:

For additions to capital account in—	*The cost recovery period is—*
1980	ADR lower limit.
1981	ADR lower limit minus 1 year.
1982	ADR lower limit minus 2 years.
1983	ADR lower limit minus 3 years.

For purposes of these transitional rules, if the shortest permissible life of a class 2 asset is more than 9 years under ADR, its shortest permissible life will be treated as equal to 9 years. These transitional rules

[14] Under present law, neither the double declining balance method nor the sum-of-the-year's digits method is available for the type of real property (i.e., commercial real property) described in class 1. New commercial buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate, and used commercial property must be depreciated under the straight-line method.

[15] Under this rule, any ADR lower limit which is not a whole number of years would be rounded down to the next lower whole number of years.

contemplate the same general type of accelerated recovery as would apply under the general rules.

Automobiles, taxis, and light-duty trucks

Class 3 property would include automobiles, taxis and light duty trucks, but the capital cost of such items to be taken into account could not exceed $100,000 for any taxable year. The capital cost of class 3 recovery property would be recovered over a term of 3 years, the applicable percentages amounting to 33 percent, 45 percent, and 22 percent in the first, second, and third recovery years, respectively.[16] The bill provides that any capital cost in excess of $100,000 for automobiles, taxis, and light duty trucks for any taxable year would be included in class 2. Special rules are also provided for (1) apportioning the $100,000 limit among the component members of a controlled group of corporations, (2) reducing the limit in the case of husband and wife filing separate returns, and (3) applying the limitation at both the partner and partnership levels.

Special rules for public utility property

The bill provides that public utility property is eligible to be treated as recovery property (i.e., eligible for the benefits of the bill) only if the taxpayer uses a normalization method of accounting. In general, a normalization method of accounting requires that, for ratemaking purposes, the tax benefits from accelerated depreciation, the investment credit, and other tax incentives are *not* immediately flowed through to customers but instead are prorated over the useful lives of the properties with respect to which the benefits are given. The rule in the bill (proposed sec. 168(g)(3)) is similar to rules in present law relating to the investment credit and accelerated depreciation (secs. 46(f) and 167(l)).

Commencement of cost recovery period

In general, the capital cost of recovery property is to be taken into account for purposes of computing the recovery allowance at the earlier of the year payment is made or the year property is placed in service. However, for self-constructed assets, the cost of recovery property is to be taken into account in the earlier of the year the property is placed in service or the year for which the cost is properly added to capital account under the taxpayer's method of accounting.[17] The bill indicates that any amount paid or incurred prior to January 1, 1980, would not be taken into account (proposed sec. 168(d)(3)).[18]

Also, the bill provides that public utilities (unlike other taxpayers) may elect to treat advance payments (i.e., amounts paid or incurred in a year prior to the year an asset is placed in service) as additions to capital account only in the year the asset is placed in service.

---

[16] Under the ADR system, an automobile or a taxi may be depreciated over a period of from 2.5 years to 3.5 years, and light general purpose trucks may be depreciated over a period of from 3 to 5 years.

[17] The rules for commencement of the cost recovery period, as described in the text, are those intended by the proponents of the bill. The language of the bill apparently would require technical changes to reach these results.

[18] Taken literally, this provision would appear to preclude any depreciation or cost recovery on amounts paid in 1979 (or prior years) with respect to assets placed in service in 1980 (or later years).

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to depreciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain (sec. 167(f)). Thus, if salvage value is less than 10 percent, it may be ignored. A taxpayer must estimate the salvage value of each asset placed in service in a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

The bill would result in the elimination of salvage value limitations on cost recovery deductions for both real property and personal property if the cost of such property is recovered under the new capital cost recovery provisions.

While these changes would not appear to have a significant effect for most depreciable personal property, the elimination of the salvage value restrictions may have a significant effect for depreciable real property (because the salvage value of such property tends to be significant and such property is not subject to the "10-percent of basis" reduction rule described above).

Election to deduct less than amount allowable

In any recovery year, the entire amount of the allowable recovery deduction may be taken into account, or, at the election of the taxpayer, only a portion thereof. The amount taken into account may be increased or decreased by the taxpayer before the expiration of the time for making a claim for refund. If only a portion of the recovery deduction is taken into account, the unused amount may be carried forward and taken into account in a subsequent taxable year. By contrast, under present law, depreciation must be deducted in the year in which it is allowable, and even if no depreciation deduction is claimed in such year, the basis of a depreciable asset must be reduced by the depreciation allowable.

Under the bill, if only a portion of the recovery deduction is taken into account in a taxable year, that portion is to be apportioned among all the recovery properties. The apportionment formula is a fraction, the numerator of which is the allowable recovery amount for each recovery property (without regard to any elected reduction) and the denominator of which is the allowable aggregate recovery deduction for all recovery property (without regard to any elected reduction). If a recovery deduction of a subsequent recovery year is increased as a result of a carryover of an unused recovery deduction, the carryover recovery deduction is to be similarly apportioned among all recovery properties.

Gain or loss on disposition

Gain or loss on disposition, including retirements, would be recognized unless nonrecognition is otherwise provided for. Under regulations to be provided by the Treasury, if mass accounts are maintained by the taxpayer, an election may be made to include in income all proceeds from the disposition. If gain or loss on a disposition is recognized, a recovery deduction with respect to the disposed recovery property is not allowed in the taxable year in which the disposition takes place.

C. Changes in the investment tax credit

Useful life requirement

Under present law, 100 percent of the cost of qualified property with a useful life for depreciation purposes of 7 years or more is eligible for the investment tax credit. If the useful life for depreciation purposes is 3 years or more but less than 5 years, only 33⅓ percent of the cost of the property qualifies for the investment credit, and if the useful life is 5 years or more but less than 7 years, 66⅔ percent of the cost of the property qualifies for the investment credit.

The bill would provide that, for class 1 or class 2 property (i.e., property for which the recovery period is at least 5 years), 100 percent of the capital cost is to be taken into account for purposes of the investment credit, and, for class 3 property, 60 percent of the capital cost is to be taken into account for such purposes. The investment tax credit would be allowable, subject to present law rules, in the first taxable year for which a recovery deduction is allowable with respect to the property if the property can reasonably be expected to qualify as investment tax credit property under present law rules.[19]

Recapture rules

The bill would also provide for new rules with respect to recapturing the investment tax credit on recovery property qualifying under this new provision. Qualified investment tax credit property which is classified as either class 1 or class 2 property would be subject to investment tax credit recapture if the property were to be disposed of within the first five years of it having been placed in service. One hundred percent of the investment tax credit claimed with respect to qualified investment tax credit property in classes 1 and 2 would be recaptured if a disposition of the property occurs in the first year in which the property is placed in service; the amount of investment tax credit recaptured thereafter would decrease at the rate of 20 percent per year. Thus, at the beginning of the fifth taxable year after the qualified property was placed in service, the investment tax credit claimed with respect to such property would not be recapturable. For qualified investment tax credit property which falls within the definition of class 3 property, 100 percent of the investment tax credit claimed would be subject to recapture if a disposition occurs in the first taxable year in which the property is placed in service; if the property is disposed of in the first taxable year after the taxable year in which it is placed in service, 66 percent of the investment tax claimed with respect to such property would be recaptured. If the property is disposed of during the second taxable year following the taxable year in which such property was placed in service, 33 percent of the investment tax credit claimed would be subject to recapture. Subsequent to the second tax-

---

[19] The changes which the bill would make in the investment credit rules relating to the useful lives of eligible assets and recapture would also affect the energy investment credit and the additional investment tax credits available in connection with certain ESOP contributions.

able year following the taxable year in which such property is placed in service, any investment tax credit claimed with respect to such property would not be subject to investment tax credit recapture. (These rules contrast with the current recapture rules which generally recapture any investment credit which would not have been allowable if the useful life taken into account in computing the credit had been the period from the date the asset had been placed in service until the date of disposition.)

D. Other changes relating to depreciation

Additional first-year depreciation

Under present law, additional first-year depreciation amounting to 20 percent of the cost of tangible personal property with a useful life of six years or more (subject to certain dollar limitations) is allowed as a deduction. The bill would provide that property which is recovery property would not be entitled to additional first-year depreciation.

Recapture

Under present law, all depreciation allowable with respect to personal property is subject to depreciation recapture and treated as ordinary income upon disposition at a gain. Similarly, with certain exceptions, depreciation allowed on real estate in excess of straight-line depreciation (but not straight-line depreciation) is also subject to recapture. The bill would provide that all depreciation allowed with respect to recovery property, whether personal or real property, would be subject to depreciation recapture under the rules currently applicable to personal property. Thus, the allowable recovery amount deducted under the provisions of this bill would be subject to ordinary income treatment upon the disposition of the recovery property to the extent of gain.

Minimum tax

Under present law, the accelerated portion of depreciation on real property is an item of tax preference in the "add-on" minimum tax. This item of tax preference applies to both corporate and noncorporate taxpayers. Also, for individual taxpayers, subchapter S corporations, and personal holding companies, accelerated depreciation on leased personal property is an item of tax preference. (This tax preference takes account of the acceleration due to use of the ADR variance as well as acceleration due to the accelerated methods of recovery.)

Under the bill, these present law rules would not apply to recovery property. For leased recovery property which is in either class 1 or 2, the recovery deduction allowed in excess of straight-line capital cost recovery would be a tax preference item subject to the minimum tax. Straight-line capital cost recovery would be an amount determined by depreciating the property on a straight-line basis using a ten-year life for class 1 property and a five year life for class 2 property. For purposes of computing the straight-line capital cost recovery amount, the taxpayer would be deemed to have begun depreciation of recovery property beginning with the middle of the taxable year in which the property was first placed in service.

Under the bill, the minimum tax provisions with respect to this tax preference item would not be applicable to corporations other than subchapter S corporations and personal holding companies; also these provisions would not be applicable to property manufactured or produced by the taxpayer.

Earnings and profits

Under present law, earnings and profits of corporations are generally computed by taking into account only straight-line depreciation. Under the bill, earnings and profits would be computed by taking into account only straight-line capital recovery.

Carryover of corporate attributes

Under present law, many corporate attributes (such as net operating loss carryovers) of an acquired corporation may be utilized by another corporation which acquires the acquired corporation (or its assets) in any of certain types of tax-free reorganizations. The bill provides that the unused capital cost recovery deduction of a corporation is a tax attribute subject to these carryover rules. In general, the carryover of this unused deduction is subject to the same limitations as apply to the carryover of net operating losses.

EFFECTIVE DATE

The amendments made by this bill would be effective with respect to taxable years ending after December 31, 1979.

REVENUE EFFECT

The revenue estimate for this bill is not yet available.

4. S. 1467—Senators Dole and Bentsen

Method of Accounting for Railroad Track Assets

Present law

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion and to obsolescence, the acquisition cost (less salvage value in excess of 10-percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use. This approach to the recovery of the cost of an asset is referred to as depreciation.

The railroad industry, however, generally uses for tax purposes what is called the "retirement-replacement-betterment" (RRB) method of accounting for railroad track (rail) and ties, and other items in the track accounts such as ballast, fasteners, other materials and labor costs. Although the RRB method is not specifically recognized as an allowable method of depreciation or accounting under the Internal Revenue Code, it has been allowed in court decisions and is recognized by the Internal Revenue Service in revenue rulings.[1] The Service's recognition of this method for tax purposes is based upon the requirement by the Interstate Commerce Commission (ICC) that this method be used for rate-making purposes. Although the ICC now requires use of the RRB method, it is presently considering a change to require the use of ratable depreciation.

For assets accounted for under the RRB method, when a new railroad line is laid, the costs (both materials and labor) of the line are capitalized. No depreciation is claimed on the original installation, but these original costs may be written off if this line is retired or abandoned. If the original installation is replaced with components (track, ties, etc.) of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. When the replacement is of an improved quality, it generally is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed.[2] Where rail and other track assets are retired, the salvage value (measured by fair market

---

[1] Rev. Rul. 67–22, 67–1 C.B. 52; Rev. Rul. 67–145, 67–1 C.B. 54; Rev. Rul. 78–199. 78–1 C.B. 66.

[2] Railroads may also claim the regular 10-percent investment credit on their track costs, including both costs which are capitalized as costs of a new line (or a betterment) and those which are currently deducted replacement costs (Code secs. 48(a) (1) (B) and 48(a) (9), Regs. § 1.48–1(d) (4)).

value) of the recovered materials is reflected as ordinary income.[3]

The operation of the RRB method can be illustrated by the following examples. If the original installation of a new rail line included a railroad tie which cost \$3, this cost is capitalized and no ratable depreciation is allowed. When this tie is replaced with a tie which currently costs \$20, the \$3 original cost remains frozen and the \$20 replacement cost is deducted currently. Where a betterment is involved, for example, where 100-pound rail is replaced with 150-pound rail which costs \$120, under the RRB method the betterment portion (\$40) [4] is capitalized and the replacement portion (\$80) is deducted currently.

Issue

The issue is whether the retirement-replacement-betterment method of accounting for railroad track assets should be codified as an acceptable method of depreciation for Federal income tax purposes.

Explanation of the bill

The bill would codify the retirement-replacement-betterment method of accounting for railroad track assets as an acceptable method of depreciation for Federal income tax purposes.[5]

Effective date

The provisions of the bill would be effective for taxable years ending after December 31, 1953 (the general effective date of the Internal Revenue Code of 1954).

Revenue effect

It is estimated that this bill will have no effect on budget receipts. The estimate is based on the assumption that the Internal Revenue Service would not, without this legislation, require a change in the method of accounting for tax purposes to a ratable depreciation method from the presently accepted retirement-replacement-betterment method.

---

[3] See, e.g., *Seaboard Coast Line Railroad Company, Successor by Merger to Atlantic Coast Line Railroad Company* v. *Commissioner*, 72 T.C. ——, No. 76 (August 22, 1979).

[4] The \$40 betterment portion is computed as follows:

$$\frac{\text{150-lb. new rail less 100-lb. old rail}}{\text{150-lb. new rail}} \times \$120 \text{ cost of new rail} = \$40$$

[5] The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means conducted hearings on an identical bill, H.R. 4446, on September 27, 1979.

O