

Overview of Depreciation Reform

I. Present law

A. Background--Capitalization vs. expensing

B. Depreciation

1. Personal property

- a. Method of depreciation (DDB, 150DB, SYD, SL)
- b. Useful life (ADR or facts and circumstances)
- c. Salvage value
- d. Recapture of all depreciation as ordinary income
- e. Deductions start when placed in service
- f. Bonus depreciation for small business
- g. Computation of earnings and profits

2. Real property

- a. Method of depreciation (residential, commercial and industrial used buildings)
- b. Useful life--facts and circumstances component method
- c. Recapture of accelerated portion of depreciation as ordinary income
- d. Special rules for low-income housing

C. Investment credit

1. Personal property

- a. Reduction for short-lived equipment (and recapture)
- b. Limit to \$25,000 plus 90% of remaining tax liability
- c. Carrybacks and carryovers
- d. Progress payment rule
- e. Availability of credit for \$100,000 of used property

2. Real property--credit for rehabilitations

II. Proposals for change

A. Jones-Conable bill (10-5-3)

1. Personal property

- a. 5-3 tax lives (vintage accounts)
- b. Accelerated method
- c. 10% ITC for 5-year class, 6% for 3-year class
- d. Retains recapture as under present law
- e. "Banked" depreciation
- f. Elimination of salvage value
- g. Half-year convention (built into rate)
- h. Elimination of first year bonus depreciation
- i. Available to normalizing utilities

2. Real property

- a. 10 year life (except residential); vintage accounts
- b. Accelerated method
- c. Full recapture for 10 year class

3. Special rules

- a. Depreciation on progress payments
- b. Computation of earnings and profits
- c. Phase-in

B. Senate Finance Committee bill (2-4-7-10)

1. Personal property

- a. Amalgamation of ADR classes into 4 classes--6-1/2 years and under goes to 2, 7 to 11-1/2 yrs goes to 4, 12 to 16-1/2 yrs goes to 7, over 16-1/2 yrs goes to 10
- b. Open-ended accounts
- c. Reduced investment credit in 2- and 4-year classes
- d. Elimination of salvage value
- e. Half-year convention
- f. Elimination of first year bonus depreciation

2. Real property

- a. General rule--optional 20 year SL composite
- b. Special rules--low-income housing, owner-occupied structures

3. Special rules

- a. Small business--\$25,000 expensing for personal property
- b. Depreciation on progress payments
- c. Utilities--ADR with 30% variance
- d. 25% investment credit for rehabilitations of structures
- e. Computation of earnings and profits

C. Constant rate depreciation

- 1. 10% ITC for all personal property (offset by less depreciation)
- 2. Open-ended accounts for assets grouped into classes
- 3. Full administrative discretion

III. Simplification issues

A. Personal property

- 1. Open-ended accounts
- 2. Number of asset classes
- 3. Advantage of uniform ITC with no recapture
- 4. Advantage of restricting taxpayer options
- 5. Limited expensing

B. Real property

- 1. Administrative problems with "facts and circumstances" rule
- 2. Composite vs. component depreciation
- 3. Distinctions between different kinds of structures

Illustration of Depreciation Methods

Example: Corporation X buys a machine for \$4,000. The machine has an estimated useful life of 8 years. After 8 years, the estimated resale or salvage value of the machine is \$400. The depreciation allowance under straight line, declining balance, and sum of the years-digits methods is determined as follows:

Straight Line (S/L)

<u>Year</u>	<u>Depreciable Cost 1/</u>	<u>Rate (%) 2/</u>	<u>Allowance 3/</u>
1	\$3,600	12.5 (100% ÷ 8)	\$ 450
2	3,600	12.5 (100% ÷ 8)	450
3	3,600	12.5 (100% ÷ 8)	450
4	3,600	12.5 (100% ÷ 8)	450
5	3,600	12.5 (100% ÷ 8)	450
6	3,600	12.5 (100% ÷ 8)	450
7	3,600	12.5 (100% ÷ 8)	450
8	3,600	12.5 (100% ÷ 8)	<u>450</u>
Total			<u>\$3,600</u>

1/ Depreciable cost is cost reduced by estimated salvage value.

2/ Rate is 100% divided by number of years of original useful life (8 years).

3/ Depreciation allowed for personal property is recaptured upon disposition to the extent of gain.

200 Percent Declining Balance

<u>Year</u>	<u>Depreciable Cost</u>	<u>1/</u>	<u>Rate</u> <u>2/</u> (%)	<u>Allowance</u> <u>3/</u>	<u>Excess ^{4/} (deficit) Allowance Over S/L</u>
1	\$4,000.00	25	(200% ÷ 8)	\$1,000.00	\$550.00
2	3,000.00	25	(200% ÷ 8)	750.00	300.00
3	2,250.00	25	(200% ÷ 8)	562.50	112.50
4	1,687.50	25	(200% ÷ 8)	421.88	(28.12)
5	1,265.62	25	(200% ÷ 8)	316.41	(133.59)
6	949.21	25	(200% ÷ 8)	237.30	(212.70)
7	711.91	25	(200% ÷ 8)	177.98	(272.02)
8	533.93	25	(200% ÷ 8)	133.48	(316.52)
Total				<u>\$3,599.55</u>	<u>(\$0.45) ^{5/}</u>

1/ Under declining balance methods, depreciable cost is cost unreduced by salvage value, but property cannot be depreciated below estimated salvage value.

2/ Rate is 200% of the S/L rate.

3/ Depreciation allowed for personal property is recaptured upon disposition to extent of gain.

4/ For real property, accelerated portion of depreciation allowed is recaptured upon disposition to the extent of gain.

5/ The remaining \$.45 would have been recovered in year 8 if the taxpayer had switched to straight line in year 8.

150% Declining Balance

<u>Year</u>	<u>Depreciable Cost</u> ^{1/}	<u>Rate (%)</u> ^{2/}	<u>Allowance</u> ^{3/}	<u>Excess ^{4/} (Deficit) Allowance over S/L</u>
1	\$4,000.00	18.75 (150% ÷ 8)	\$ 750.00	300.00
2	3,250.00	18.75 (150% ÷ 8)	609.38	159.38
3	2,640.62	18.75 (150% ÷ 8)	495.12	45.12
4	2,145.50	18.75 (150% ÷ 8)	402.28	(47.72)
5	1,743.22	18.75 (150% ÷ 8)	326.85	(123.15)
6	1,416.37	18.75 (150% ÷ 8)	265.57	(184.43)
7	1,150.80	18.75 (150% ÷ 8)	215.78	(234.22)
8	935.02	18.75 (150% ÷ 8)	<u>175.32</u>	<u>(274.68)</u>
			<u>\$3,240.30</u>	<u>(\$359.70) ^{5/}</u>

1/ Depreciable cost is cost unreduced by estimated salvage value, but the property cannot be depreciated below estimated salvage value.

2/ Rate is 150% of the straight line rate.

3/ Depreciation allowed for personal property is recaptured upon disposition to extent of gain.

4/ For real property, accelerated portion of depreciation allowed is recaptured upon disposition to the extent of gain.

5/ In this example, more than 8 years is required to recover cost less salvage. To recover that amount in 8 years the taxpayer may change to the straight line method. The straight line rate will be based on remaining useful life. This rate will be applied to the remaining undepreciated cost less salvage. In this example, if the taxpayer changed to straight line beginning in year 5, a depreciation rate of 25% (based on remaining useful life of 4 years) would apply to \$1,343.22 (the unrecovered cost less \$400 salvage) thus, \$335.81 would be allowed in each of the last 4 years, resulting in recovery of entire \$3,600 over the 8 year period.

Sum of the Years Digits (SYD)

<u>Year</u>	<u>Depreciable Cost</u> ^{1/}	^{2/} <u>Rate (%)</u>	<u>Allowance</u>	<u>Excess (Deficit) Allowance Over S/L</u>
1	\$3,600	22.22 (8 ÷ 36)	\$800	\$350
2	3,600	19.44 (7 ÷ 36)	700	250
3	3,600	16.67 (6 ÷ 36)	600	150
4	3,600	13.89 (5 ÷ 36)	500	50
5	3,600	11.11 (4 ÷ 36)	400	(50)
6	3,600	8.33 (3 ÷ 36)	300	(150)
7	3,600	5.56 (2 ÷ 36)	200	(250)
8	3,600	2.78 (1 ÷ 36)	<u>100</u>	<u>(350)</u>
		Total	<u>\$3,600</u>	<u>-0-</u>

1/ Depreciable cost is cost reduced by estimated salvage value.

2/ Rate is a fraction, the numerator of which is remaining years of useful life, and the denominator of which is the sum of the digits for the years of original useful life (1 + 2 + 3 + 4, etc.).

3/ Depreciation allowed for personal property is recaptured upon disposition to extent of gain.

4/ For real property, accelerated portion of depreciation allowed is recaptured upon disposition to the extent of gain.

Summary Comparison of First 8 Years

<u>Year</u>	<u>S/L</u>	<u>Allowance</u>		
		<u>150% DB</u>	<u>200% DB</u>	<u>SYD</u>
1	\$450	\$750.00	\$1,000.00	\$800
2	450	609.38	750.00	700
3	450	495.12	562.50	600
4	450	402.28	421.88	500
5	450	326.85	316.41	400
6	450	265.57	237.30	300
7	450	215.78	177.98	200
8	<u>450</u>	<u>175.32</u>	<u>133.48</u>	<u>100</u>
	\$3,600	\$3,240.30	\$3,599.55	\$3,600

Table 1.-ADR Useful Lives of Various Assets

Description of assets in guideline class	Asset depreciation range (in years)		
	Lower limit	Asset guide- line 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 land 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.

Table 2.--Guidelines Lives for Certain Buildings Under
Revenue Procedure 62-21

<u>Type of Building</u>	<u>Useful life</u> (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

Table 3.--Comparison of 1962 Guidelines and Lives Claimed
for Certain Building Types

[In years]

Building type	Guideline lives under revenue pro- cedure 62-21	Average lives claimed by taxpayers (new build- ings 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).

Table 4.--Capital Cost Recovery Table

If the recovery year is--	The applicable percentage for the class of property is:		
	<u>Class 1</u>	<u>Class 2</u>	<u>Class 3</u>
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		

Estimated Revenue Effects of Various Proposals Changing
Depreciation Methods and the Investment Tax Credit 1/

Table 5.

	Calendar Years (billions of dollars)					
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
<u>"10-5-3"</u>						
Equipment	5.6	14.1	24.6	36.2	50.0	60.8
Structures	.8	2.6	4.9	8.0	11.7	16.5
Total	6.4	16.7	29.5	44.2	61.7	77.3
<u>"10-5-3" No phase-in</u>						
Equipment	11.3	27.8	40.7	48.6	53.1	53.3
Structures	1.9	5.5	8.7	12.2	15.7	19.3
Total	13.2	33.3	49.4	60.8	68.8	72.6
<u>Senate Finance Committee</u>						
Equipment	9.2	16.7	15.9	14.9	14.2	13.5
Structures	.9	1.8	2.5	3.4	4.4	5.4
Total	10.1	18.5	18.4	18.3	18.6	18.9

1/ All estimates have been made without allowing for the new Commerce Dept. benchmarks. The new benchmarks may increase the revenue loss of each of the above proposals, and may not have the same relative effect on each proposal.