

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF S. 1758
RELATING TO
SIMPLIFIED COST RECOVERY SYSTEM
FOR PERSONAL PROPERTY**

SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE
ON FEBRUARY 24, 1984

PREPARED BY THE STAFF
OF THE
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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on February 24, 1984, on S. 1758 (introduced by Senators Bentsen, Wallop, Symms, Bradley, Grassley, Mitchell, Durenberger, Baucus, Matsunaga, and Roth). The bill relates to a simplified cost recovery system for personal property.

The first part of the pamphlet is a summary. This is followed in the second part with a description of S. 1758, including present law, explanation of provisions, and effective dates.

I. SUMMARY

S. 1758—Senators Bentsen, Wallop, Symms, Bradley, Grassley, Mitchell, Durenberger, Baucus, Matsunaga and Roth

Simplified Cost Recovery System for Personal Property

Present Law

Under present law, the cost of most tangible personal property (other than long-lived public utility property) placed in service after 1980 may be written off over 3 years or 5 years under the Accelerated Cost Recovery System (ACRS). Recovery schedules are provided which approximate the benefits of using the 150-percent declining balance method in the early years and the straight-line method in later years. Unless the taxpayer elects a reduced investment tax credit for the property, the cost that may be written off is decreased by one-half the amount of the credit for which the property qualifies.

Recovery of progress expenditures made during the period of construction does not begin until the property is placed in service. Gain from the disposition of personal property is recaptured as ordinary income to the extent of prior recovery deductions taken. For purposes of earnings and profits, depreciation of property in the 3-year and 5-year classes is generally computed by using the straight-line method over 5 and 12 years, respectively.

S. 1758

Under the bill, an open-ended accounting method of cost recovery would apply to property, other than public utility property, that is treated under present ACRS rules as 3-year or 5-year property. Unlike current procedures under ACRS, where a separate account may be established for each item of property, property subject to the bill would be pooled using a much smaller number of accounts. An open-ended accounting method is available for income tax purposes in certain other countries, including Canada, Denmark and Hong Kong.

The present basis adjustment, and the reduced credits which apply in lieu of basis adjustment, would be repealed for property subject to the new system. The combined effect of open-ended accounts and no basis adjustment would be to keep the present value of the economic benefit of cost recovery for purchased assets very nearly the same as under present ACRS rules, assuming in both cases that the taxpayer chooses the most accelerated options for recovery.

Cost recovery for qualified progress expenditures would start when the expenditures are made, if the asset would be depreciated under the new system when placed in service. The new system would generally eliminate determination of gain and recapture on

the disposition of assets and would modify the computation of depreciation for purposes of determining earnings and profits.

II. DESCRIPTION OF S. 1758

A. Present Law

Overview

The cost of most tangible personal property (other than long-lived public utility property) placed in service after 1980 may be written off over 3 years or 5 years under the Accelerated Cost Recovery System (ACRS). Recovery schedules are provided which approximate the benefits of using the 150-percent declining balance method in the early years and the straight-line method in later years. Unless the taxpayer elects a reduced investment tax credit for the property, the cost that may be written off is decreased by one-half the amount of the credit for which the property qualifies.

Recovery of progress expenditures made during the period of construction does not begin until the property is placed in service. Gain from the disposition of personal property is recaptured as ordinary income to the extent of prior recovery deductions taken. For purposes of earnings and profits, depreciation of property in the 3-year and 5-year classes is generally computed by using the straight-line method over 5 and 12 years, respectively.

Cost recovery under ACRS

General rules

The cost of most tangible personal property placed in service after 1980 is written off under ACRS (Code sec. 168). Under ACRS, each item of personal property is assigned to one of four recovery classes. For each class, ACRS provides both a recovery period, the number of years over which costs may be written off, and a schedule of recovery percentages.

The recovery percentages approximate the benefits of using the 150-percent declining balance method (with a half-year convention) in the early years of the recovery period and the straight-line method in the later years. The recovery deduction for an asset is computed by multiplying the cost of the property times the appropriate recovery percentage. For this purpose, cost is first decreased by one-half the amount of investment credit for the property ("basis adjustment"), unless the taxpayer elects to take a reduced credit (sec. 48(q)).

Present law provides certain options for, and restrictions on, the use of ACRS as it is summarized above.

3-year property

Automobiles, light-duty trucks, certain special tools, personal property used in connection with research and experimentation, and other short-lived property are assigned to the 3-year class. The recovery period for this class is 3 years, and recovery percentages are 25 percent for the first year, 38 percent for the second year,

and 37 percent for the third year. The investment credit for qualifying property in the 3-year class is 6 percent, unless the taxpayer elects a 4-percent credit in lieu of basis adjustment.

To illustrate the operation of ACRS and basis reduction for assets in the 3-year class, assume that a calendar-year taxpayer places a \$100 asset in service in 1984 and that the asset qualifies for the investment credit. The amount of the credit would be \$6, available in 1984. The basis adjustment would be \$3, which leaves \$97 to be recovered. If the taxpayer continues to use the asset at least through 1986, recovery deductions would be \$24.25 for 1984, \$36.86 for 1985, and \$35.89 for 1986.

5-year property

Personal property which is not in the 3-year class and is not long-lived public utility property is, with certain limited exceptions, assigned to the 5-year class. (Long-lived public utility property is assigned to the 10-year class or 15-year public utility class under ACRS.) Also, certain single-purpose agricultural and horticultural structures and certain petroleum storage facilities are included in the 5-year class.

The recovery period for property in this class is 5 years, and the recovery percentages are 15 percent for the first year, 22 percent for the second year, and 21 percent for each of the three following years. The investment credit for qualifying property in the 5-year class is 10 percent, unless the taxpayer elects an 8-percent credit in lieu of basis adjustment.

Progress expenditures

Generally, investment credits are claimed for the taxable year in which qualifying property is placed in service. However, in certain 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 (sec. 46(d)). In any case, cost recovery of progress expenditures does not begin until the property is placed in service.

Disposition of assets and recapture

Gain or loss is generally recognized on each disposition of an asset, including retirements from service, unless other provisions of the Code provide for nonrecognition. Gain from the disposition of depreciable personal property is recaptured as ordinary income to the extent of prior recovery deductions taken for the property (sec. 1245). For this purpose, the amount of any basis adjustment for investment credits is treated as a cost recovery deduction, except to the extent there is any investment credit recapture. Gain in excess of recovery deductions taken may be treated as a capital gain under section 1231 (unless the gain is offset by losses on sec. 1231 assets).

Earnings and profits

A corporate distribution with respect to the corporation's stock is generally taxable as a dividend only if it is made out of the corporation's current or accumulated earnings and profits. The computa-

tion of earnings and profits is similar to the computation of taxable income, as modified by certain adjustments and special rules.

Under one of these special rules, depreciation for earnings and profits is generally computed by using the straight-line method over 5 years for 3-year property and over 12 years for 5-year property (sec. 312(k)).

B. Explanation of the Bill

Overview

An open-ended accounting method of cost recovery would apply to property, other than public utility property, that is treated under present ACRS rules as 3-year or 5-year property. The present basis adjustment and the reduced credits which apply in lieu of basis adjustment would be repealed for property subject to the new system.

Cost recovery for qualified progress expenditures would start when the expenditures are made, if the asset would be depreciated under the new system when placed in service. The new system would generally eliminate determination of gain and recapture on the disposition of assets and would modify the computation of depreciation for earnings and profits.

Cost recovery under open-ended accounts

General rules

In general, an open-ended accounting method of cost recovery would apply to property (referred to as post-1983 recovery property) that is placed in service after 1983 and is treated under present ACRS rules as 3-year or 5-year property.¹ However, this recovery method would not apply to any public utility property, the costs of which would be recovered under present rules. The bill would repeal the present basis adjustment and the reduced investment credits in lieu of basis adjustment for post-1983 recovery property.

Post-1983 recovery property would be assigned to one of two categories (referred to as category 1 and category 2). For each category, there would be one open-ended recovery account and a recovery percentage selected, within limits, by the taxpayer.

Unlike current procedures under ACRS, where a separate account may be established for each item of property, the costs of all property in the same category would be placed in the same recovery account, regardless of the year of acquisition. This would be done according to a half-year convention, under which one-half the cost of an asset is added in the taxable year it is placed in service and the remaining half is added in the subsequent taxable year. An account balance would be reduced by the amounts realized (fair market value, in the case of certain transfers other than a sale) on disposition of assets which had been assigned to the account. The recovery deduction for an account would be computed by multiplying the account balance at the close of a taxable year times the ap-

¹ The bill, as introduced, was prepared for consideration in 1983. Therefore, the bill is described in this pamphlet as if the effective dates were one year later than the effective dates which are in the introduced bill. The latter dates are described in the section below ("Effective Date").

propriate recovery percentage. This deduction would be subtracted from the account to determine the opening balance in the account for the following year.

For each taxable year, a taxpayer would elect a separate recovery percentage, within limits, to apply to each recovery account. The permissible recovery percentages would reflect the benefits of continually using a declining balance method, not more rapid than 150 percent and not less rapid than 75 percent, and assuming a recovery period of 3 years for property in category 1 and 5 years for property in category 2. Technically, this would mean that the cost of an asset would never be completely written off. However, for a broad range of discount rates, the present value of the economic benefit of cost recovery for purchased assets (using the highest permissible recovery percentage in either recovery account) would be very nearly the same as cost recovery under present ACRS rules, taking into account the investment credit in each case.

In sum, a taxpayer would maintain only two accounts for property covered by the bill, rather than the more numerous asset-by-asset accounts under ACRS. This open-ended accounting method is available for income tax purposes in certain other countries, including Canada, Denmark and Hong Kong.

Category 1

Property that is assigned to the 3-year class under present ACRS rules, excluding public utility property, would be assigned to category 1. The recovery percentage that a taxpayer could select for the corresponding open-ended recovery account could be no greater than 50 percent and no smaller than 25 percent for any taxable year. The investment credit for qualifying property in category 1 would generally continue to be 6 percent, as under present law. However, the bill would allow a taxpayer to elect to place in category 2 any item of post-1983 recovery property that would otherwise be in category 1. The investment credit for qualifying property for which this election is made would be 10 percent.

To illustrate the operation of the open-ended system for assets in category 1, assume that a calendar-year taxpayer places a single \$100 asset in service in 1984, that the taxpayer elects 50 percent as the recovery percentage in every year, that the asset qualifies for the investment credit, and that the taxpayer acquires no additional assets. The amount of the credit would be \$6, available in 1984. The amounts added to the corresponding recovery account under the half-year convention would be \$50 in 1984 and \$50 in 1985. The recovery deduction for 1984 would be \$25 (50 percent times the closing balance of \$50). The 1985 closing balance would be \$75 (the 1985 opening balance of \$25 plus \$50 of acquisition cost under the half-year convention) and the cost recovery deduction for 1985 would be \$37.50. If the taxpayer continues to use the asset beyond 1985, the recovery deduction for a particular year would be one-half as great as the recovery deduction in the preceding year.

Category 2

Property that is assigned to the 5-year class under present ACRS rules, excluding public utility property, would be assigned to category 2. The recovery percentages that a taxpayer could select for

the corresponding open-ended recovery account could be no greater than 30 percent and no smaller than 15 percent for any taxable year. The investment credit for qualifying property in category 2 would be 10 percent. This would be the same credit as under present law, except for category-1 property which the taxpayer elects to treat as category-2 property (discussed above).

Progress expenditures

Cost recovery for qualified progress expenditures would start in the taxable year the expenditures are made (using the half-year convention provided by the bill), if the completed asset would be post-1983 recovery property when placed in service. The cost of the asset placed in service would be added to a recovery account only to the extent it exceeds progress expenditures for the asset which were previously taken into account.

Disposition of assets and recapture

Under the open-ended account system, gains and losses on the disposition of assets would generally be deferred. Instead of immediate gain or loss recognition, the amount realized would reduce the appropriate account balance which, in turn, would reduce the amount of recovery deductions in the year of the disposition and in subsequent years. If the amount realized reduces the account balance to a negative amount, such amount would generally be treated as a capital gain under section 1231, and section 1245 recapture would not apply. The amount so treated would be reduced to the extent of one-half of the depreciable bases of assets placed in service (or qualified progress expenditures made) during the taxable year. No reduction in the balance of a recovery account would be made by reason of a transfer at death.

In general, the fair market value of an asset would be subtracted from the appropriate recovery account in the case of transfers other than a sale. Property which ceases to qualify for cost recovery, such as property which is converted to personal use, would be treated as disposed of at fair market value.

The bill would provide special rules for the treatment of like-kind exchanges, involuntary conversions, and certain transactions in which basis carries over. In the case of like-kind exchanges or involuntary conversions where the properties were assigned to the same recovery account, no changes would be made to the account unless additional consideration in the form of money or other non-qualifying property were involved. Where such additional consideration is involved or the properties exchanged were assigned to different recovery accounts, adjustments would be made in accordance with regulations to be prescribed by the Treasury Department. In a disposition in which post-1983 recovery property is transferred and the transferee's basis is determined by reference to the adjusted basis of the transferor, the transferor's recovery account would generally be reduced by an amount which bears the same ratio to the account balance as the fair market value of the transferred property bears to the fair market value of all assets (including the transferred property) in the account. The transferee's basis in the transferred property would be the amount by which the transferor's account was reduced.

Earnings and profits

In the case of post-1983 recovery property, earnings and profits would be computed in the same way as recovery deductions, except that recovery percentages of 25 percent for the category-1 recovery account and 15 percent for the category-2 account would be used in every taxable year. Two separate accounts would be maintained for this purpose.

C. Effective Dates

In general, the provisions of the bill, as introduced, would apply to property placed in service by the taxpayer after December 31, 1982, in taxable years ending after that date. The provisions relating to qualified progress expenditures would apply to expenditures made by the taxpayer after December 31, 1985, in taxable years ending after that date.

