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SUGGESTED METHODS FOR LIBERALIZING DEPRECIATION

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BY THE

STAFF OF THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION

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METHODS FOR DETERMINING DEPRECIATION DEDUCTIONS

Introduction

The staff has prepared this brief description of suggested methods for liberalizing depreciation which have been brought to its attention. In connection with this description, it was believed desirable to set forth a brief review of the existing law.

All physical property, other than land, used in an income-producing activity loses value as time passes due to one or both of two factors: (1) "wearing out," that is, deterioration because of use or age (livestock, trees); and (2) improvement in the design and construction of competing property made to perform the same function (obsolescence). It is necessary to account for this loss of value in order to compute the income of a taxpayer and this is done through the use of so-called depreciation deductions. The depreciation deduction for any year is not measured by a specific amount of money paid during that year as are the deductions for rent, interest, and salaries. The determination of the amount to be deducted depends on the approach adopted, as well as on the particular estimates of useful lives and probable salvage values. Because these estimates involve predictions of future events and conditions, sharp differences of opinion easily develop.

The simplest method of computing depreciation is the so-called straight-line method. Under this procedure, the loss of value from the time the property is acquired until the time it is disposed of is spread evenly over the intervening years. Thus, if an asset costs $120, and the taxpayer intends to use it for 10 years and its estimated value at the end of this time is $20, then a deduction of $10 for each year of use is taken against income.

Other methods of depreciation accounting are sometimes considered desirable for a variety of reasons. Those methods in which the deductions taken during the earlier part of the life of an asset are greater than the deductions taken during the later part of its life are generally referred to as "accelerated depreciation." The main arguments advanced in support of these methods are:

(1) Property usually loses a greater amount of value in the earlier years of its life than in the later years, whether value is tested by market price or by productivity.

(2) Depreciation deductions in the early years in excess of the loss of value in these years are desirable to provide funds for quicker replacement or expansion.

(3) Since we have been in a period of generally rising prices the investment in a new machine is usually greater than the investment in the machine it replaces. It is, therefore, urged that large deductions should be allowed during the early part of the life of the new machine, since the deductions allowed for the use of the old machine

would be grossly inadequate if these deductions were to cover the cost of the new machine. It is apparent that this approach is a compromise between allowing depreciation deductions based purely on cost and allowing deductions (with respect to the old machine) to create a replacement fund. This, in effect, is the basis of H.R. 422 (87th Cong., 1st sess.), described below.

Prior to the enactment of the 1954 Code the only criterion for a proper depreciation deduction was its reasonableness. The Internal Revenue Service permitted the use of the straight line as well as various other methods of depreciation, but only upon a specific showing that these other methods were reasonable in the circumstances. Under the 1954 Code certain special methods are deemed to be reasonable whenever they are applied to tangible property, which has never been used, acquired after 1953.

Recent Supreme Court decisions have interpreted the terms "useful life" and "salvage value." Under this interpretation, "useful life" is the probable useful life in the taxpayer's business without regard to the total useful life in the hands of the taxpayer and other persons. The term "salvage value" (which must ordinarily be determined at the time of acquisition) means, according to the Supreme Court, the value that the property may have when the taxpayer wishes to stop using it; that is, the price for which the property may then be sold, not its value (if any) when it can no longer be used. *The Hertz Corporation* v. *U.S.*, 80 Sup. Ct. 1420 (1960), and *Massey Motors, Inc.* v. *U.S.*, 80 Sup. Ct. 1411 (1960).

A. PROPOSALS FOR NEW LEGISLATION

(1) *Unlimited choice by each taxpayer.*—The most drastic proposal is that each taxpayer shall be allowed to deduct as depreciation whatever he wants, whenever he wants, as long as the aggregate deductions over the life of the property do not exceed the cost or other tax basis. Under this proposal a taxpayer could, if he wished, deduct the entire cost in the year of acquisition. In the alternative he could spread the cost in any manner. So, for example, for an asset having a useful life of 4 years or more he could deduct 50 percent in the year of acquisition, nothing in the next year, 10 percent in the third year, and 40 percent in the fourth year.

(2) *Unrestricted choice within a maximum.*—Another proposal is that the law should provide maximum rates for large classes of depreciable assets or permit the Treasury to fix such rates. Presumably these rates would be considerably higher than, perhaps double, the straight-line rate based upon past experience by industrial groups. For example, if Bulletin "F" indicates a normal useful life of 20 years for a class of assets, a maximum rate of depreciation for that class might be established at 10 percent. The proposal is that each taxpayer may deduct in any year any percent of the cost or original tax basis up to this maximum of 10 percent, double the straight-line rate of 5 percent. Thus, he could deduct 10 percent in the first year, nothing in the second year, 3 percent in the third year, 10 percent in the fourth year, etc. This proposal could also be modified by requiring minimum deductions.

(3) *Unrestricted choice of useful life.*—This proposal would permit each taxpayer to choose what he believed to be the useful life for each item or class of items. However, he would be required to use one of the methods permitted under section 167(b) of the 1954 Code.

(4) *Unrestricted use of a consistent method.*—Under this proposal (which is an expansion of (3) above), each taxpayer would determine the method of depreciation to be used, without regard to the limitations in section 167 (b) and (c). He would also be permitted to determine the rate to be used, without regard to the actual physical life of the asset and without regard to the period of time he intends to use it. Having determined the method and the rate or the life he wishes to use with respect to each individual asset or each reasonable class of assets, he would be permitted to use that rate and method, so long as he used them consistently, until the item or all the items in the class had been fully depreciated.

(5) *Brackets for useful lives.*—According to this proposal the law or the regulations would provide minimum and maximum useful lives to be used for large classes of depreciable property. For example, if the average life of a certain class of property is 20 years, the taxpayer might be permitted (without dispute) to use a life as short as 10 years or as long as 30 years. In such a case the law would permit the issuance of regulations which would state that for any item in this class of property the minimum useful life is 10 years and the maximum life 30 years, with the taxpayer free to choose any useful life within this minimum and maximum for each item.

(6) *Percentage variation for useful life.*—Under a suggestion, similar to (5) above, the Service would publish tables such as those in present Bulletin F showing average lives. Any taxpayer would then be permitted to base his depreciation deductions on a useful life varying, say, not more than 20 percent from this published figure. Thus, if the published figure for residential housing was 40 years, any useful life from 32 years to 48 years would be permitted without dispute.

(7) *Greater acceleration.*—It has been suggested that a declining balance method using 300 percent of the straight-line rate instead of 200 percent be permitted. Under such a schedule the deductions for the first 3 years for an item with a life of 10 years would be 30 percent, 21 percent, and 14.7 percent of the original cost as compared with deductions of 20 percent, 16 percent, and 12.8 percent under the 200 percent declining balance method.

(8) *Larger first-year deductions.*—Various proposals have been made to increase the small business deduction provided by section 179. Instead of being permitted to deduct, in the year of acquisition, 20 percent of $10,000 ($20,000 for joint returns), it has been suggested that a first-year deduction of 20 percent of acquisitions up to $20,000, $30,000, $50,000, $100,000 or some other figure be permitted.

(9) *Larger rate of first-year deductions.*—As a variation on the preceding suggestion it has been suggested that the first-year deduction be not limited to 20 percent of the allowable base, but that the deduction be 25 percent, 30 percent, 50 percent or some other percentage.

In considering the above suggestions, it should be kept in mind that numerous restrictions, expansions, and modifications of the plans outlined are possible.

Proposals relating to inflationary price increases

Due to the pronounced rise in the level of prices which has been experienced during the last 20 years, taxpayers argue that depreciation based on original cost is inadequate, because the aggregate depreciation deduction when the item is retired is materially less than the amount which must then be paid for the replacement item. It is argued, therefore, that "depreciation" deductions should in one way or another be geared to the proper replacement cost and not to the lower original cost.

(10) *Deductions geared to changing index figures.*—A frequent suggestion is that one or another index reflecting changing prices, such as the Consumer Price Index, the Wholesale Price Index, a construction cost index, etc., be used to determine the additional deduction which should be allowed each year to reflect changing prices. Under such a proposal, if depreciation based on cost were $1,000 per year and the index showed a price level of 105 at the end of the first year, 109 at the end of the second year, and 115 at the end of the third year, the depreciation deductions would be $1,050 for the first year, $1,090 for the second year, and $1,150 for the third year.

(11) *Deductions geared to aggregate change in index figures.*—Assuming a substantial and continued increase in prices during the life of the asset, under the preceding suggestion the deductions would not, in the aggregate, equal the cost of replacing the original item. A modification of the use of indexes, therefore, would be that aggregate depreciation deductions to the end of any year would be increased to equal the change in the index at that time, by appropriately increasing the deduction for that year. Thus, using the facts as given in the preceding paragraph, the deduction for the first year would be $1,050, the deduction for the second year would be $1,130, instead of $1,090, so that the aggregate deduction for 2 years ($2,000 based on original cost) would be increased to a total of $2,180, 109 percent of depreciation based on cost. For the third year the deduction would be $1,270, instead of $1,150, so as to make the aggregate deductions to that point $3,450, 115 percent of the aggregate deductions based on original cost.

(12) *Additional deduction at time of replacement.*—To avoid difficulties involved in the use of index numbers and to eliminate a criticism that depreciation would not be based on costs actually incurred, it has been suggested that when an item is replaced the excess cost of the replacement item over the cost of the item replaced, be deducted in the year the replacement item is acquired. Thereafter depreciation on the new item would be based on the purchase price less the inflationary element which was immediately deducted. This proposal differs in theory from proposals generally advocating large first-year deductions in that here the first-year deduction is intended to reflect alleged inadequate deductions with respect to the item replaced, rather than to provide an incentive for expansion. H.R. 422 (Mr. Keogh) is an application of this approach with certain modifications.

Special depreciation allowances based on expansion

In order to limit special depreciation deductions to situations where such deductions are likely to result in benefits to the economy, it has been proposed that special depreciation deductions be permitted only where the taxpayer expends in the current year for newly acquired depreciable property a greater amount than his total depreciation deduction for that year. Thus, if a taxpayer had a total depreciation deduction of $50,000 for 1961 (without regard to assets acquired in that year) and in that year he invested $40,000 in depreciable property, no special allowance would be granted. If, however, he invested $70,000, either for replacement, for expansion, for more efficient items of plant and equipment, or merely to buy facilities formerly rented by him, a special allowance would be permitted, but only with respect to the excess $20,000.

Various methods of determining special allowances for expanded investment are possible. The special allowance might be additional first-year depreciation, as now allowed in a limited way under section 179. Thus, 20 percent, 25 percent, 50 percent, or 100 percent of this $20,000 excess might be allowed as a deduction in the year of acquisition, with ordinary depreciation being allowed with respect to the balance (if any) of the cost of assets acquired.

Tax credits or special allowances (other than depreciation deductions) based on expansion

Other proposals involve an absolute deduction in addition to depreciation with respect to the excess amount invested. Under one such proposal there would be a deduction from income of a stipulated portion of the excess and, in addition, a depreciation allowance computed in the ordinary way would be permitted on the entire cost of the asset acquired.

Alternatively, instead of a deduction from income, it is suggested that there be an immediate tax credit of a stipulated percentage of the amount of the excess investment. In such cases full depreciation deductions would also be permitted on the entire cost of the assets.

B. RESULTS OF TREASURY SURVEY AS TO SOME PROPOSED METHODS

In 1960 the Treasury, in cooperation with the Small Business Administration, made a survey on depreciation in the course of which it sent questionnaires to many large and small corporations. On January 5, 1961, the Treasury released to the public a "Preliminary Report" on this survey made on the basis of the answers received up to that time (from 1,918 large corporations and from 1,177 small corporations). From this report it appears that a large majority of both the large and small corporations favored a method according the taxpayer freedom to follow his own judgment as to useful lives and depreciation methods, consistently applied, method No. (4) above. It should be noted, however, that method No. (1) above, unlimited choice, was not one of the alternatives suggested in the questionnaire.

The Treasury further states in its report that over half of the corporations indicated interest in some form of depreciation adjustment to reflect increased price levels. About a fifth of this group favor the reinvestment depreciation allowance which would permit the difference between the original cost and current replacement value of a retired asset to be deducted at the time of replacement, with a corresponding reduction of the depreciable basis of the new property (substantially the same as No. (12) above). A much larger fraction favored adjusting the depreciation deduction annually on the basis of changes in the price level.

C. ADMINISTRATION BILL IN 86TH CONGRESS AND SECTION 1231 ASSETS

During the 2d session of the 86th Congress, the Committee on Ways and Means held hearings on H.R. 10491, "A bill to provide for the treatment of gain from the sale or exchange of tangible personal property used in the trade or business." The reason for the bill is set forth in a letter from Secretary Anderson to the Vice President and Speaker of the House:

> Under existing law, gain realized by a taxpayer upon the sale of depreciable personal property used in business is taxable as long-term capital gain even though part or all of the gain may be attributable to depreciation allowances which have been taken as ordinary deductions. This has hampered the sound administration of the depreciation laws because through the medium of the depreciation deduction ordinary income may be converted into capital gain. Accordingly, agents of the Internal Revenue Service have been zealous in insisting upon full proof that depreciation rates and salvage values claimed by a taxpayer can be substantiated by expert opinion or actual experience.
>
> Informed opinion often differs as to the period of time over which an item of machinery or other depreciable property may reasonably be expected to be useful to the taxpayer in his trade or business. The necessity of establishing a salvage value for an item of personal property also causes innumerable problems for industry and the Internal Revenue Service.
>
> The proposed statutory change which would require that gains from sale of depreciable personal property be treated as ordinary income, to the extent of depreciation previously claimed, would make it possible for agents of the Internal Revenue Service to accept more readily taxpayer judgments and taxpayer practices with respect to depreciation rates and salvage value. In short, if enacted the proposed legislation, by eliminating the opportunity which now exists of converting ordinary income into capital gains, would contribute to the sound administration of the depreciation laws.

The introduction of the bill and the discussion in connection with it point up the fact that excessive depreciation deductions result in capital gain rather than ordinary income at the time the property is sold, because of the provisions of section 1231. The arguments made in favor of the bill by the Treasury will have even greater force if some of the proposals now under consideration are adopted.

In connection with the problems arising out of section 1231, it should be noted that the Treasury's report on its survey (referred to above) states:

> A substantial majority who answered (73 percent for large and 63 percent for small firms) also expressed willingness to forego capital gain benefits on disposals of depreciable property to the extent of depreciation previously taken if depreciation were liberalized.

In view of the information in the above quotation, it has been suggested that only those taxpayers who elect to use certain more liberal methods of deducting depreciation be required to treat gains from the sale of depreciable property to the extent of depreciation previously allowed as ordinary income rather than as capital gain.

D. METHODS PERMITTED UNDER PRESENT LAW

(1) *Straight-line depreciation.*—This method (already described above) was the method used under the 1939 Code and is still used under the 1954 Code in many cases. Under this procedure, equal deductions are taken for each year of the useful life. Thus, if an asset costs $1,000, has a useful life of 10 years and will have no salvage value at the end of that time, the annual deduction will be $100.

Special methods under 1954 Code (described below in (2), (3), (4), and (5)).—Sections 167(b) and (c) provide that certain methods shall be deemed to be reasonable if they are used for tangible property acquired after 1953 which has never previously been used and has a useful life of more than 3 years.

(2) *200 percent declining balance method.*—Under this method twice the straight-line rate is applied to a diminishing balance. For an asset with a probable life in a taxpayer's business of 10 years, the deduction for the first full year is 20 percent; for the second full year it is 20 percent of the remaining 80 percent or 16 percent of the original cost; for the third year it is 20 percent of the remaining 64 percent, or 12.8 percent, etc. The probable salvage is not deducted from the cost, but deductions for depreciation must stop at the time the undepreciated balance is equal to the probable salvage value. Under this procedure about 40 percent of the cost is deducted in the first quarter of the useful life and about two-thirds in the first half of the useful life. Where there is any substantial salvage value, this method generally permits the fastest writeoff possible under the present law.

(3) *Sum-of-the-years-digits method.*—Under this method, in the case of an asset having a 5-year life, the digits 1, 2, 3, 4, and 5 are added, the sum being 15, and the deduction is five-fifteenths of the cost (after salvage value has been deducted) for the first year, four-fifteenths for the second, etc. This differs from the 200 percent declining balance method in that all the cost less salvage is deducted during the useful life, whereas under the declining balance method there is always an undeducted amount progressively becoming smaller until salvage value, if any, is reached. Where there is no salvage value, the sum-of-the-years-digits method permits the faster writeoff, since the writeoff is about 75 percent of the cost in the first half of the life. On the other hand, since probable salvage must be deducted from the cost, if there is substantial salvage, this method will involve smaller deductions in the early years than the 200 percent declining balance method.

(4) *Combination declining balance and straight-line method.*—Section 167(e) of the 1954 Code permits a shift from the declining balance method allowed by section 167(b) to the straight-line method at any time. For a $1,000 asset with a zero salvage value and a 10-year life, it would be advantageous to shift to the straight-line method after the sixth year in order to avoid a long-continued "tail" under the diminishing balance method. The undepreciated cost is then $262.14, and the straight-line deduction is $65.53 for each of the remaining 4 years as compared with deductions of $52.43, $41.94, $33.55, and $26.84 under the declining balance method.

(5) *Stepladder straight-line method.*—Section 167(b) permits the use of any consistent method as long as the amount charged off at any time during the first two-thirds of the useful life is not a greater

amount than would have been deducted under the 200 percent declining balance method. Therefore, with an asset having a useful life of 10 years, for example, the taxpayer may elect to charge off 15 percent per year for the first 3 years, 8 percent per year for the next 6 years, and 7 percent for the last year (assuming no salvage value at the end of 10 years).

Comparison of methods.—

Annual and cumulative depreciation deductions for asset costing $1,000, having no salvage value, and with useful life of 10 years

	Straight-line method (1)		200-percent declining balance method (2)		Sum-of-the-years-digits method (3)		Combination declining balance and straight-line method (4)		Stepladder straight-line method (5)	
	Annual	Cumulative	Annual	Cumulative	Annual	Cumulative	Annual	Cumulative	Annual	Cumulative
1	$100.00	$100.00	$200.00	$200.00	$181.82	$181.82	$200.00	$200.00	$150.00	$150.00
2	100.00	200.00	160.00	360.00	163.64	345.46	160.00	360.00	150.00	300.00
3	100.00	300.00	128.00	488.00	145.45	490.91	128.00	488.00	150.00	450.00
4	100.00	400.00	102.40	590.40	127.27	618.18	102.40	590.40	80.00	530.00
5	100.00	500.00	81.92	672.32	109.09	727.27	81.92	672.32	80.00	610.00
6	100.00	600.00	65.54	737.86	90.91	818.18	65.54	737.86	80.00	690.00
7	100.00	700.00	52.43	790.29	72.73	890.91	65.54	803.40	80.00	770.00
8	100.00	800.00	41.94	832.23	54.55	945.46	65.54	868.94	80.00	850.00
9	100.00	900.00	33.55	865.78	36.36	981.82	65.53	934.47	80.00	930.00
10	100.00	1,000.00	26.84	892.62	18.18	1,000.00	65.53	1,000.00	70.00	1,000.00

(6) *150 percent declining balance method.*—Where the limitations of section 167(c) of the 1954 Code prohibit the use of the 200 percent declining balance method (for example, in the case of used assets), it is, nevertheless, possible to use a 150 percent declining balance method. Under this method, for an asset with a 10-year life the deductions for the first 3 years would be 15 percent, 12.75 percent, and 10.84 percent of the cost as compared with deductions of 20 percent, 16 percent, and 12.8 percent for the first 3 years under the 200 percent declining balance method. No change may be made from this declining balance method to straight-line depreciation without the consent of the Commissioner.

(7) *Unit of production method.*—It can be argued that in some circumstances depreciation should be tied to actual production. Under both the 1939 Code and the 1954 Code it is permissible to do this by the use of the unit of production method. This method is permitted, however, only in those relatively few cases where the units to be produced by the structure or machine can be estimated with reasonable accuracy (generally, machinery and equipment used in the extraction of natural resources). For example, if a total of 100,000 tons of coal can be extracted from a mine, and after this extraction the machinery used will be worth nothing (that is, less than the cost of moving it away), then 1/100,000 of the cost of the machinery is deducted as each ton of coal is mined. This method involves no estimates of the length of the probable useful life since the deduction varies automatically with production whether the useful life is short or long. In some circumstances this method may result in a greater deduction than that under any other method permitted by the code. It has another value in that, in general, it allows a larger deduction in a year when the gross income is larger and a smaller deduction in a year when the gross income is smaller.

(8) *Income forecast method.*—On November 28, 1960, the Internal Revenue Service published a revenue ruling (Rev. Rul. 60–358, I.R.B. No. 1960–48, p. 9), which states that "as to television shows, taped shows for reproduction and other property of a similar character," the "income forecast method" is permitted. Under this method, the total income the property will produce is first forecast. Thereafter, the fraction of the cost to be deducted each year is determined by dividing the income produced in that year by the total income forecast.

(9) *Other methods.*—Many other methods are possible since section 167(a) permits the use of any method which is reasonable and consistently applied, and section 167(b), if applicable, permits the use of any consistent method as long as the amount charged off is not more than under the 200 percent declining balance method during the first two-thirds of the life. However, nearly all taxpayers use one or another of the methods listed above.

(10) *Small business deduction.*—Section 179 (enacted in 1958) permits the deduction of 20 percent of so much of the cost of property acquired during the year as does not exceed $10,000 ($20,000 for spouses filing a joint return). The section applies only to tangible personal property, new or old, having a useful life of at least 6 years. Any corporation or single individual buying $10,000 worth of tangible personal property may deduct $2,000 in addition to ordinary depreciation on the remaining $8,000. A man filing a joint return with his wife may deduct $4,000 if he buys $20,000 worth of tangible personal property. Thus, if a sole proprietor, single, buys $20,000 worth of new tangible personal property in 1961 having a useful life of 8 years, he may deduct $2,000 (20 percent of the first $10,000), plus whatever depreciation deduction he may take on the remaining $18,000 in the first year. If he uses the 200 percent declining balance method, he may deduct 25 percent of this $18,000, so that he has a total deduction of $4,000 out of the first $10,000 cost (20 percent of $10,000 plus 25 percent of the remaining $8,000) and $2,500 (25 percent of $10,000) out of the remaining $10,000 cost. It should be observed that the deduction permitted by section 179 does not increase the total depreciation deduction for the first year by a full 20 percent of the first $10,000 cost, because the basis for computing ordinary depreciation is diminished by the special deduction. The special deduction has no relation to the life of the asset, and, furthermore, in some circumstances the 20 percent may be deducted if the asset is used in the business for only 1 day during the taxable year.

E. USE OF EXISTING METHODS AS SHOWN BY TREASURY SURVEY

In its preliminary report on its survey the Treasury stated:

> About 70 percent of the responding large corporations reported that they used one or more of the new liberalized depreciation methods authorized under the Internal Revenue Code of 1954, leaving 30 percent which did not report using the new methods for any significant part of their depreciable property accounts. Of those reporting that they had adopted one or more of the new methods, nearly two-thirds indicated that they were using the double declining balance method. More than one-half reported using the sum-of-the-

> years-digits method. About 1 percent reported that they were using other equivalent new methods.
>
> Among the smaller business firms, 57 percent reported the use of one or more of the new methods. About three-fourths of these indicated that they were using the double declining balance method. More than one-third reported use of the sum of the years digits method, with a small number using other equivalent methods.
>
> As might reasonably be expected, the preliminary survey data disclosed differences in the extent of use of the additional first-year depreciation allowance provided under the Small Business Tax Revision Act of 1958, [sec. 179] as between large and small firms. This allowance permits the taxpayer at his election to write off in the first year 20 percent of up to $10,000 capital expenditures annually ($20,000 on a joint return) for both new and used equipment, other than certain short-lived assets. Although equally available to large and small firms, it is of importance chiefly for small business. About 22 percent of the larger corporations surveyed had elected to use the additional first-year depreciation allowance. About 37 percent of the smaller firms had elected to use the additional first-year allowance.

Question No. (5) on the questionnaire was: "Do you think the present allowances for depreciation for tax purposes are reasonably satisfactory?" The Treasury reports on the answers to this questionnaire:

> About 32 percent of the large corporations and 53 percent of the smaller firms indicated that they regard the present allowances for depreciation for tax purposes as reasonably satisfactory. About 63 percent of the large corporations and about 42 percent of the smaller firms considered the present allowances unsatisfactory. A minority of 5 percent had no opinions as to whether present provisions are reasonably satisfactory.

F. CANADIAN DEPRECIATION PRACTICE

In a symposium conducted by the Tax Institute at Princeton, N.J., in November 1958, the Canadian system was described (by Mr. Harvey Perry) in these terms:

> The capital cost allowance scheme is an important part of the revision of our income tax legislation introduced by the Minister of Finance in 1949, an overhaul comparable to your 1954 Internal Revenue Code revision. Among the more important of its many changes was the introduction of a completely new concept of writeoffs for expenditures on fixed assets. The main features of the new scheme were—
>
> 1. The rates of writeoff were set at about double the normal level, which meant in effect that the level that had prevailed for new industrial plant and equipment in the postwar period was adopted permanently.
> 2. The basis of writeoff was changed from straight line on original cost to diminishing balance.

3. In place of a variety of rates on individual assets rates were established for about a dozen main classes of assets. The assets in each class are of reasonably similar age although varying widely in type.
4. Each class of assets might be described as an open account for income tax purposes. The balance on which the capital cost allowance for the year is based is calculated as the opening balance plus new assets acquired during the year and minus recoveries from assets sold during the year but not exceeding in the latter case the original cost of the asset.
5. When a whole class of assets is liquidated and a net recovery results the excess must be taken into income but may be spread back over taxable income of the previous 5 years.

This is an extremely compressed exposition of our capital cost allowance system and some further words of explanation would be advisable.

1. Assets need not be in use nor even completely installed to be subject to allowance; for example the amount expended on a partially completed building during a tax year is included in the balance for capital cost allowance at the end of the year.
2. Under the scheme an allowance is given in effect for obsolescent assets; they are simply left in a class and are eligible for capital cost allowance whether they are in use or not, or for that matter whether they are even in the ownership of the taxpayer.
3. The unique character of the new scheme is its abandonment of the "engineering" or "wear and tear" approach. As the Minister himself emphasized in his introductory statement the governing principle is "the amortization of costs of depreciable assets." In a sense it is a financial concept rather than an engineering or accounting one. It rests on the simple assumption that if a writeoff for outlays on fixed assets is to be allowed in the business and tax computation it is sensible to allow it over a period of years rather than all in 1 year, but the exact period is not of much consequence. It also takes the logical approach that if a fairly high rate of writeoff is granted as a permanent concession then the Treasury must take steps to protect itself fully against abuses arising from resale of assets that have been fully written off.

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