

**STATE BAR OF CALIFORNIA
TAXATION SECTION
TAX POLICY, PRACTICE & LEGISLATION COMMITTEE**

MODERNIZING AND RATIONALIZING DEPRECIATION

This proposal was prepared by Annette Nellen, chair of the Tax Policy, Practice & Legislation Committee of the State Bar of California's Taxation Section, and Chad Jaben, law student at the University of San Francisco School of Law.¹ The authors wish to thank John D. Milikowsky for his insights, and the reviewers Mark Hoose, Daniel Lathrope of University of San Francisco School of Law, and Stuart A. Simon of Buchalter Nemer, A.P.C., for their helpful comments.²

Contact Person: Annette Nellen
 San José State University
 One Washington Square
 San Jose, CA 95192-0066
 (408) 924-3508
 annette.nellen@sjsu.edu

¹ The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or the Los Angeles County Bar Association.

² Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participation has been specifically engaged by a client to participate on the project.

EXECUTIVE SUMMARY³

Our “modern” tax depreciation rules are based on a decades old system of classifying assets. Current rules lack a systematic and equitable approach for reflecting changes in useful lives and new assets. In addition, the rules are overly complex and favor some taxpayers and assets over others. The depreciation system should be modernized and rationalized to address these weaknesses.

There have been numerous studies on the depreciation system, its weaknesses, and possible improvements. Yet, depreciation reform remains elusive. The significance of the issues, which include the effect of depreciation on tax liabilities and business operations, clearly shows that depreciation warrants stand alone reform. Also, the topic should have a significant place in discussions about tax reform, including simplifying the tax system, minimizing compliance costs, reducing the tax gap, and addressing economic competitiveness concerns. This report summarizes key problems with today's depreciation system within the context of whether the current system reflects principles of good tax policy.

Recommendations are offered for reforming and updating depreciation and amortization rules to better ensure that the system meets the principles of simplicity, certainty, neutrality, economic efficiency and equity. The recommendations include providing more information to taxpayers, repeal of the mid-quarter convention, broadening the types of assets subject to §179 expensing, removal of computers and cell phones from the listed property limitations of §280F, allowing regular depreciation to be used for alternative minimum tax (AMT) purposes, modification of the general asset account rules, updating the §280F limitation to reflect current prices, broadening the definition of passenger vehicles for §280F purposes to include vehicles weighing up to 14,000 pounds, and providing the Treasury Department with authority to modify class lives and address new assets.

³ Annette Nellen, CPA, Esq, is a professor in the College of Business at San José State University and Director of the graduate tax program. She is the 2010 chair of the California Bar Tax Section's Tax Policy, Legislation and Practice Committee. Chad Jaben is a second year law student at University of San Francisco School of Law. The information contained in this paper is not intended as legal advice.

DISCUSSION

I. INTRODUCTION

Tax depreciation rules should be modernized and rationalized.

Depreciation and amortization are key elements of measuring taxable income for most businesses. Ineffective rules can lead to errors, challenges to competitiveness, inefficient investments, and ineffective use of tax dollars. The depreciation rules as currently provided in multiple Internal Revenue Code⁴ sections are overly complex, do not always tie to the economic use of assets, are not structured to support any common economic or business goals, and lack an effective mechanism for updating to reflect changes in technology and business operations.

A. Approach of this Paper

This paper reviews the current depreciation/amortization system, issues that exist, and possible reforms. The goal is to help bring this important topic to the forefront and encourage rational change to the depreciation system rather than only treating the rules as tools for revenue generation and isolated incentives that do not address the overall depreciation/amortization system. Issues discussed include ones that make the system too complex, non-neutral, non-transparent and harmful to business competitiveness. This paper merges a review of various government studies on this topic with the authors' analysis of the current rules using principles of good tax policy. In addition to specific recommendations, principles are suggested that can serve as guidelines in future efforts to reform depreciation rules on a stand alone basis or as part of broader tax reform activities.

B. Why Problems Exist

Tax depreciation rules have been changed frequently to address various concerns such as a slowing economy, inflation, protracted depreciable lives for certain assets, complexity for small businesses, and

⁴ References to Code, IRC or section refer to the Internal Revenue Code of 1986 as amended, 26 United States Code. References to regulations refer to the Department of Treasury Regulations, 26 Code of Federal Regulations.

personal use of luxury business assets. Numerous piecemeal changes have resulted in an assortment of Code provisions that have come to lack an overall strategic rationale and fail to meet some key principles of good tax policy. Proposals for changing depreciation rules are quite varied indicating a lack of uniform agreement on how the rules can be improved as well as insufficient discussion and debate as to what types of changes are appropriate for today's tax system and economy.

C. Benefits from Rationalizing and Modernizing Depreciation Rules

Appropriate depreciation rules are crucial for economic growth and efficiency, simplicity, and fairness among taxpayers. Efforts to reduce the tax gap, improve competitiveness of U.S. businesses, and simplify the tax laws will benefit from an improved depreciation system that has been modernized and rationalized.

II. DEPRECIATION THEORIES

In measuring income for both tax and accounting purposes, an expense called "depreciation" is included to, in effect, allocate a calculated portion of the cost or basis of a long-lived asset over its useful life. Such allocation supports a matching concept in that usage of assets is needed to generate income. Depreciation provides a way for the cost of an asset with a life exceeding one year to be reflected in income over time to "avoid heaping an unusually large expenditure on particular periods for wear and tear going on gradually during a whole series of years[.]"⁵ The term "depreciation" typically refers to tangible assets, while the term "amortization" refers to intangible assets. The concepts are similar, although the computation methods differ under federal tax law.

For tax purposes, §167(a) describes depreciation deductions as "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in a trade or business or held for the production of income. However, tax depreciation rules might also be designed to provide an incentive for certain types of businesses or assets. In addition, some businesses may be allowed to

⁵ DAVID W. BRAZELL, LOWELL DWORIN & MICHAEL WALSH, TREAS. DEP'T, A HISTORY OF FEDERAL TAX DEPRECIATION POLICY 2-3 (1989), available at <http://www.treasury.gov/offices/tax-policy/library/ota64.pdf>.

"expense" (*i.e.*, deduct the entirety of purchase price in the year of acquisition) all or a portion of the tangible personal property and software in the year acquired rather than depreciate them. Such an approach serves to both encourage investment and simplify tax compliance for eligible businesses.

To calculate depreciation, the following asset information is needed: (1) basis, (2) useful life, (3) appropriate depreciation method (usually straight-line for accounting and accelerated for tax), and (4) salvage value (what the asset might be worth at the end of its useful life).

Under today's tax depreciation rules, referred to as MACRS (Modified Accelerated Cost Recovery System), the Code assigns an asset an applicable useful life (or "recovery period") and a method based on the type of asset. MACRS does not consider an asset's salvage value. MACRS includes one more factor called the "convention" that affects the depreciation calculation only in the first and last year; "convention" is not a required factor in calculating depreciation.

There are some instances where tax depreciation rules may vary from traditional MACRS guidelines. Today's tax depreciation rules include several exceptions where either MACRS might not be available for particular assets and businesses or reduced depreciation is mandated. Alternatively, some assets may be eligible for different calculation methodologies, such as the income forecast or units-of-production methods.

In contrast to tax and accounting depreciation, economic depreciation focuses more on measuring the annual decline in the market value of the asset, rather than allocating an appropriate amount of the asset's cost against annual income generated from the use of the asset. Accelerated depreciation methods attempt to reflect economic depreciation on the assumption that assets lose a greater portion of their value in their early years.

In 1984, the Treasury Department's study on tax reform suggested that inflation adjustments be included in the depreciation rules. Per the report, this change would "eliminate the need for the arbitrary ad hoc adjustments for inflation currently incorporated in the investment tax credit, the accelerated write-off of depreciable property, and the partial exclusion of long-term capital gains." The report also noted that economic depreciation would eliminate the disparities among industries and assets of the current

system.⁶ While the Tax Reform Act of 1986 repealed the investment tax credit, lengthened most depreciable lives and eliminated the capital gains deduction, inflation adjustments were not added to the depreciation rules. However, greater acceleration of depreciation was enacted (in the form of the 200% declining balance method for most tangible personal property rather than the 150% declining balance method) as part of the 1986 reform. In 1995, a proposal for "neutral cost recovery system" (NCRS) called for both inflation and interest adjustments to depreciation expense; however, it has yet to be implemented.⁷

For tax purposes, the reflection of an asset's cost and earnings in the tax base also depends on the type of tax involved. In an income tax, assets are generally depreciated over their useful lives. Under a consumption tax (sometimes mentioned in U.S. tax reform discussions), assets are expensed in the year acquired. This approach ensures that the return from the investment in the asset is not subject to tax as generally, consumption taxes do not tax investment earnings.

III. OVERVIEW TO THE TAX DEPRECIATION CALCULATION

US depreciation laws have changed repeatedly since inception.⁸ As a result, the depreciation calculation process under today's depreciation system remains quite intricate. Several Code sections must be consulted in order to calculate the appropriate depreciation expense. First, the taxpayer must determine if the asset is considered tangible or intangible under the tax law. If intangible, §197 must first be considered and might call for a 15-year life; if §197 does not apply, then §167 might apply. If tangible personal property is involved, §168 and Revenue Procedure 87-56 are used to determine the recovery period. Section 168 provides the recovery period for real property and the methods and conventions to use. For real property, straight-line depreciation with a mid-month convention is required. The recovery period for residential real estate is 27.5 years while for other real property it stands at 39 years. Land is not depreciable.

⁶ TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, VOL. 1, 41 (1984), *available at* <http://www.treas.gov/offices/tax-policy/library/tax-reform/>.

⁷ Introduced as part of the Republican Contract with America, Job Creation and Wage Enhancement Act; *available at* <http://www.house.gov/house/Contract/CONTRACT.html>. Also introduced in 2001 as H.R. 3042 (107th Congress).

⁸ See Appendix B for a Brief History of US Depreciation Law.

For tangible personal property, the taxpayer must determine if the property is "listed property" as defined under §280F. If yes, annual depreciation deductions may be limited and a slower method required. If the taxpayer has placed in service (during the taxable year in question), less than \$500,000 of tangible personal property and off-the-shelf software, then an expensing election under §179 must be considered. The deduction under §179 is limited if the acquired property is subject to the §280F limitation. Taxpayers must also be aware of several special rules including temporary ones that might, for example, allow additional depreciation in the first year. Special rules and exceptions tend to be narrowly defined so taxpayers must pay careful attention to the details. For example, for 2009, §168(k) allowed 50% bonus depreciation in the first year. The acquired property had to be new and it had to not only be purchased, but also placed in service by December 31, 2009 to qualify for the extra first-year depreciation deduction.

In addition to the tedious considerations above, taxpayers need to calculate different depreciation expense for alternative minimum tax (AMT) purposes for their tangible personal property (§56(a)(1)). Recordkeeping is important so that gain or loss can be calculated upon disposition and the character properly determined.

IV. EVALUATING FEDERAL DEPRECIATION RULES USING PRINCIPLES OF GOOD TAX POLICY⁹

Various formulations exist to describe principles of good tax policy.¹⁰ The following analysis considers key principles (such as simplicity, economic efficiency and equity) most relevant in critiquing today's federal depreciation rules. Ideally, tax rules should satisfy all principles of good tax policy. As noted by the American Institute of Certified Public Accountants (AICPA) in its description of the principles: "not all ten of the principles can always be achieved to the same degree for all proposed tax changes. For example, to exclude a particular type of economic benefit from taxation may

⁹ This report uses a tax principles approach to highlight significant weaknesses in today's depreciation rules. Many of these issues are also highlighted and explained in depth, along with several other weaknesses, in TREAS. DEP'T. REPORT TO THE CONGRESS ON DEPRECIATION RECOVERY PERIODS AND METHODS (2000), *available at* <http://www.treasury.gov/offices/tax-policy/library/depreci8.pdf>.

¹⁰ ANNETTE NELLEN, POLICY APPROACH TO ANALYZING TAX SYSTEMS, *available at* http://www.cob.sjsu.edu/facstaff/nellen_a/TaxReform/PolicyApproachToAnalyzingTaxSystems.pdf (last visited Feb. 10, 2010).

satisfy the simplicity principle, but not the equity or neutrality principles. Thus, lawmakers must carefully balance the ten principles to achieve an optimal law."¹¹

A. Compliance and Administration

The tax law should follow principles of simplicity and certainty while limiting unintended costs and errors associated with compliance and administration. As described below, the federal tax depreciation rules violate these principles.

1. *Simplicity*

The tax law should be simple to enable taxpayers to understand the law's effect on themselves and their transactions. However, in their current form, Senator Grassley describes them as "extraordinarily complex."¹²

While depreciation rules are primarily covered in §§167 and 168, other rules are scattered throughout the Code, including at §§179 and 280F. Several additional Code sections address depreciation or basis adjustments for depreciation, such as §169, *Amortization of Pollution Control Facilities*, §1400I, *Commercial Revitalization Deduction*, and §30, *Certain plug-in electric vehicles*. This complexity not only makes it difficult for tax practitioners to locate and apply the rules, but also for taxpayers to comprehend them.

The length of the provisions and guidance also illustrates the complexity of the depreciation rules. Section 168 is over 15,000 words long (roughly 50 pages of text) although its key purpose is to explain the recovery period, method and convention of various assets. The addition of

¹¹ AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), GUIDING PRINCIPLE OF GOOD TAX POLICY: A FRAMEWORK FOR EVALUATING TAX PROPOSALS, 15 (2001), available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>.

¹² *Updating Depreciable Lives: Is There Salvage Value in the Current System?: Hearing before the Subcomm. on Long-Term Growth and Debt Reduction of the S. Comm. on Finance*, 109th Cong. (2005) (statement of Senator Chuck Grassley, Senator, Iowa), available at <http://finance.senate.gov/hearings/statements/072105cg.pdf>.

many special rules over the past twenty years has made this a complex provision.

Even the IRS informal guidance on depreciation is quite lengthy. The 2-page Form 4562, *Depreciation and Amortization*, is accompanied by 19 pages of instructions. IRS Publication 946, *How to Depreciate Property*, is 122 pages long.

Complexity also exists in the requirement of different depreciation calculations for most tangible personal property for AMT purposes. For example, tangible personal property is depreciable using the 200% declining balance method for regular tax purposes, but must be computed using 150% declining balance method for AMT purposes (IRC §56(a)). Corporations must use different depreciation lives and methods for purposes of calculating depreciation in order to compute earnings and profits (E&P) (IRC §312(k)). The existence of varying sets of depreciation rules (regular tax, AMT, E&P, state income tax and financial reporting) creates complexity for many taxpayers.

2. *Certainty*

The tax law should maintain a high degree of certainty to ensure that taxpayers have a high level of confidence in applying the rules correctly. A review of recent IRS rulings and court cases illustrates that the depreciation rules present many areas of uncertainty to taxpayers. Following is a sampling of issues that have been addressed in IRS and judicial guidance.

- IRS Coordinated Issue Paper, *The Applicable Recovery Period Under I.R.S. § 168 (a) for Open-Air Parking Structures (7/31/09)*: Is an open air parking garage a building with a 39-year recovery period or a land improvement (Rev. Proc. 87-56, Asset Class 00.3) with a 15-year recovery period?
- FSA 200203009: Does tangible personal property used in connection with a hotel/casino fall into Revenue Procedure 87-56 asset class 57.0, Distributive Trades and Services, or 79.0,

Recreation? Are facades, wall coverings, decorative lighting and door locks personal or real property?

- FSA 200021013: Are the costs of preparing land for use as a ski slope and costs of surfacing roads and trails depreciable? If yes, over what recovery period?
- FSA 200033002: Are raised floors in an office building to facilitate the installation of computer systems considered personal property or a structural component of the building?
- Revenue Ruling 97-54: Is "line pack gas" depreciable property or inventory?
- *Simon v. Commissioner*, 68 F3d 41 (2nd Cir. 1995): Can antique musical instruments used by professional musicians be depreciated?

3. *Economy in collection*

The complexity of the rules increases compliance costs and risk of errors for taxpayers. Depreciation issues often become the subject of IRS examinations creating costs not only for taxpayers, but also for the IRS. In fiscal year 2000, depreciation issues involving §167 were ranked fourth and those involving §168 ranked tenth, as the most frequently raised issues in Coordinated Examination Program (CEP) audits. For fiscal years 1994 to 1998, §167 depreciation was the number one issue in Appeals for CEP cases as ranked by frequency (938 cases) and number two in terms of dollar amount (\$10.4 billion). In those same years, §168 depreciation was the number ten issue measured by number of CEP cases (139).¹³

4. *Minimum tax gap*

¹³ STAFF ON J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986. 115, 122 (Comm. Print 2001), available at <http://www.jct.gov/publications.html?func=startdown&id=2088>.

Tax rules should be designed to minimize non-compliance. Complex rules are prone to causing unintentional errors and an increased tax gap (the difference between taxes owed and taxes paid).

The National Taxpayer Advocate (NTA) notes that many self-employed individuals rely on IRS assistance in preparing their returns, but that depreciation is an area not supported by Taxpayer Services. The NTA describes how this lack of support can increase the tax gap:

If the questions are too complex for IRS employees to answer, then they are likely to be too complex for the small business person. This complexity engenders ill-will toward the IRS and a willingness to fudge. After all, the IRS wasn't there to answer the question.¹⁴

A 2008 report by the Government Accountability Office (GAO) found that approximately 166,000 taxpayers with rental real estate activities claimed depreciation on land on their 2001 returns. The GAO also found that for 2001, 11% of taxpayers with rental real estate miscalculated depreciation and 5% of such taxpayers expensed items that should have been depreciated.¹⁵

B. Fairness

Fairness or equity can be described as applying rules similarly to taxpayers in similar circumstances. The depreciation rules violate the principle of equity because of numerous special rules which favor certain types of taxpayers, industries, or assets. For example, §168(l) allows 50% bonus depreciation for "qualified cellulosic biofuel plant property" in the first year.

The application of § 280F, which limits the annual depreciation deduction for luxury automobiles, is another example of dissimilar treatment of similar situations. The limitations for passenger automobiles only apply if

¹⁴ *Concurrent Resolution on the Budget for Fiscal Year 2007: Hearings Before the S. Comm. on the Budget*, 109th Cong. 11 (2006) (written Statement of Nina E. Olson, National Taxpayer Advocate). available at http://budget.senate.gov/democratic/testimony/2006/olsen_taxgap021506.pdf.

¹⁵ GOV'T ACCOUNTABILITY OFF. (GAO), *TAX GAP: ACTIONS THAT COULD IMPROVE RENTAL REAL ESTATE REPORTING COMPLIANCE*, 13-14 (2008), available at <http://www.gao.gov/new.items/d08956.pdf>.

the vehicle is "rated at 6,000 pounds unloaded gross vehicle weight or less" (§280F(d)(5)(A)). Thus, the limitations apply to passenger vehicles, but not to most sport utility vehicles (SUVs). For example, if a business purchases a 2010 Range Rover, weighing approximately 7,000 pounds and costing between \$78,000 and \$94,000,¹⁶ the §280F depreciation limitation on luxury automobiles will not apply even if the business uses it in the same way it would use a Ford Taurus that costs less. While §179(b)(6) limits the expensing election amount to \$25,000 for higher weight vehicles (up to 14,000 pounds) such as SUVs, without a §280F limitation the depreciation allowed each year is far greater for heavier passenger vehicles than for standard passenger vehicles.

A commonly noted area of dissimilar treatment of taxpayers and assets involves the effective tax rate on different types of assets due to the varying depreciation rules that apply. As noted by the Treasury Department in their 2000 study of depreciation rules, "current law fails to vary depreciation allowances so as to maintain uniform taxes on all investments." Treasury further notes that the current rules do not "provide a uniform investment incentive."¹⁷ These differences are further discussed below in the section on the principle of neutrality.

C. Strategy and Impact

The design of any tax, including the measure of taxable income, will have effects beyond generating revenue for the government. For example, whether the depreciable life assigned for semiconductor manufacturing equipment is 5 years or 30, taxable income can be measured. However, a 30-year life would harm the industry because the equipment does not last that long and competitors outside of the U.S. are not subject to such a long life. Thus, the economic impact of rules should also be considered in the design of a tax system. In addition, favorable rules provided to some taxpayers typically means that others have higher tax liabilities; in addition, in the context of depreciation rules, asset prices can be impacted.

¹⁶ Land Rover, http://www.landroverusa.com/us/en/shopping_tools/Build_Your_Landrover/overview.htm (last visited March 1, 2010). (information obtained from manufacturer's website about pricing of 2010 Range Rover).

¹⁷ TREAS. DEP'T. *supra* note 9, 34-35.

A 2006 report of the Joint Committee on Taxation summarized the considerations of neutrality and economic efficiency and depreciation as follows:

The choice of cost recovery rules has an effect on the after-tax rate of return from business assets. Policy issues arise as to whether cost recovery rules should be neutral as to a taxpayer's choice whether or in which assets to invest or should be used to encourage investment generally or investment in particular kinds of assets.¹⁸

1. *Neutrality*

Tax depreciation must be administered in a neutral manner in order to properly maintain the integrity and efficiency of our economy.

If tax depreciation is not neutral – because it does not appropriately match the economic decline in value of physical assets – capital will be allocated inefficiently. This distorts business decisions because companies will invest in tax-favored equipment over other alternatives (even if such alternatives may be better suited to the company's operations and competitive needs).¹⁹

Because the primary purpose of a tax system is to generate funds for government operations, the effect of the tax law on economic decision-making should be kept to a minimum. Yet, several depreciation rules are purposefully designed to encourage or discourage certain asset investments. For example, temporary bonus depreciation rules encourage taxpayers to purchase new rather than used assets and to do so prior to the expiration date of the rule rather than when it might be best from a business operations perspective. Such a rule affects business decisions as to how and when to spend funds.

¹⁸ STAFF ON J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO SELECTED BUSINESS TAX ISSUES 43 (Comm. Print 2006), available at <http://www.jct.gov/x-41-06.pdf>.

¹⁹ PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 96 (2005), available at <http://govinfo.library.unt.edu/taxreformpanel>.

If the depreciable life of an asset is too long, taxpayers might be discouraged from investing in the asset. This can harm both the taxpayer and the economy. A 2008 report of the House Small Business Committee, notes that heating, ventilation, air conditioning and refrigeration (HVACR) equipment must be depreciated over 39 years even though the actual life is 15 to 20 years. Per the Committee, this rule discourages businesses from investing in new HVACR equipment even though new systems are likely to be more energy efficient and better for both the business and the environment.²⁰

Neutrality in the context of tax depreciation can also be viewed as "the degree to which a tax system imposes a uniform marginal effective tax rate on all investments."²¹ The Treasury Department's 2000 report (Table 5) noted the marginal effective tax rate for various corporate assets to illustrate that the depreciation rules are not neutral. Following is an excerpt from this report:²²

<u>Asset</u>	<u>Marginal Effective Tax Rate (%)</u>
Furniture and fixtures	27.8
Office and computing machinery	36.2
Autos	40.1
Industrial buildings	43.0
Commercial buildings	39.1
Land	37.4

A 1999 report by the Congressional Research Service (CRS) concluded that "based on the evidence available on economic depreciation, structures appear to be overtaxed relative to equipment." This report found that for 1993, assuming 2% inflation, the effective tax rate for equipment was 27% compared to 38% for a factory and 31% of an apartment building. A rationale for slower depreciation on real property is that it is usually debt-financed. However, the CRS report found "no evidence that structures are more leveraged than other assets."²³

²⁰ STAFF ON H. COMM. ON SMALL BUSINESS, 110th Cong., SEVEN WAYS TO STIMULATE THE ECONOMY BY UPDATING THE INTERNAL REVENUE CODE, 10 (Comm. Print 2008), available at <http://www.house.gov/smbiz/reports2008/embargoed-small-business-committee-tax-report.pdf>.

²¹ TREAS. DEP'T., *supra* note 9, at 35.

²² *Id* at 37.

²³ Jane Gravelle, Congressional Research Service, CRS Report for Congress: Depreciation and the Taxation of Real Estate, 10-15 (1999).

2. *Economic growth and efficiency*

“The tax system should not impede or reduce the productive capacity of the economy.”²⁴ Current depreciation rules violate this principle in that the lives of many assets are longer than their economic life, and methods and lives vary among industries and types of asset resulting in disparate effective tax rates on asset investments.

Rapid technological changes of the Internet era have shortened the life of computers and other technology equipment and created new assets that might not be addressed in the current depreciation rules. The House Small Business Committee found that the recovery period on several assets were out of date, including cars, personal computers, retail improvements, goodwill, covenants not to compete, and HVACR equipment. For cars, the Committee observed that the depreciation limits of §280F were based on 1984 prices.²⁵

These weaknesses in the system can increase the cost of capital for firms, lead to over- or under-investment in some industries or assets, and impede international competitiveness. The weaknesses primarily stem from (1) an outdated system, (2) no efficient mechanism to update depreciable lives, and (3) several piecemeal changes rather than overall reform of the entire depreciation system.

The Treasury Department's comprehensive 2000 report on depreciation noted that the current system for determining recovery periods has not changed significantly since 1981. Worse yet, many of the class lives used to determine recovery periods date back to 1962.²⁶ Thus, the system does not reflect the types of assets used in industries that did not even exist in the 1960s such as software and Internet enterprises.

While the Tax Reform Act of 1986 provided the Treasury Department with authority to monitor and prescribe new class lives for assets, that authority was revoked shortly thereafter by the Technical and

²⁴ AICPA, TAX POLICY CONCEPT STATEMENT – GUIDING PRINCIPLES OF GOOD TAX POLICY: A FRAMEWORK FOR EVALUATING TAX PROPOSALS, 10 (2001), available at [http:// ftp.aicpa.org/ public/ download/members/div/tax/3-01.pdf](http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf).

²⁵ STAFF ON H. COMM. ON SMALL BUSINESS, *supra* note at 19, 8–10.

²⁶ TREAS. DEP'T., *supra* note 9, at 2.

Miscellaneous Revenue Act of 1988. Thus, changes in asset lives, depend on legislative action. Such changes have resulted in a more complex §168 due to the various special rules added to modify depreciation for particular assets or industries. Also, without a systematic approach to monitoring and updating depreciation rules for all types of assets, some warranted changes might not end up in legislation and changes might occur for reasons other than to reflect changes in actual useful lives, such as revenue generation.

Several asset incentive provisions in the past few decades have been temporary ones to help generate economic stimulus. While such changes may generate some stimulus, they can also generate inequities, such as favoring capital-intensive firms over labor-intensive ones, as well as favoring profitable taxpayers and those able to obtain financing. The issues have been longstanding ones. For example, a 1979 review of the ITC by the General Accounting Office (GAO) found that it rewarded investments that would have occurred anyway, favored investment in machinery and equipment over other assets, favored capital investment over labor, did not help businesses that either do not require significant capital investment or those operating at a loss, and made the law more complex. The GAO suggested a review of alternatives including (1) direct subsidies to business such as direct payments, loans or loan guarantees, (2) a lower tax rate, or (3) more generous depreciation allowances.²⁷ Basically, incentives, while well-intentioned, may not achieve the stated goal and are likely to violate the principles of simplicity and neutrality.

V. SELECTED PROPOSALS

In each of the past few sessions of Congress, over 100 bills proposing some type of change to the tax depreciation rules were introduced. A few of these bills, such as S. 1197 (110th Congress) propose changes to modernize and simplify depreciation rules. Most bills, though, propose a change to address a particular industry or asset. A sampling of proposals is summarized in Appendix A.

²⁷ GOV'T ACCOUNTABILITY OFF. (GAO), TAX EXPENDITURES AND RESULTS OF STUDY ON INVESTMENT TAX CREDIT 3-6 (1979); *available at* <http://archive.gao.gov/f0302/108909.pdf>.

VI. RECOMMENDATIONS

The following recommendations are offered and include both administrative and legislative changes.

A. Greater Certainty and Reduced Tax Gap

Incorporate additional questions and information on tax forms. By improving ways to get information to taxpayers, the IRS can minimize confusion and mistakes such as claiming depreciation deductions on land. Taxpayers and preparers are more likely to read lines on tax forms than form instructions and publications. Thus, incorporating additional questions and information on tax forms should improve taxpayer understanding and compliance with depreciation rules. For example, as suggested by the GAO, Schedule E could require taxpayers to report (as an information item) the basis of land.²⁸ That entry could also include a statement that land is not depreciable. Similarly, Form 4562 could include questions for taxpayers to answer to ensure that they are entitled to §179 expensing and the amount available to them.

Develop interactive websites to aid taxpayers. Recently, the IRS created a few interactive websites to help guide taxpayers through some complex rules such as AMT ([http:// www.irs.gov/ businesses/small/article/ 0,,id=150703,00.html](http://www.irs.gov/businesses/small/article/0,,id=150703,00.html)) and retirement plans ([http:// www. retirementplans. irs.gov/](http://www.retirementplans.irs.gov/)). A similar tool would be useful to help guide taxpayers through (1) depreciation and amortization rules in general, (2) eligibility for a §179 deduction, and (3) classification of property within the asset classes of Revenue Procedure 87-56.

B. Simplification

Section 179 should be modified to cover all types of assets a small business is likely to acquire. This modification will better enable this provision to meet its simplification goal of reduced recordkeeping for taxpayers. For example, the temporary provision allowing off-the-shelf software to be treated as a §179 asset should be made permanent. Other

²⁸ GAO, *supra* note 14, at 31.

assets to add include the costs of creating a website and other intangible assets.

The mid-quarter convention should be repealed. This special rule poses the complication of not knowing until the end of the year what convention applies for most tangible personal property. This proposal was also made by the Joint Committee on Taxation in its simplification report released in 2001.²⁹ Consideration should also be given to eliminating all conventions, or at the very least, making the elimination of conventions an option for taxpayers. Today, almost all businesses claiming depreciation will compute it and track it using software which makes it easy to compute depreciation as of the actual placed in service date or the start of the month (or mid-point of the month if preferred).

Remove computers, cell phones and similar property from application of §280F. Today these items are necessities for almost all businesses and are not expensive relative to other business assets. Thus, the purpose for making them "listed property" which existed back in the 1980s, no longer exists today. Existing rules already prevent taxpayers from claiming any depreciation on the personal use of assets.

Allow regular tax depreciation expense to also be used for AMT purposes. Prior changes to §56(a)(1) on AMT adjustments have limited the effect of the depreciation adjustment, yet it still exists, creating recordkeeping burdens for taxpayers.

Pursue recordkeeping simplifications suggested by the Treasury Department in its 2000 report regarding general asset accounts (§168(i)).³⁰ A general asset account consists of assets with the same recovery period, grouped together as if they were a single asset. If an asset from the group is disposed of, 100% of the sales proceeds are treated as ordinary income in the year of disposition. The Treasury Department suggests that this disadvantage be addressed to encourage more taxpayers to use general asset accounts. For example, a modification could be made to require a portion of the disposition proceeds to be recognized currently and the balance of the proceeds to reduce the account's depreciable basis.³¹ Also, S. 1197 (110th Congress) proposes to allow mass asset accounts where each asset with

²⁹ STAFF ON J. COMM. ON TAXATION, *supra* note 12, at 22.

³⁰ TREAS. DEP'T., *supra* note 9, at 98-99.

³¹ *Id* at 98.

identical recovery periods and a cost not exceeding \$10,000 be grouped for depreciation purposes. These proposals should be considered together to determine how the general asset account rules can be improved to encourage more taxpayers to utilize what may be a simplified depreciation approach for some taxpayers.

Allow taxpayers the option of claiming a standard deduction for home office usage in lieu of claiming specific office expenses including depreciation.

C. Fairness, Neutrality, and Economic Efficiency

The authority the Treasury Department had from the Tax Reform Act of 1986 to monitor and analyze class lives should be restored. Without a specific process for monitoring and updating class lives, some assets get a new life via legislative change while others that also warrant a change are ignored. A Depreciation Analysis Division within the Treasury Department, as established in 1987, can ensure that all existing assets are regularly reviewed and that new assets are assigned class lives. The analysis should also consider the effective tax rate on different assets to ensure that assignment of the class life, given the available depreciation method for the asset, can result in a more equitable, neutral and efficient depreciation system for all taxpayers.

The Treasury Department should also have authority to regularly review §197 on amortization of intangibles to identify new assets that should be treated as §197 intangibles. For example, such authority would allow the Treasury Department to label domain names as §197 intangibles, thereby providing greater certainty to taxpayers. In addition, "(G) or similar asset" should be added to the end of §197(d)(1) which defines "section 197 intangible."

In its 2000 report, the Treasury Department observed that for authority to establish class lives to be most useful, there should also be a requirement to allow the department to obtain data from taxpayers.³²

Any concerns regarding Treasury Department determinations could be addressed through a public hearing process before release of the

³² *Id* at 107.

final guidance via regulations or revenue procedure (such as an update to Revenue Procedure 87-56). Congress would also have an opportunity to express concerns it had with any proposal.

Section 280F should be updated to allow for a limitation that is more in line with current prices. For vehicles placed in services in 2010, the depreciation limit under §280F equates to only allowing full depreciation for cars costing \$15,300 or less.³³ Very few cars have this low of a purchase price. For example, a 2010 Ford Taurus has a manufacturer's suggested retail price (MSRP) of about \$25,000 to \$37,000. The MSRP for a 2010 Honda Civic Sedan is between about \$15,600 and \$24,400.³⁴

Section 280F should also be modified to include passenger vehicles weighing up to 14,000 pounds. This change would need to be accompanied by repeal of the \$25,000 expensing limit for sport utility vehicles in §179 (since such vehicles would be prohibited from claiming that much first year depreciation due to the §280F limitation).

New investment incentives that apply to narrow categories of assets (such as new assets or ones in a particular industry) should be carefully crafted and considered to better ensure they are simple, equitable and efficient.

Any tax reform discussions, such as consideration of reducing the corporate tax rate, should also consider depreciation reform, similar to the Treasury Department's analysis of international reform in 2007.³⁵

D. Depreciation Principles to Guide Tax Reform

Reform of the depreciation rules to modernize and rationalize the system, whether done as stand alone reform or part of other reform efforts such as possible lowering of the corporate tax rate (such as proposed in H.R. 3970 (110th Congress)), would provide many benefits to taxpayers and the overall tax system, as noted in this paper. Following are some general principles to consider in any reform effort.

³³ Rev. Proc. 2010-18, 2010-9 I.R.B. 427, indicating maximum depreciation in Year 1 of \$3,060 which equates to a car costing \$15,300 based on a 5-year life and 200% declining balance depreciation.

³⁴ Consumer Guide Automotive. <http://consumerguideauto.howstuffworks.com> (last visited Feb. 17, 2010) (information obtained about pricing of 2010 Ford Taurus and 2010 Honda Civic).

³⁵ TREAS. DEP'T., APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (2007), *available at* <http://www.treas.gov/press/releases/hp749.htm>.

- Aim to meet principles of good tax policy.
- Given today's information age where intangible assets are important business investments, amortization rules should not be omitted in depreciation reform.
- Given the global competitive environment that all sizes of U.S. businesses operate in today, depreciation reform should also be informed by the depreciation/amortization rules used in other industrialized countries.³⁶

³⁶ See Brent W. Mast, Congressional Research Service, CRS Report for Congress: Selected International Depreciation Rates by Asset and Country, (1995), *available at* http://assets.opencrs.com/rpts/RL33854_20070130.pdf.

APPENDIX A

SELECTED DEPRECIATION PROPOSALS OF RECENT YEARS

Proposal	Date	Broad Reform?	Simplification?	Longer or Shorter Lives or Expensing?
Neutral Cost Recovery System (NCRS)	107 th Congress (H.R. 3042); Contract with America (1995)	Yes. An elective system that uses 150% declining-balance for most equipment with annual deductions adjusted for both an inflation and interest factor. Annual depreciation for real property is only adjusted for an inflation factor, not also a 3.5% interest factor.	No	Lives unchanged
President Bush Tax Reform Advisory Panel ³⁷	2005	Two proposals: (1) a simplified income tax and (2) a consumption tax, with depreciation changes: (1) reduce number of asset classes and methods to four (2) under a consumption tax proposal, all assets would be expensed and interest expense would not be deductible	Yes	Mostly shorter
Treasury Proposals Related to International Tax Reform	2007	Yes. Various proposals including: (1) replace business income tax with business activity tax with assets expensed when acquired (2) lower corporate tax rate by broadening tax base including eliminating accelerated depreciation. ³⁸		Various changes.
House Small Business Committee ³⁹	2008	Yes. Proposals include: (1) Allow standard deduction for home office expenses. (2) Remove computers, PDAs and similar devices from the listed property rule of §280F. (3) Adjust the §280F car limits to allow full depreciation on a car costing \$25,000 (to be adjusted for inflation) for a taxpayer who uses the car over 75% for business use.	Yes.	Shorten

³⁷ PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 18.

³⁸ TREAS. DEP'T., APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (2007), *available at* <http://www.treas.gov/press/releases/hp749.htm>.

³⁹ STAFF ON H. COMM. ON SMALL BUSINESS, *supra* note at 19.

		(4) Shorten the lives of assets where needed, such as for computers, retail improvements, HVACR equipment, and goodwill.		
H.R. 2320	109 th Congress	No. Makes 50% bonus depreciation for new personal property permanent as well as use of the minimum tax credit (MTC) in lieu of bonus depreciation.	No	Over 50% of basis depr. in first year.
H.R.4151	109 th Congress	No. Shortens depreciable life of race horses to 3 years.	No	Shorter
H.R. 5058	109 th Congress	No. Shortens life of qualified retail improvement property and certain systems installed in nonresidential buildings to 15 years	No	Shorter
H.R. 3970	110 th Congress	No. Lowers corporate tax rate to 30.5% and makes many base changes including extending the life of acquired intangibles under §197 from 15 to 20 years. Makes the \$125,000 expensing amount of §179 permanent.	Partly	Longer for intangibles. Expensing for some tangible personal property and software
S. 319	110 th Congress	No. Broadens §280F to also apply to passenger vehicles with gross vehicle weight up to 14,000 points. Updates the annual depreciation deduction limits and indexes it for inflation based on 2007 figures (rather than 1988).	No	No changes in lives.
S.1197	110 th Congress	Yes. Restores Treasury authority to adjust lives, repeals conventions, makes higher §179 expensing permanent and allows elective mass asset treatment for assets costing \$10,000 or less	Yes	Lives can be updated if needed; expensing permanent.
S. 2100	109 th Congress			
S. 1361	110 th Congress	No. Makes permanent the shorter life (15 years) for certain leasehold improvements.	No	Shorter
S. 2247	110 th Congress	No. Makes permanent the shorter life (7 years) for motor sports entertainment complex.	No	Shorter
H.R. 165	110 th Congress	No. Shortens to 20 years the depreciable life of roof systems.	No	Shorter
H.R. 6601	110 th Congress	No. Removes cell phones and similar telecommunications property from listed property of §280F. Shortens the life of certain HVACR property. Allows an	Partly	Shorter

		optional standard deduction for home office use.		
S. 233	111 th Congress	No. Makes permanent 50% bonus depreciation for new personal property and the §179 expensing amounts.	Partly	Over 50% of basis depreciated in first year.
S. 1349	111 th Congress	No. Allow an optional standard home office deduction with no other deductions for the home (thus, no depreciation expense). Relax the exclusive use requirement.	Yes	n/a
S. 2947	111 th Congress	No. Shortens depreciable life of fire sprinkler equipment to 5 years.	No	Shorter
Administration's FY2011 proposals	February 2010	No. Proposals include removal of cell phones from the §280F listed property rules.	Yes	n/a

APPENDIX B

A BRIEF HISTORY OF US DEPRECIATION LAW

Approaches to calculating federal tax depreciation expense have changed repeatedly since the inception of the modern federal income tax. With the advent of the 16th Amendment, Section II of the Tariff Act of 1913 officially granted businesses “a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business.”⁴⁰ Although depreciation deductions were first based on a periodic loss of value method, or an “actual perceived losses in asset values (arising from wear and tear, or exhaustion)”, this view soon changed with the Revenue Act of 1918 to an allocated cost method. Under the new system, Congress began emphasizing a “limited useful life” of property and recognizing depreciation deductions as “original capital cost (less salvage) over an estimated useful life.”⁴¹

In response to a need for more revenue and better regulation of depreciation, Treasury Secretary Henry Morgenthau, Jr. proposed Treasury Decision 4422.⁴² The Secretary suggested that a change in administrative procedure could increase revenues while ensuring that depreciation deductions were indeed taken over the useful lives of assets, and not beyond. These new administrative procedures “required taxpayers to file detailed depreciation schedules, stipulated that deductions must be limited to amounts considered necessary to recover the unrecovered basis of any asset during its remaining useful life, and placed the entire burden of justifying deductions claimed on the taxpayer.”⁴³ But most notably, it emphasized use of the straight-line depreciation method.

With the onset of a mild recession following the post-World War II boom, Congress began searching for ways to encourage business growth.⁴⁴ In response, Congress enacted the Internal Revenue Code of 1954, which among other changes, represented a “major change in depreciation policy.” The new Code authorized the use of the double-declining balance method (i.e., 200% declining balance method) because it was determined to be a

⁴⁰ BRAZELL *et. al.*, *supra* note 5, at 4-6

⁴¹ *Id.* at 4-6.

⁴² *Id.* at 8-10.

⁴³ *Id.* at 8-10.

⁴⁴ *Id.* at 10-13.

better measure of net income and simpler in application. However, it was only extended to tangible property with a useful life longer than three years and not to intangible property.⁴⁵

In addition, the 1954 Code added the sum-of-years digits method because the double-declining balance method only allowed for 90 percent of an asset's cost to be recovered by the end of its useful life.⁴⁶

In 1958, §179 was enacted to further accelerate the deductions associated with the depreciation of assets, invoking an "authorized additional first year depreciation allowance of twenty percent of cost (not reduced by salvage)" limited to a specified cost.⁴⁷

By 1962, Congress was under the impression that prior depreciation methods had "inadequately reflected the fast-moving pace of economic and technological change." In an attempt to lessen the tax burden and increase U.S. competitiveness, Revenue Procedure 62-21 was issued to more accurately align the useful lives of assets with depreciation periods. The new system involved the use of industry-wide guidelines to determine asset lives.⁴⁸

In 1962, an investment tax credit (ITC) was created to encourage business modernization and increase investment. The value of the ITC in meeting these goals was subsequently debated resulting in various changes, repeal and reinstatement of the ITC.⁴⁹ The ITC was finally repealed by the Tax Reform Act of 1986 (P.L. 99-514).

In 1969, Congress reigned in accelerated depreciation by reducing the 200% declining balance method to 150% for new construction and requiring all purchasers of used buildings to revert to the straight-line method. After economic growth began to falter in 1970, the business community pressed for tax reductions and depreciation liberalization to stimulate the economy. In June 1971, the Treasury Department issued regulations for the Asset

⁴⁵ *Id.* at 10-13.

⁴⁶ *Id.* at 10-13.

⁴⁷ *Id.* at 12-13.

⁴⁸ *Id.* at 13-17.

⁴⁹ Robert E. Rosacker & Richard W. Metcalf, *United States Federal Tax Policy Surrounding the Investment Tax Credit: A Review of Legislative Intent and Empirical Research Findings Over Thirty Years (1962-1991)*, 9 AKRON TAX J. 59 (1992); *see also* GAO, *supra* note 26.

Depreciation Range (ADR) System. The Joint Committee on Taxation described the pre-1981 system as follows:

Under the ADR system, a present class life was provided for all assets used in the same activities, other than certain assets with common characteristics... Assets were grouped into more than 100 classes and a guideline life was determined by the former Office of Industrial Economics in the Treasury Department.⁵⁰

In an attempt to provide greater investment incentives,⁵¹ the Economic Recovery Tax Act of 1981 replaced the Asset Depreciation Range System with the Accelerated Cost Recovery System ("ACRS"), which permitted "recovery of capital costs for most tangible depreciable property using accelerated methods of cost recovery over predetermined recovery periods generally unrelated to, but shorter than, [prior] law useful lives."⁵² Although these rules were tightened in 1982 and 1984, the Reform Act of 1986 set out to again accelerate the depreciation allowance by adopting the Modified Accelerated Cost Recovery System ("MACRS"). Under MACRS, the 200-percent and 150-percent declining balance methods were allowed for most tangible personal property, switching to the straight-line method for the tax year in which that method produced a greater depreciation deduction.⁵³ Also, as a part of the Tax Reform Act of 1986, an office in the Treasury Department was granted authority to "monitor and analyze actual depreciation and to recommend asset class lives for assets that did not have ADR guideline lives or to replace existing ADR guideline lives."⁵⁴ However, Congress revoked this authority two years later under the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, 11/10/88, §6253).

In 1984, to address concerns that favorable depreciation rules and the investment tax credit were being used "to subsidize the element of personal consumption associated with the use of very expensive automobiles," §280F,

⁵⁰ STAFF OF J. COMM. ON TAXATION, PRESENT LAW AND LEGISLATIVE BACKGROUND RELATING TO DEPRECIATION AND SECTION 179 EXPENSING (JCX-54-05) 2-3 (2005), available at <http://www.jct.gov/x-54-05.pdf>.

⁵¹ *Id.* at 3.

⁵² *Id.* at 3.

⁵³ BRAZELL *et. al.*, *supra* note 5, at 20-23. See also IRC §168.

⁵⁴ TREAS. DEP'T., *supra* note 9, at 119.

*Limitation on depreciation for luxury automobiles; limitation where certain property used for personal purposes, was added.*⁵⁵ Property subject to the §280F limitation is referred to as "listed property." The limitation originally applied to passenger automobiles, other transportation assets, entertainment property, computers, and other assets noted in regulations. In 1989, Congress expanded "listed property" to also include cell phones and similar telecommunications property.⁵⁶

In 1993, Congress enacted §197, *Amortization of goodwill and certain other intangibles*.⁵⁷ This provision allowed goodwill and most other types of acquired intangible assets to be amortized over 15 years using the straight-line method. At the same time, §167(f) was added, allowing off-the-shelf software to be amortized over 36 months.

In recent years, temporary changes have been made to §§168 and 179, primarily to stimulate the economy. In 2002, §168(k) was added to allow for bonus depreciation in an asset's first year. This provision was extended a few times, but expired at the end of 2009. The §179 limitations were temporarily increased to allow for larger expensing amounts. These increased amounts as well as the application of §179 to off-the-shelf software, expire at the end of 2010.⁵⁸

⁵⁵ STAFF OF THE J. COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 559 (1984).

⁵⁶ Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7643, 103 Stat. 2106 (1989).

⁵⁷ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312 (1993).

⁵⁸ Various acts including the Economic Stimulus Act of 2008, Pub. L. No. 110-185 (2/08/08) and the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2/17/09), Sections 1201 and 1202 and the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147 (3/18/10), Section 201(a).