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PROS AND CONS: GUIDELINE DEPRECIATION?

The first day of March 1963 has marked the end of 50 consecutive years of federal income taxation. It may also be the beginning of a better period in understanding the law that governs the tax. After all, starting from scratch, we are well on our way to create a new and distinct law of income taxation. To that end we have accumulated an unprecedented volume of technical legal knowledge respecting the tax.

The treatment of depreciable property has long been a troublesome aspect of the tax law. Alfred Marshall, a 19th century economist, summed up the basic depreciation problems in a few sentences which have withstood the test of time, when he wrote: "Almost every trade has its own difficulties and its own customs connected with the task...of allowing for the depreciation which...capital has undergone from wear-and-tear from the influence of the elements, from new inventions, and from changes in the course of trade...And people whose minds are cast in different moulds or whose interests in the matter point in different directions, will often differ widely on the question what part of the expenditure required for adopting buildings and plant to changing conditions of trade may be regarded as an investment of new capital; and what ought to be set down as changes incurred to balance depreciation, and treated as expenditure deducted from current receipts, before determining the net profits or true income earned by the business."[1]

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1 Alfred Marshall, Principles of Economics, Eighth Edition, p. 354,n.d.

From the inception of the modern income tax under the Sixteenth Amendment in 1913, provision has always been made for the deduction of a reasonable allowance for depreciation. The basic statute merely provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. However, the administrative approach under the statute has undergone redirections from time to time. On the assumption that the decline in the value of an asset for any of the above reasons represents a true cost of production, it has been felt that an allowance for depreciation must be made if tax burdens are to be fairly distributed among business firms with different capital output ratios.

Businessmen have not always been satisfied with the manner in which depreciation allowances have been administered. Differences of opinion have arisen with regard to (1) the total amount of depreciation that can be charged against any particular asset or group of assets, (2) the time period over which this amount may be recovered and (3) the particular formula which should be used in distributing a given amount of allowable depreciation over a given time period. With respect to the total amount of allowable depreciation, the practice has always been to permit the recovery of orginal cost. With regard to the depreciation period, taxpayers have long been guided by the Bureau of Internal Revenue's Bulletin "F" which lists the probable useful life of several hundred items, including wherever practicable lives for composite accounts and group accounts. Taxpayers have contended that these lives for certain types of assets are too short and they should be given more freedom in taking depreciation deductions. With respect to the distribution formula, most business firms used the straight-line method prior to 1954; first, because the bureau was known to favor it; and second, because the alternatives were not generally attractive, according to Gordon Keith, Professor of Finance and Associate Dean at the University of Pennsylvania. The Internal Revenue Code of 1954, however, liberalized periodic depreciation expense charges for income tax purposes by approving two declining amount methods--the double declining balance method and the sum of the years' digits method.

Although an important aspect of present depreciation policies is found in the accuracy with which costs and net income are determined, this is not the only test of soundness. The question may also be asked whether they are contributing as much as they should to the attainment of certain economic goals, such as an adequate rate of economic growth and a high-level of employment. Speeding up depreciation can encourage the purchase of depreciable assets by business firms, both by increasing cash-flow, which reduces the financial drain associated with asset purchase, and by increasing their after-tax profitability.[2]

In the words of Secretary of the Treasury Dillon: "Clearly, we must improve our performance; otherwise we cannot maintain our national security, we cannot maintain our position of leadership in the eyes of the world and we cannot achieve our national aspirations. The pressing task before us, then, is to restore the vigor of our economy and to return our traditionally high rate of economic expansion and growth."[3]

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[2] Gordon Keith, "Importance of the Depreciation Deduction to the Economy," Taxes, vol. 40, (March 1962), p. 163, 164 & 167.

[3] Ibid., p. 168.

Noting that the average age of our plant today is 24 years, and that the stock of our business machinery and equipment now averages more than 9 years, Mr. Dillon, in his statement before the Committee on Wages and Means last May, called attention to the greater need for plant renewal.

PAST ENCOURGEMENTS

The succession of tax encourgements to date have run something like this:

1. Five-year amortization during World War II and the Korean emergency.
2. The 1954 revenue legislation, which permitted deductions under the accelerated methods, such as the double declining balance and the sum-of-the-digits methods, and by special allowances for small companies.
3. Shortening the duration of the tax write-off period by the new guidelines for asset lives.
4. The investment tax credit.
5. The extension of the number of years loss carry over in certain cases.[4]
6. Additional first-year depreciation allowance.
7. Rate reductions.

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[4] Dean, Joel and Harris, C. Lowell, "Railroad Accounting Under the New Depreciation Guidelines and Investment Tax Credit," The Accounting Review, vol. 38, (April 1963), p. 230-233.

GUIDELINE DEPRECIATION

The need for a major depreciation reform has been apparent to many accountants, lawyers, and businessmen for many years. In July 1962 the Treasury Department issued its Revenue Procedure 62-21 establishing new guidelines in determining service lives of depreciable property for tax purposes. This was the first comprehensive revision of service lives since those set forth in Bulletin "F" in 1942; however, with the permission of the Revenue Service, some companies had been using shorter lives. One announced purpose of the new guidelines, along with the investment credit, was to stimulate investment in capital goods. This the Treasury hoped, would increase the efficiency of American industry to create jobs for the rapidly expanding work force, to reduce the current level of unemployment, to solve the balance of payments problem, and to help the US compete with other areas of the world which are highly industrialized.[5]

DEPRECIATION REFORM

What is depreciation reform? It's a new approach to depreciation deductions. The determination of the economic useful life of an asset is a matter of an educated guess. In the past the IRS has relied for many years on Bulletin F. The IRS has conceded that these lives are out of date and too long. Revenue Procedure 62-21 is to bring these lives up to date. The new lives average 1/3 shorter than the old Bulletin F lives and 1/4 shorter than the lives now actually allowed

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[5] Edward J. Harney, "Experience with the Depreciation Guidelines," Taxes, vol. 42, (February 1964), p. 144.

to the normal taxpayer.[6]

In effect, this will show up as a higher depreciation deduction on many returns. For example, if you would have been depreciating a $15,000. machine over 15 years, your deduction would have been $1,000. a year. If the new guideline shortens the life to 10 years your deduction will increase to $1,500. a year. Second, there are fewer lives. The new guidelines cover only the 75 broadest categories. Old Bulletin F listed over 5,000 separate asset items for those who wished to use them.[7]

DEFINITIONS OF TERMS USED IN GUIDELINE DEPRECIATION:

Guideline Class - One of 75 broad categories of depreciable property listed in the Procedure, such as for the manufacture of textile products.

Guideline Life - The life listed in the Procedure as being reasonable for the guideline class, such as 9 years for the assets used to manufacture textiles.

Class Life - The life used by the taxpayer in computing his tax depreciation for the guideline class.

Test Life - The appropriate life to be used in making the permitted reserve ratio test for a guideline class. It can either be the guideline life, the life used in the preceding year or the life used in the

[6] The Revolutionary New Tax Rules for Depreciable Property, p. 40 n.d., Prentice Hall Inc. Englewood Cliffs, N.J.

[7] Ibid., p. 41

current year.

Permitted Depreciation Reserve Ratio - The maximum percentage of depreciation reserve relative to the gross basis of assets in the guideline class which the Procedure's objective test permits at the end of the taxable year.

Actual Depreciation Reserve Ratio - The taxpayer's own percentage of tax depreciation reserve relative to gross basis for a guideline class at the end of the taxable year.[8]

GUIDELINE DEPRECIATION: AN ANALYSIS

Guidelines for depreciation, listed in Revenue Procedure 62-21, are listed in four groups. These groups consist of; Group One: Guidelines for Depreciable Assets Used by Business in General; Group Two: Guidelines for Non-manufacturing Activities, Excluding transportation, Communication, and Public Utilities; Group Three: Guidelines for Manufacturing; and Group Four: Guidelines for Transportation, Communication, and Public Utilities.

Included in these four groups there are seventy-five broad classes (guideline classes) of property listed. Each guideline class has a listed guideline life. For example, included in Group Three, on page 46 of the Procedure, the guideline class of assets used to manufacture chemicals has a guideline life of 11 years. These lives are supposed to give greater weight to prospective technology and economic life (as opposed to physical life) than was previously allowed.

For the first three years, the depreciation claimed will remain

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[8] John Mendenhall, "New Depreciation Rate Guidelines," Taxes, vol. 40, (October 1962), p. 753.

undisturbed for any guideline class, if the taxpayers' depreciation each year is not more than that allowed by using; (1) the guideline life, (2) the life previously justified by a revenue agent's examination, which tested the lives, or (3) the life continuously used for at least half of the class life used in the preceding year.

After the third year, generally the guideline lives lose their significance, and the reserve ratio test becomes more important. The reserve ratio test is used to determine whether a taxpayer's retirement history is consistent with the lives he is using for depreciation purposes. If the reserve ratio test is failed, the taxpayer must lengthen the life used unless: (a) the reserve ratio test is inapplicable, (b) a "transitional" rule applies or (c) the taxpayer can prove by a complete showing of his particular facts and circumstances that the life is correct. These facts and circumstances include all relevant consideration such as whether the life used is supported by; (1) the taxpayer's book life, (2) extraordinary obsolescence, (3) past or intended replacement practices, (4) abnormally intensive use, (5) large acquisition of used assets or (6) a disproportionate number of short-lived assets in the class.[9]

[9] Ibid., p. 747 & 748.

TRANSITION RULE

The Procedure provides a transition rule which consists of two aspects:

1. A three-year Moratorium - this rule is for taxpayers using lives at least as long as the guideline life. This permits unquestioned use of these lives for the three years. The reserve ratio test is presumed to be met for the first three years.

2. Period Equal to Guideline Life Allowed to Align Replacement Practice with Tax Life - after the three-year moratorium, the taxpayer will be given a period of years equal to the guideline life, beginning with the first year when the new Procedure was applied, to bring his reserve ratio within the designated reasonable range, provided the ratio is moving towards the appropriate limit during this period. This is called the replacement cycle transition, which provides that use of the guideline life or equivalent-automatically allowed at the outset-will continue to be accepted unless there are clear indications that the taxpayer's replacement practices do not conform with the depreciation claimed and are not even showing a trend in that direction. Also the guideline lives are not minimums. Shorter lives which have been established or which may in the future be justified will be permitted.[10]

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[10] Richard E. Slitor, "Federal Tax Treatment of Depreciation and Obsolecence," National Tax Association, p. 391 & 392, (Proceedings of Fifty-Fifth Annual Conference 1962).

RESERVE RATIO TEST

Comparison of related facts and the drawing of inferences from the comparison is one of the most useful of auditing techniques. Experts in depreciation accounting recognized that the normal relationship between depreciation reserves and the property accounts will vary, depending on (1) the average useful life; (2) the method of depreciation used; (3) the mortality characteristics of the property and (4) the growth factor, regular or irregular, in the property account. In short, the reserve ratio test provides a method of ascertaining whether the retirement and replacement practice proves to be consistent with the depreciable life used by the taxpayer. It assures the taxpayer that his rate of write-off will not be questioned so long as it is consistent with actual practice in retirement and replacing machines.[11]

In cases where the test is not met, whether the taxpayer's retirement and replacement practices are consistent with the class life being used must be determined on the basis of all the facts and circumstances. Where a class life used by a taxpayer cannot be justified under any of the rules set forth, the life shall be lengthened.[12]

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[11] Richard E. Slitor, "Depreciation: Working with the evolving problems," The Journal of Taxation, vol. 18, (May 1963), p. 258-260.

[12] "U.S. Treasury Department Internal Revenue Service Publication No. 456," New Depreciation Guidelines and Rules, (July 1962), Prentice-Hall, Inc., p. 25. Englewood Cliffs, New Jersey.

SUMMARY

The fundamental concept underlying the new Procedure is that the depreciation claimed will not be disturbed if there is an overall consistency between the depreciation schedule he uses and his actual practice in retiring and replacing his assets. Demonstration of this consistency will be based upon the application of the reserve ratio test used in conjunction with broad classes of assets.

Guideline lives are established for each of these classes with shorter lives than those previously suggested for the guideline class as a whole. The broad class approach is designed to achieve reasonable overall results, simplify administration and compliance, and minimize controversy over specific items or narrow classes of assets.

The new Procedure not only shortens previously suggested guideline lives by about 30 to 40 percent, but also simplifies the administrative framework based on objective rules. However, the new administrative rules do not supersede existing practices for those taxpayers who wish to follow the older methods.[13]

OPINION OF THE AICPA ON GUIDELINE DEPRECIATION

It is the opinion of the AICPA that: "Net income for the period should not be increased as the result of the adoption of Guideline lives for income-tax purposes only. Accordingly, where Guideline lives are shorter than the lives used for financial accounting purposes are adopted for income-tax purposes, and there is an excess of tax-return depreciation over book depreciation, provision for deferred income taxes should

[13] Ibid., p. 388.

be made with respect to the part of the excess that is attributable to the adoption of Guideline lives."[14]

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[14] The Accounting Principles Broad of the American Institute of CPA's, "Interpretive opinion No. 1 'New Guidelines and Rules,'" <u>The Journal of Accountancy</u>, vol. 114, (December 1962), p. 64.

CONCLUSION

The Treasury's depreciation reform has been a step forward in the liberalization of depreciation policies.

As we have seen depreciation charges can play two quite different roles in the present economy. First, it can be focused on the problem of correctly measuring income and costs, with a view to achieving a fair distribution of tax burdens. Second, it can be used to encourage investment in depreciable assets. Although an important aspect of depreciation policies is how it measures income, we should not forget the possibility of having it contribute to the attainment of certain economic goals such as economic growth and high-level employment.

The new guidelines measure up to these two goals much better than did the lives set forth in Bulletin "F". First, the new guidelines bring the depreciation standards closerto actual business experience, considering obsolescence and technological advances caused by progress. Secondly, as an indication of a stimulated business activity corporate cash flow increased in 1962 by $2.3 billion as a result of the new depreciation guidelines and the investment credit, according to a survey conducted by the Office of Business Economics of the Department of Commerce.[15] The new guidelines permitted by the Treasury regulation resulted in a decrease in corporate income tax accruals of $1.25 billion in 1962, while the investment credit

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[15] Barry R. Peril, "Recapture rules bring new factors into planning business acquisitions," <u>The Journal of Taxation</u>, vol. 19, (September 1963), p. 141.

reduced corporation tax liabilities by another $1 billion.[16]

On the minus side the surveys show that a substantial number of taxpayers are not yet utilizing guideline depreciation for a number of reasons, and as a result the economy is losing $800 million annually, which should be invested in productive plant and machinery.[17]

Among the reasons for firms not using the new guidelines, it has been found or thought that:

> There is a reluctance, in some cases, to endorse something new and not immediately understood.
>
> Many small firms found the guidelines too complicated to operate or understand.
>
> And according to the survey carried out by the Department of Commerce, of corporations, the guidelines were passed up because the corporations were using service lives which were as short or shorter than the guideline lives, or management preferred existing procedures because they did not approve of faster write-offs, they preferred an individual item system rather than grouping the assets, or they wanted to keep comparability records over a period of time.

With regard to future developments of depreciation deduction change is certain, as recognized by Secretary Dillion that where depreciation

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16 Lawrence Bridge, "New Depreciation Guidelines and the Investment Tax Credit," Survey of Current Business, vol. 43, (July 1963), p. 3.

17 "Small firms find depreciation guidelines too complex to use," The Journal of Taxation, vol. 21, (September 1964), p. 149

is concerned "the job is never done".[18]

What are some possible avenues to be taken in the future for depreciation deductions? One suggestion is to eliminate the reserve ratio test. The taxpayer could be allowed to use lives as short as the guidelines or even shorter if justified on the facts and circumstances. This would eliminate many of the complex mechanical techniques.

Many problems could have been solved by the adoption of Sen. Vance D. Hartke (D., Ind.) proposal which was to codify the guideline lives and also the Treasury would be prohibited from establishing longer lives, although it would be free by administrative action to establish shorter lives. His bill also would eliminate the reserve ratio test.

More of the problems and benefits should be felt when the three year "honeymoon period" will be ending for taxpayers using the guidelines. This is when the reserve ratio test will be of primary importance.

The Procedure will not benefit all taxpayers, it will cause a great deal of work, but it should eliminate much of the haggling between the Internal Revenue Service and taxpayers over the rates and amounts of depreciation.

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[18] Statement of Douglas Dillion before the Business Council, Hot Springs, Virginia, May 11, 1962

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