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Property Accounting and Guideline Depreciation

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THERE have probably been no recent developments in the tax field with greater effect on business tax planning than those relating to property accounting and depreciation.

The rules which have been established are sufficiently new and still sufficiently in flux so that our understanding both of where we are and of where we may possibly be expected to go from here can be helped by a brief review of the background out of which some of these changes have arisen.

BACKGROUND

As you know, there has been for some time a demand in business and professional circles for depreciation reform. Partly this demand has grown out of exasperation with time-consuming and inconclusive arguments with Revenue Agents over small rate adjustments. Perhaps more fundamentally we have been conscious that the processes of inflation remove a substantial part of the value of a deduction which is deferred. If the expenditure was made years ago when cost was greater in terms of real value than at the time it is recovered for tax purposes, the effect obviously is a failure to recover real cost for tax purposes. While this problem cannot be fully met without some application of price-level depreciation, it is apparent that any acceleration of depreciation reduces the problem by lessening the time for inflation to act between the expenditure and the deduction.

Rather recently we have also become aware that most European countries have more liberal capital recovery programs for tax purposes than we have. Some countries grant large initial allowances; others provide for arbitrary determination of short useful life; and there has also been some recognition of price-level changes. It has been believed that these more liberal rules have encouraged modernization of plant relative to our own and that our less favorable provisions have tended to worsen our competitive position.

In view of these factors the Treasury some time ago made a survey of depreciation practices used by a number of rather large

corporations, including the methods employed, useful lives, and reforms that would be desired.

One of the results of these studies and the agitation with regard to depreciation was the depreciation Guidelines.

The Guidelines establish new lives for about 75 broad classes of assets. I understand that the Treasury estimates that the Guideline lives are about 13 per cent shorter on the average than lives actually in use, although they are 30-odd per cent shorter than Bulletin F lives.

GUIDELINES

From a technical standpoint, the method used by the Treasury to approach the question of depreciation liberalization is interesting and may well have considerable future importance. It should be recognized that the Code section concerning depreciation has not been amended, nor have the depreciation Regulations been changed. The fundamental concept of depreciation over useful life therefore remains theoretically intact. However, in Rev. Proc. 62-21, which established Guidelines, the Treasury in effect issued instructions to its Agents that although depreciation should theoretically be computed by the same methods as previously, if it is in fact computed in accordance with the method set out in the Procedure, the Revenue Agent is not allowed to raise questions.

Superficially the new Revenue Procedure is not unlike Bulletin F. However, there is a fundamental difference in that Bulletin F, first, purported to be representative of actual conditions, and second, was only a guide that could be overruled by either side if the facts in a particular case were at variance. The Guidelines are not based on experience and, within limitations, purport to give the taxpayer an absolute right to use certain lives in any event.

The question is bound to arise when years covered by the Guidelines come up for examination of how much reliance the taxpayer is entitled to place on them. The recent case of *The Central Bank Co.,* 39 TC No. 90, points up the problem. This case dealt with a bank's bad-debt reserves, for which a formula has been provided by rulings. The Tax Court, however, declined to consider the case in the light of the rulings as desired by the taxpayer. Instead, it concluded that the Commissioner's determination was proper on general principles under section 166. The concurring opinion stated that the bad-debt rulings could not authorize an excessive reserve "any more than that

reasonable guidelines to methods of computing depreciation could authorize such deductions beyond their adequacy to compensate for a taxpayer's basis."

Some of the interpretations of the original Guideline Procedure have already been modified, enlarged upon, or superseded by subsequently published material.

It should also be recognized that many very important questions concerning the application of Guidelines have been covered informally by Treasury and Internal Revenue Service spokesmen. If there is grave doubt about the ability a taxpayer has to enforce even the published Procedures, how much more difficult will it not be to enforce these informal interpretations?

In spite of our conceptual difficulties with the Treasury approach, it may well prove effective to the extent beneficial to the taxpayer. In other words, if neither the taxpayer nor the Internal Revenue Service raises any questions there will be no issues. Theoretically, at least, the Procedure cannot be used against the taxpayer and, once again, should not therefore give rise to any questions. Practically, of course, many practitioners are concerned that the reserve ratio puts a new tool in the hands of the Agent that may ultimately cause trouble. Whether or not this is so may not be perfectly clear for a few more years.

GUIDELINES AND FUNDAMENTAL DEPRECIATION CONCEPTS

A few years ago there was quite a bit of controversy about whether the term "useful life" meant inherent life or life to the taxpayer. The term "useful life" was used in the 1954 Code without definition and the question arose concerning the meaning of the term as generally understood. In the *Hertz* case (364 U.S. 122), the Supreme Court apparently settled the controversy, holding that useful life meant life to the particular taxpayer.

The Guidelines, on the other hand, appear to revert to the inherent life concept inasmuch as, at least for the first three years, every taxpayer will use the assigned lives regardless of its own experience. On the other hand, the reserve-ratio test will ultimately inject an element based on the taxpayer's own experience, but even here the effect is limited by the arbitrary adjustment tables provided for.

Another important question wherein the Guidelines affect depreciation concepts is the matter of salvage. Salvage has always been recognized as an element of depreciation even in the case of the

declining-balance method where the salvage is the somewhat arbitrary "built-in" amount. In the *Evans* case (364 U.S. 92) salvage was held to be estimated resale value.

The effect of the Guidelines is to ignore salvage, although there is a somewhat complicated explanation to the effect that the Guidelines as set forth without salvage can be regarded as equivalent to different Guidelines with salvage.

With respect to salvage estimated not to exceed 10 per cent of basis, the Code has been amended so that salvage may be ignored as to personal property acquired after October 16, 1962. In this regard the departure of Guidelines from established concepts will decline in importance.

MORE DEPRECIATION UNDER GUIDELINES?

Adoption of depreciation Guidelines is optional with the taxpayer. Under these circumstances the question of whether the Guidelines increase allowable depreciation must be answered in order to settle upon an advisable course of action. In this connection it should be noted that each Guideline class constitutes a separate election so that a taxpayer can adopt the suggested life for any particular class and fail to adopt the Guideline life and continue present practices with respect to any other class.

It has been noted that the class for buildings is generally less favorable than the allowances under Bulletin F, particularly when it is considered that under the old rules such things as elevators, air-conditioning equipment, and the like are usually separately classified, whereas the new Guideline rates for buildings include such items. This exception from the apparent intention to provide somewhat more liberal lives was evidently related to the fact that the 1962 Act did not apply depreciation recapture to buildings. Presumably most taxpayers will not apply Guideline rates to buildings.

If the taxpayer is going to adopt Guidelines with respect to any class, it must include in the class all of its assets falling within that grouping. If the taxpayer has more than one plant it must include assets pertaining to the Guideline class in all plants.

As the Guidelines are set up there are several cases of what appear to be sub-classes; thus, under transportation equipment there are eight different listings with a different Guideline life for each listing. Under agriculture there are four sub-classifications and in one of these sub-classifications (i.e., animals) there are four sub-sub-classifications.

Each sub-class or sub-sub-class for which a life is specified is considered a separate Guideline class to be adopted, or not, at the taxpayer's election. Thus, a taxpayer engaged in agriculture could adopt the Guideline life for cattle (seven years) and not use the life applicable to breeding hogs (three years). Similarly, all computations applying to a class are to be made separately for each group constituting a class under this rule even though the grouping is placed in a subordinate position in the published Procedure.

When the Guidelines were first introduced many taxpayers expressed disappointment with the useful lives provided, which were often no shorter than those already in use. However, this initial analysis was often deceptive because property accounting as done by the majority of taxpayers provides for dropping fully depreciated assets from the depreciable base whereas the Guidelines make it possible to include such assets. Often, therefore, the effective depreciation rates under Guidelines are substantially more favorable than they appear to be merely from examination of the useful life tabulation.

In order to get the benefit of depreciation on assets formerly considered fully depreciated, however, it is necessary for the taxpayer to adopt a method of accounting for depreciable property that conforms to this concept.

Previously there have been four basic ways to account for depreciable property: (1) item; (2) group; (3) classified and (4) over-all composite accounts.

Within the various group methods it has also been possible either to maintain or to ignore the year of addition. If accelerated depreciation has been used it has been necessary to maintain at least a division between pre-1954 and post-1953 acquisitions. The Guidelines are designed for classified accounts—that is, accounts classified in the same groupings as the Guidelines. However, within each Guideline class the taxpayer is entitled to maintain or not, as it chooses, the forms of accounting previously used. For example, it can continue to account separately for each item within a Guideline class or it can group its items within the class by year of addition, or it can put all assets within the class together in one account.

Various consequences flow from these various methods of accounting. For example, losses on ordinary retirements are recognized with item accounts—generally not with the other methods. However, under groups where year of addition is maintained taxpayers have often regarded this as equivalent to item accounting with the same

life for each item. On this basis losses have also been claimed on retirements from year of addition accounts.

If a taxpayer now wishes to regroup in accordance wtih the Guidelines it may do so without having a change of accounting method.

It should be noted that the double-declining-balance method and sum-of-the-years-digits method are applicable only to post-1953 additions. If either of these methods is to be used, therefore, it is necessary to preserve a separate grouping within each Guideline class for at least the pre-1954 and post-1953 acquisitions. Similarly, if more than one accelerated method is used a corresponding grouping will have to be preserved as a minimum.

Whatever method of grouping is employed the appropriate rate can be applied to the gross asset balance. However, when any group becomes fully depreciated it is the Treasury position that depreciation on that group must stop even though the assets in question could enter into the depreciable base under a different method of grouping.

For this reason it is usually advisable to attempt to maintain a balance in each component of the Guideline class. It will be recollected that any method of depreciation can be applied to new acquisitions. Consequently, additions can ordinarily be put in whichever component appears advantageous. Where accelerated depreciation has been used, the older (pre-1954) assets will be in the straight-line component of the Guideline class. When this component approaches a fully depreciated state it may be advisable to elect straight-line depreciation on some or all of the new acquisitions in order to maintain an undepreciated balance in the component.

Some control over the classes can also be exercised by switching methods of depreciation. Ordinarily such switching requires permission, although the double-declining-balance method may be changed to the straight-line method without permission. For the first year beginning after December 31, 1962 the taxpayer also has a one-time opportunity to change from accelerated depreciation to straight-line depreciation.

LOOKING FORWARD

If the Guideline life is adopted for any class of assets, the taxpayer will ultimately have to justify continuing to use these Guideline lives by the so-called reserve-ratio test. This test is a mechanical one based on tables supplied by the Internal Revenue Service.

If a taxpayer's actual reserve ratio—that is, the ratio of its

reserve for depreciation to its asset account at the end of the year being tested—does not fall within the range of the test table, the appropriate life will be determined by the use of an adjustment table. In general, the adjustment table provides a specific life longer or shorter than the life previously used. In shortening the life, the comparison is made with that used in the preceding year. In lengthening the life the comparison is made with the three-year average class life. For example, if an eight-year class life has been used in the year being tested and in each of the two preceding years, and if the reserve ratio test indicates that this life is too short, the adjustment is automatically to a ten-year life. After three years, another test can be made which might result in an additional adjustment.

Where different methods of depreciation are used for assets falling within a single Guideline class, the appropriate reserve ratio range is the weighted average of the separate reserve ratio ranges determined for the different methods of depreciation. Because accelerated depreciation produces more depreciation in the early years, the reserve ratio ranges allowed for an accelerated depreciation component are higher than those applicable to a straight-line component. A problem arises where an asset is transferred from one component to another—in particular where an asset formerly on declining-balance depreciation is transferred to straight-line depreciation. Both the asset and the applicable reserve must be transferred. Because the reserve will have been computed by the declining-balance method, it will tend to be high in relation to the straight-line, reserve-ratio range. Unfortunately, there is no provision for modifying the test with respect to this type of situation.

Another problem arises with respect to assets acquired in a tax-free liquidation or reorganization. Here the asset should be regarded as having been acquired at its gross value and the accumulated reserve should also be added in. For purposes of computing the rate of growth, the asset should be regarded as having been acquired at the time it was acquired by the transferor.

Perhaps the most widely appreciated feature of the Guideline rules is the three-year moratorium on adjustments. As time passes, more importance may well attach to the transitional period in which the reserve-ratio test will be considered met if the excess of taxpayer's reserve ratio over the upper limit of the appropriate reserve-ratio range is diminishing. The period during which this rule applies is one full Guideline class life beginning with the first year under the new Procedure. The excess will be regarded as diminshing if it is

less than the excess in any one (the worst) of the three preceding years.

The Guideline procedures were designed to stimulate property additions and replacements. The reserve ratios in any one year are improved by additions and by the retirement of fully depreciated assets. After expiration of the three-year moratorium and during the remainder of the transition period it may well be that a rather small property transaction in a particular year will nudge the reserve ratio enough to avoid a fairly large depreciation adjustment. This matter will require annual review.

SPECIAL PROBLEMS

The first year for which the Guidelines could have been used was the first year for which a return was due on or after July 12, 1962 without regard to extensions. It is to be noted that the Procedures are to be used "in connection with examination" of such returns. It therefore appears that the Procedures can be applied retroactively, as by claim for refund, to the appropriate years. For prior years, the Guidelines do not apply except that the reserve-ratio tests may be used to demonstrate that prior rates were too low.

The Guidelines include not only some departures from previous tax accounting, but also from book accounting as usually applied. The Guidelines can be applied for tax purposes only without any change in book accounting provided adequate supplemental records are maintained.

However, taxpayers are not obligated to apply the Guidelines. If the Guidelines are not applied, allowable depreciation will be determined, as in the past, with reference to all the "facts and circumstances." In this situation, one of the circumstances to which some weight will be given is the depreciation used for book purposes except in the case of regulated industries. Particular weight will be given to the book depreciation of publicly held companies.

To the extent that Guideline lives are shorter than lives previously in use, the question is raised concerning the effect, if any, on the possible basis adjustment for allowable depreciation in excess of allowed depreciation in prior years and in future years to the extent Guidelines are not applied. The Treasury takes the position that allowable depreciation for this purpose will be computed without reference to the Guidelines.

Under certain circumstances the Guideline procedures may be applied to lives shorter than the basic Guideline lives. Generally,

these lives will not be disturbed during the three-year moratorium if either the same lives have been used for at least one-half of the class life being claimed or if the class life has been examined and accepted by the Internal Revenue Service. Examination will be presumed only if depreciation adjustments were made or if the Report contains comments that the depreciation deduction was examined but not adjusted or where there is "other specific evidence" that depreciation was examined.

Where the shorter life is to be justified by prior use, a problem will arise if the taxpayer is switching from a grouping method that considers some assets as fully depreciated to one that does not. In such a case, it appears that the taxpayer will have to recompute the class life he was using by comparing the depreciation taken on assets not fully depreciated with the total of all assets, including the fully depreciated.

The place where guidelines tend to be helpful is in a class that includes a substantial amount of used assets. Obviously, used assets can not be expected to last as long as the same assets would have had they been acquired new. This fact has generally had recognition through setting shorter remaining lives on the used assets. There is no provision in the Guidelines for adjusting with respect to used assets. The Treasury position is that the Guidelines were set with reference to studies comparing total assets, including used, with depreciation. In effect, any Guideline class is assumed to include a normal amount of used assets. Of course a taxpayer can revert to the facts and circumstances test. However, in so doing it loses the benefit of whatever liberalization is achieved by the Guidelines. If, for example, prior practice would suggest a fifteen-year life for certain assets bought new, and if a particular taxpayer has sufficient used assets to justify a 20 per cent reduction in lives, the facts and circumstances test would suggest a twelve-year life. If the Guideline life is also twelve years, that life would be available even if all assets were new, and the taxpayer gets no additional depreciation by reason of the shorter life of its particular assets.

One of the first issues to arise under the Guideline Procedure was the treatment of special tools and the like. As originally constructed, such tools had to be included with the basic Guideline class, thus much limiting the value of the Procedure because Guideline lives are generally longer than the lives of this type of item. Also, because such tools are often accounted for by retirement or other methods, the question arose as to whether many taxpayers would be

entitled to use the machinery and equipment Guidelines at all. Fortunately, the original Procedure was modified in this respect so that special tools and the like are now a separate class to be accounted for under any permissible method.

If the Guidelines are not adopted with respect to any class of assets, it appears that the taxpayer will be entitled to continue the same methods and rates as previously. One constructive step is the reaffirmation in the Guideline Procedure of Revenue Rulings 90 and 91. These rulings, published in 1953, indicate that a taxpayer's established depreciation practices and rates would ordinarily not be disturbed unless they were clearly and substantially in error. Although these rulings were never revoked, there seems to have been some doubt among Internal Revenue Service personnel and practitioners alike as to how much force they had through the various changes of top level administrators. Their apparent approval by the present administration should be helpful in reducing controversy for those taxpayers who do not adopt Guidelines.

DEPRECIATION RECAPTURE

Although the Guidelines are generally favorable, the other depreciation development that I shall discuss is an adverse one. This is the provision for depreciation recapture.

In general, if section 1245 property is sold at a gain, the gain will be treated as ordinary income to the extent of depreciation taken after December 31, 1961.

The property subject to this provision includes depreciable personal property (except livestock) whether tangible or intangible.

Also included is other tangible property used as an integral part of certain specified activities or in connection therewith as a research or storage facility.

Buildings and structural components of buildings are not included.

The depreciation subject to recapture is not only the depreciation taken by the particular taxpayer on the particular property. It also includes other depreciation entering into the adjusted basis of the property. (In every case the depreciation referred to is depreciation attributable to periods after December 31, 1961.) Thus, it includes depreciation on other property previously owned by the taxpayer where there is a substituted basis such that the depreciation on the other property is reflected in the adjusted basis of the particular property. It also includes depreciation taken on the property by

another taxpayer if the property has a transferor's basis to the particular taxpayer.

The definition of section 1245 property may be met in dealing with other property, which generally must have been used as an integral part of certain specified activities, if the property has at any time been so used. Similarly, if the property has a transferor's basis and was so used by the transferor, it is subject to the recapture provisions. Or, if property, the basis of which is used as a substituted basis, was so used, the presently owned property is subject to the recapture provisions.

TRANSACTIONS THAT MAY RESULT IN RECAPTURE

It will thus be seen that property possibly not appearing to be concerned is in fact subject to these provisions. Perhaps even more dangerous is the fact that various transactions not ordinarily taxed may trigger these taxing rules.

Generally, any disposition gives rise to this ordinary gain despite any other provision of the Code. There are certain exceptions relating to situations where the property has a transferor's or substituted basis after transfer. For this purpose property distributed by a partnership to a partner is considered to be determined with reference to the partnership's basis. Transfers at death are also excluded.

There is no exclusion for distributions by a corporation to a shareholder except where there is a transferor's basis by reason of a nontaxable liquidation.

There is no exclusion for a sale by a corporation otherwise tax free by reason of section 337.

The exclusion for nontaxable corporate liquidations does not apply unless there is also a transferor's basis. In other words, if there is a purchase and liquidation within two years so that the basis of the stock is applied to the assets received in liquidation, the liquidating corporation may be subject to tax under the recapture provisions.

Finally, although gifts do not trigger the recapture provisions as such, the charitable deduction is reduced by the amount that would have been subject to recapture if the property contributed had been sold at its fair market value.

In short, the effect on tax liabilities and planning of these new rules respecting property is a matter that is bound to require a substantial part of our thought for an indefinite time to come.