

University of Mississippi

eGrove

Haskins and Sells Publications

Deloitte Collection

1957

Tax savings and depreciation

Gordon L. Hopper

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

Haskins & Sells Selected Papers, 1957, p. 142-150

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Tax Savings and Depreciation

BY GORDON L. HOPPER
Partner, San Diego Office

Presented at a Tax Conference sponsored by the San Diego Chamber of Commerce and the San Diego Chapter of The California Society of Certified Public Accountants — November 1957

Depreciation has long been a controversial subject and nearly all businessmen have had their problems with it at one time or another. Probably several of those present here today have had amounts of depreciation which they had deducted in their tax returns questioned by the Internal Revenue Service. However, there are those who have some mistaken ideas about what depreciation is. A common misconception seems to be that depreciation is the difference between the cost of an asset and the price at which it might be sold or that there is at least some relationship between depreciation and market value. The truth is that market value is not a factor in determining the amount of depreciation and more often than not the depreciated value and the market value of depreciable assets are two very different amounts.

DEFINITION OF TERMS

It might be helpful in discussing the subject to define some of the terms used. Depreciation may be defined as the gradual wearing-out of property over the period of its useful life because of wear and tear, corrosion, decay, and other physical factors, due consideration being given to obsolescence. Depreciation accounting, the topic we are mainly concerned about here, is the process of systematically spreading the basis, which is usually the cost, of depreciable property over the period of its estimated useful life. Depreciable property is property used in a trade or business or held for the production of income. Useful life is the period of a property's usefulness to the taxpayer rather than the period of its existence.

This last definition is particularly important because it represents a change from past practice. Whereas the life inherent in the property in the past generally measured useful life, regulations under the 1954 Code emphasize that useful life for depreciation purposes is the useful life *to the taxpayer*. To illustrate the effect of this change, the situation of some businessmen who diligently maintain their equipment and generally do not dispose of it until it is practically worn out may be cited. According to present

regulations, these taxpayers will be required to use relatively long lives and salvage value will be nominal if recognized at all. Other businessmen have rather lax maintenance policies and customarily dispose of equipment long before its usefulness is exhausted. This group will use shorter lives but will find it necessary to recognize much larger amounts as salvage value. Accordingly, policies adopted for the maintenance and disposition of depreciable assets should be carefully considered from the standpoint, among others, of their effect on depreciation deductions and the related possibilities for tax savings.

DEPRECIATION BEFORE 1954 CODE

Before enactment of the 1954 Internal Revenue Code, businessmen-taxpayers frequently concerned themselves only with one or both of the following two questions about depreciation:

Can it be charged to expense or must it be capitalized?

If it must be capitalized, what is the maximum rate of depreciation acceptable for tax purposes?

Obtaining answers to these questions was often the extent of planning for tax savings through depreciation. In many cases little more could be done. Although several different depreciation methods were available before 1954, their use had been so restricted by rulings of the Internal Revenue Service that the straight-line method was the one used by almost all taxpayers.

EFFECTS OF 1954 CODE

This situation was changed materially by the 1954 Code which greatly increased the opportunities for substantial tax savings by careful planning of depreciation. Furthermore, the opportunities are available to all taxpayers who own even a modest amount of depreciable assets. Obviously, the more a businessman has invested in depreciable assets, the more vital are his decisions on depreciation.

DEPRECIATION METHODS AVAILABLE

One of the first and most important decisions to be made for obtaining the maximum tax benefit from depreciation deductions is the selection of the method that best fits the particular circumstances. The 1954 Code authorized the use of any consistent method which produces a reasonable

allowance. It concedes, specifically, that a reasonable allowance will result from use of the straight-line method, the declining-balance method, and the sum-of-the-years-digits method. This is important, since the taxpayer, if he uses any other method, has the burden of proving that it produces an allowance that is reasonable. Although the use of other methods may be desirable in some circumstances, they are so seldom used as not to merit lengthy discussion. Therefore, any subsequent reference to liberalized methods will be to the 200 per cent declining-balance method or to the sum-of-the-years-digits method.

FEATURES OF LIBERALIZED DEPRECIATION

Since these two methods have received much publicity, it should not be necessary to go into a detailed explanation of their mechanics. Their main feature is that they result in larger depreciation deductions than the straight-line method in the earlier years of whatever estimated useful life is used. Thus a maximum of twice straight-line depreciation may be deducted in the first year and the amount of the annual deduction as to a particular asset decreases steadily in each subsequent year. Under both methods, something like two-thirds of the total available deduction — usually the property's cost or cost less salvage value — is taken in the first half of estimated life. A comparison of the two methods and some comments on salvage value will be made later.

Possible Tax Savings

The tax-saving possibilities in using one or both of these liberalized methods lie in the fact that, as previously mentioned, depreciation deductions in the earlier years of estimated useful life are materially greater than those produced by the straight-line method. Since, in the long run, the total amount of depreciation deductions is theoretically the same under any acceptable method, some view the reduction of taxes in the earlier years of using the liberalized methods as a tax deferral rather than a tax saving. However, it can be demonstrated that use of these methods produces permanent tax savings in those cases where net property additions are uniform from year to year or where they are increasing because of the growth of the business. Also, it is clear that by the reduction of tax liabilities in the earlier years of these methods' use, additional cash is made available that otherwise would be used to pay taxes. The practical effect of this is interest-free borrowing from the Government. For businesses that have interest-bearing debt, the savings in interest can be substantial, especially after it has been compounded for a number of years.

Possible Tax Losses

A common argument against the use of these liberalized methods is that potential tax savings under present conditions might become tax losses if tax rates are increased. Obviously, it is usually desirable to obtain maximum deductions in years of higher tax rates. It follows therefore that if rates are to be increased it might be better to defer depreciation deductions rather than to accelerate them. Recent international developments provide some basis for believing that tax rates may have to be increased. On the other hand, we should note that in the past, tax rates have generally followed the rate of business activity. If this pattern should continue, other recent developments indicate that the probability of rate increases may not be too great.

California Law

Probably a stronger argument of California taxpayers against using a liberalized method is that this State does not permit such methods for California income and franchise tax purposes. This generally means some additional expense (and a resultant reduction of potential tax savings) to a taxpayer who elects to use the liberalized methods for Federal tax purposes, because he will be required to maintain two sets of property and depreciation records. No one, including the Franchise Tax Board, is happy with this situation, but there is no apparent likelihood that it will be changed in the near future. The State's position in this matter was taken for the express reason that it could not afford the reduction in revenue which would result from use of the liberalized methods. This, of course, is a rather effective argument that tax savings do result from use of the methods..

LIMITED DECLINING-BALANCE METHOD

Another method that should be explained here is the declining-balance method with the rate limited to 150 per cent of the applicable straight-line rate. This method was permitted for both Federal and State returns before the 1954 Code and it is again sanctioned under present Federal regulations on depreciation. The State has recently indicated that it will follow these regulations. The method may be used for depreciating second-hand assets as well as those new with the taxpayer and, if used for both Federal and State purposes, eliminates the need for maintaining a second set of property and depreciation records. However, before electing to use it, the taxpayer should understand that the statute does not guarantee the production of reasonable allowances under this method. Furthermore, the taxpayer should remember that the burden is on him to prove that allowances are reasonable.

CONDITIONS FOR LIBERALIZED DEPRECIATION

In a situation where use of a liberalized method is desirable, certain essential planning must be done and, as with all tax planning, it must be done beforehand. This area probably offers the most frequent opportunities for tax savings from careful planning of depreciation accounting. The reason for this is that certain conditions specified in the Code must be satisfied if a liberalized method is to be used. These conditions are that the property in question must:

- 1) be tangible property,
- 2) have a useful life of 3 or more years,
- 3) have been constructed or acquired after 1953, and
- 4) have been put into use originally by the taxpayer.

All of these conditions must be present if a liberalized method is to be used. Perhaps an example would serve to illustrate the importance of satisfying these conditions.

USEFUL LIFE

Suppose a business owns some automobiles — perhaps a number of salesmen's cars or light panel trucks. Assume that the cars were new when purchased, that their life for depreciation purposes as shown on the taxpayer's depreciation schedule is, say, three or four years, and that they apparently qualify for the liberalized method elected in computing their depreciation. Then suppose that the taxpayer's experience clearly demonstrates a policy of selling or trading cars at the end of 2½ years on the average is advantageous. It is probable in these circumstances that the Internal Revenue Service would be successful in contending that the useful life of the cars to this taxpayer is less than the required three years and that they accordingly do not qualify for either of the liberalized methods. This result probably would be very costly to the taxpayer, but could be easily avoided by better planning and by a slight change in timing of sales or trade-ins of cars.

ORIGINAL OWNERSHIP

Several specific situations which demand careful planning may be cited with respect to the requirement that original use of the property must commence with the taxpayer. Experience has shown that this is the most troublesome of the required conditions.

Very soon after the liberalized methods became available, one of our clients entered into negotiations to buy a rather large rental property then

under construction. For reasons which need not concern us here, he was planning to purchase the property about six months after its completion, the builder to act as principal and rental agent in the interim. This would have been costly under the circumstances since use of a liberalized method clearly would produce substantial tax savings, whereas he was really planning to prevent its use by not being the first user of the property. Needless to say, after consultation, he changed his plan, with the result that all original tenants' leases bore his signature.

Individual v. Corporation

Another less happy situation concerns a businessman who became a client but sought advice too late. He had constructed a new business building, installed expensive new fixtures and equipment in it, and commenced operating as a sole proprietorship. He had known from the beginning that it would be necessary to incorporate the business but in his rush to open for the Christmas season, did not get around to having the corporation formed or to obtaining any tax advice until three or four months after the store had opened. The business was very successful from the start and use of a liberalized depreciation method would therefore have produced substantial tax savings. However, this taxpayer found out the hard way that neither method was available to the corporation because it was not the first user of the property.

The reverse of this situation should also be planned for. A corporation may have properly used one or both of the liberalized methods but if its depreciable property is subsequently distributed to its stockholders upon dissolution, such property does not qualify for fast depreciation in their hands — for the reason that they are not the original users.

Partnerships

Similar rules apply to partnerships. A partnership is not the first user of property contributed to it by a partner and a partner is not the first user of property distributed to him by a partnership. In transfers between partners and partnerships and between stockholders and corporations the importance of properly timing the acquisition of property is apparent if a liberalized method should be used.

CHOICE OF METHOD

If a liberalized method is elected, the next problem is to decide on the method most suitable. Each has advantages and disadvantages but, as usual,

the choice depends on the circumstances. The choice need not be limited to single method because different methods may be used for different assets.

Besides being easier to use, one of the principal advantages of the declining-balance method is that it provides automatically for the recognition of a certain amount of salvage value so that salvage values are ignored in making the computation. However, this means that the full basis of the property will not be recovered using this method and the unrecovered portion will frequently be much greater than a reasonable allowance for salvage value. This undesirable feature may be avoided by changing to the straight-line method at an appropriate time during the property's useful life. Making this change, which may be done without obtaining the permission of the Commissioner, would seem to permit full recovery of basis but may not be as attractive as it sounds. The regulations require that when the change is made, the useful life must be reappraised and a salvage value must be established. Coming late in the period originally estimated to be useful life, the change may not give a desirable result.

It may be said that the declining-balance method produces a larger deduction in the first two years of useful life and that, after two years, recovery of basis will be faster under the sum-of-the-years-digits method. This assumes that salvage values need not be recognized, which is not a sound assumption in all cases. Nevertheless, it is fair to say that the principal advantage of the sum-of-the-years-digits method is that it generally produces larger deductions after the very early years of useful life.

SALVAGE VALUE

In the past, although the Government did occasionally insist on its recognition, salvage value has generally been ignored by most taxpayers in computing depreciation. Present regulations give it much greater emphasis and there is recent convincing evidence that agents may have been instructed to give more attention to it. This apparent change in the attitude of the Internal Revenue Service does not mean that all taxpayers should change their policies on salvage value, since many taxpayers probably will not be affected by it. However, it seems certain that the issue will be raised more frequently than in the past and if a taxpayer believes that he may have the problem, he would be well advised to plan the defense of his position in advance.

LEASED PROPERTY

There are some important points to be considered in planning for the depreciation or amortization of improvements made by a lessee on leased

property. The regulations provide that if the useful life of leasehold improvements is equal to or less than the remaining term of the lease, they are subject to depreciation and their cost may be recovered under a liberalized method. If their useful life exceeds the term of the lease, the improvements are subject to amortization which must be computed on the straight-line method. This position seems to conflict with the concept previously explained that useful life means useful life to the taxpayer and there does not appear to be support for it in the Code. However, most lessee-taxpayers probably would not be interested in testing the regulation, so the alternative is careful planning. For example, as often happens, a lessee may plan to make improvements costing a substantial amount soon after executing or renewing a lease. If the improvements have a useful life of ten years and that is also the term of the lease, the lessee would not be permitted to depreciate them under a liberalized method since, being completed probably several months after the date of the lease agreement, the improvements would have a useful life exceeding the remaining term of the lease. This result could be prevented simply by making the original term of the lease eleven or twelve years, or perhaps by extending the term a couple of years before the improvements are ready for use, thus producing material tax savings.

Many businessmen have chosen to lease or rent certain types of equipment used in their business. The choice is usually influenced by the fact that the rental deductions are larger than the deductions for depreciation would be if the property were owned and therefore result in a reduction in income taxes. Several factors must be considered in making this decision but very often the tax-savings feature is the key. If such a choice was made before 1954 and has been continued since that time, the matter should be reconsidered because it is possible that use of a liberalized method would swing the balance in favor of owning the equipment.

PLANNING AND TIMING

If taxes are to be kept at the minimum, the importance of planning in advance of business transactions cannot be over-emphasized. From the discussions of the various subjects today, you will almost certainly notice that most tax savings result from proper timing. Proper timing requires careful planning before the election is made and before the deal is closed.

CONCLUSION

Before concluding I would like to make a few comments that do not relate to depreciation. I have heard it said more than once that there is

something dishonest or immoral in tax planning. People with this mistaken idea usually use some term such as "tax schemes." Such an idea is obviously ridiculous. It is no more dishonest or immoral to plan in such a way that taxes are reduced to their legal minimum than it is to plan to increase sales and profits by honest means.

On the other hand, even though most taxpayers are willing to pay their fair share, cheating on income taxes can become a grave problem. History has repeatedly shown that this condition usually attends the decline of governments and nations. Men have never had it so good as we do in this country under our form of government and, with world conditions what they are, it is the duty of every citizen to help prevent taxation and tax evasion from destroying us. Think about it.