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Analysis of capital cost recovery proposals; Statement of tax policy 7

American Institute of Certified Public Accountants. Federal Taxation Division

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Analysis of Capital Cost Recovery Proposals
Statements of tax policy of the federal tax division are issued for the general information of those interested in the subject. They present the conclusions of the division, which is the senior technical body of the Institute authorized to speak for the Institute in the area of federal income taxation.

Statements of tax policy are intended to aid in the development of federal tax legislation in directions that the division believes are in the public interest.

Statements of tax policy do not establish standards enforceable under the Institute's Code of Professional Ethics and are not intended for that purpose.
Analysis of Capital Cost Recovery Proposals

Issued by the Federal Taxation Division of the American Institute of Certified Public Accountants
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Foreword

Statements of Tax Policy represent a conscientious effort by the AICPA Federal Taxation Division to explore, comment, and, where appropriate, develop positions on matters of tax policy covering major areas of taxation in which members of the accounting profession have special competence.

Statements of Tax Policy are approved by the executive committee of the Federal Taxation Division after they are developed by the division’s tax policy subcommittee. Other division subcommittees may develop a policy statement if requested to do so. This statement was approved by the 1979–80 policy subcommittee and executive committee.

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Introduction

The AICPA Federal Taxation Division is very much concerned with the problems of the American economy and thinks that our present system of taxation has been a contributing factor to many of them. The problems include inflation and declining productivity, as well as the need for a tax system that is easier to understand, apply, and administer. We believe that the recommendations contained in this study would, if enacted, have a significant beneficial effect on our economy.

Inflation is clearly one of the major problems facing our country, and its impact on the tax system is of great concern to the integrity of the system. In this paper our analyses of alternative capital cost recovery proposals are based on assumed annual rates of inflation ranging from 6 percent to 14 percent. Our analyses lead us to conclude that the capital cost recovery proposals presently embodied in H.R. 4646 and S. 1435 and the simplified cost recovery system of H.R. 7015 are the best alternatives of those now being considered. However, because of the devastating impact of inflation rates on capital recovery allowances, if future rates increase significantly, our conclusions about the preferable method of cost recovery may change. It may then be necessary to enact provisions for immediate write-off of capital investment or, in spite of its complexity, some form of indexation.

This policy statement is limited to consideration of tax policies that affect capital cost recovery and does not purport to cover all of
the factors affecting capital formation. Thus such other major tax policy areas as tax rates, savings incentives, and tax-deferred investment rollovers might also be considered by Congress in meeting our needs for increased capital formation and other economic incentives.
The Need for Increased Capital Investment

For the past five years Congress has become increasingly aware of fundamental structural problems in the American economy. The economic growth of the United States has lagged behind that of its allies and trading partners. Americans need increased incentives if such problems as inflation, low productivity, and international trade imbalance are to be overcome.

At least since the Revenue Act of 1978, which significantly lowered the tax on capital gains, Congress has shown a recognition of the important part that capital formation and investment play in fostering economic growth. Just as the nation has grown more conscious of the need to preserve and better utilize natural resources, so has it become aware that capital resources must be developed and managed carefully if the country is to return to a more sound economic course.

Aside from our demands for plant expansion and modernization, we must consider capital requirements for creation of new jobs for entrants into the labor market, encouragement and development of new technology, improvement of our environment, and the critical need for developing new energy sources. Not only do we need a tax system and an economic environment that will encourage savings and the creation of new capital, but we must do all that we can to preserve and use efficiently the capital now available.
Productivity

Declining growth in productivity has become a major policy issue in the United States. It is generally conceded to be a significant factor in our high rate of inflation and, because of the declining ability of U.S. manufactured products to compete in world markets, in our balance of payments. Productivity is affected by factors other than the level of capital investment, but the experiences of other industrialized nations indicate a definite correlation between the level of investment and productivity performance.

Widespread recognition of the need for increased productivity was forced on the United States during the late 1970s with the admission that, in comparison with the world’s leading industrial nations, the United States was among those with the lowest productivity growth. Figure 1 and figure 2 show just how far the United States has lagged behind its competitors in recent years and the very disturbing adverse trend that this represents.

Figure 1

Average Annual Percentage Change of Output Per Hour in Manufacturing

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>4.9</td>
<td>4.4</td>
<td>3.1</td>
<td>0.6</td>
<td>13.6</td>
<td>28.0</td>
</tr>
<tr>
<td>Canada</td>
<td>-2.6</td>
<td>5.0</td>
<td>5.5</td>
<td>4.7</td>
<td>13.0</td>
<td>55.0</td>
</tr>
<tr>
<td>France</td>
<td>2.8</td>
<td>8.5</td>
<td>5.0</td>
<td>4.9</td>
<td>22.9</td>
<td>80.2</td>
</tr>
<tr>
<td>Germany</td>
<td>4.4</td>
<td>5.9</td>
<td>5.4</td>
<td>3.6</td>
<td>20.7</td>
<td>75.1</td>
</tr>
<tr>
<td>Italy</td>
<td>-4.3</td>
<td>8.5</td>
<td>1.1</td>
<td>2.9</td>
<td>8.1</td>
<td>72.7</td>
</tr>
<tr>
<td>Sweden</td>
<td>-1.3</td>
<td>0.7</td>
<td>-0.6</td>
<td>5.7</td>
<td>4.4</td>
<td>60.5</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-1.3</td>
<td>2.4</td>
<td>-0.7</td>
<td>1.8</td>
<td>2.2</td>
<td>30.5</td>
</tr>
<tr>
<td>Japan</td>
<td>-3.9</td>
<td>8.1</td>
<td>4.5</td>
<td>7.9</td>
<td>17.2</td>
<td>112.9</td>
</tr>
</tbody>
</table>

U.S. rank 1  6  5  8  4  8


The need for increased investment in productive assets exists throughout the economy. A Fortune survey of leading U.S. industrials showed that for 1979, the average asset investment per employee was $64,000, where six years earlier it was less than $36,000.
Figure 2

Increases in Output in Manufacturing
1967–1978
(1967 = 0)

UNITED STATES
UNITED KINGDOM
GERMANY
FRANCE
SWEDEN
JAPAN

LEGEND

SOURCE OF INDEX:
BUREAU OF LABOR
STATISTICS
JANUARY 1980
This increase is significant. Not only does it show the impact of inflation on investment needs, but it clearly reflects the greatly increased asset investment required to support an employee.

The need for capital investment is no less significant for smaller companies. In January 1980, five of the top fifteen priorities of the White House Conference on Small Business related to increased capital formation and retention.

Since investment is so very important at all levels, it is particularly alarming that during the recovery following the 1974–75 recession, real business fixed investment recovered much later than was the case in prior cycles. In addition, the growth of the nation's capital during that period did not keep pace with the increase in the work force. The inevitable result of insufficient investment has been lower productivity, which has contributed to growing inflation rates.

**Inflation**

Increased productivity, spurred by increased capital investment, should help to reduce inflation rates. Currently our economy is caught in a loop. As inflation drags down capital spending, productivity is reduced; as labor costs rise, more inflation is generated. The loop can be broken if policies are adopted that stimulate capital growth, thereby reducing unit labor costs. The periods of 1962–1966 and 1975–1977 were associated with rapid capital formation, relatively strong productivity, and moderate inflation. Conversely, in 1978, wages rose 9.3 percent, but productivity increased only 0.4 percent. Hence, unit labor costs increased 8.9 percent, and the Consumer Price Index rose at a rate of 9 percent.

In 1975, Secretary of Labor John Dunlop testified before the Joint Economic Committee on the interrelationship of increased investment, productivity, and inflation:

Creation of jobs through investment capital broadens opportunities, thus allowing more upward mobility in salary and skills as people are promoted and new jobs created. . . . The most basic and far-reaching objective for national policy in this context should be to encourage de-

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1. G. William Miller, chairman of the Federal Reserve Board, testimony before the Senate Finance Committee on September 6, 1978.
2. Allen Sinai, vice president and senior economist, Data Resources, Inc., comments to the Committee for Effective Capital Recovery, September 13, 1979.
velopment of new technologies and the formation of new capital. Also, the increase in output and income implied by new capital formation means a higher level of living and income for all Americans, whether or not they are employed by the industries involved with new capital formation and productivity gain.

**Balance of Payments**

With such a low rate of productivity increase and a high rate of inflation, the United States is at a competitive disadvantage among its trading partners. The following table (figure 3) shows that American workers are no longer the most highly paid, so "cheap foreign labor" is not always the culprit in our trade losses.

*Figure 3*

**Comparative Wage Rates**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>$4.19</td>
<td>$6.36</td>
<td>$8.26</td>
</tr>
<tr>
<td>Canada</td>
<td>3.46</td>
<td>6.11</td>
<td>7.44</td>
</tr>
<tr>
<td>Japan</td>
<td>.99</td>
<td>3.05</td>
<td>5.41</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.08</td>
<td>6.69</td>
<td>10.18</td>
</tr>
<tr>
<td>France</td>
<td>1.74</td>
<td>4.61</td>
<td>6.80</td>
</tr>
<tr>
<td>Germany</td>
<td>2.35</td>
<td>6.27</td>
<td>9.41</td>
</tr>
<tr>
<td>Italy</td>
<td>1.77</td>
<td>4.64</td>
<td>6.17</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.14</td>
<td>6.59</td>
<td>9.88</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.96</td>
<td>7.19</td>
<td>9.93</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.48</td>
<td>3.27</td>
<td>4.29</td>
</tr>
<tr>
<td>U.S. rank</td>
<td>1</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>


In six of the eight years from 1971 to 1978, the United States experienced trade deficits. The deficits have often been blamed on the cost of imported oil. However, both Germany and Japan, which have virtually no domestic oil, had substantial trade surpluses. The keys to their success are high rates of productivity and investment. Again, increased American investment could provide the foundation for an expanded export program that would, in turn, enhance our balance of payments and reduce inflation.

The need for greater investment and productivity is pervasive. Other tax reform objectives of simplicity and fairness can also be met
if we adopt an adequate program of capital-resource management. All resource management programs involve conservation, as well as proper resource use and growth maximization.

**Importance of Capital Recovery**

Traditionally, about two-thirds of private sector capital has come from the tax benefits from capital recovery allowances and from retained earnings; the balance has come from personal savings. In recent years, inflation has eroded the real value of traditional capital recovery allowances, and the combination of inflation and high taxation of investment income has discouraged personal savings.

In January 1979, Martin Feldstein and Lawrence Summers of the National Bureau of Economic Research completed a study entitled *Inflation and the Taxation of Capital Income in the Corporate Sector*, which found that, relative to replacement cost, depreciation allowed on existing plant and equipment was understated by $39.7 billion in 1977 due to the inflation factor. Alone, the impact of inflation on depreciation allowances increased corporate tax payments by $19 billion, or almost one-third of the $59 billion of corporate tax liabilities for 1977. Clearly, there is no advantage in taxing the illusory profits caused by inflation—such taxation inhibits formation of new capital resources and utilization of existing capital.

Similar studies have been made periodically by the Machinery and Allied Products Institute (MAPI). The institute considered both the understatement of depreciation costs and the understatement of inventory costs caused by inflation. Figure 4 summarizes MAPI data and shows the significant overstatement of reported profits of nonfinancial corporations during the last few years.

While MAPI follows a slightly different approach in analyzing the impact of inflation on financial income and on taxes, the overall results are similar to Feldstein's and Summers's work. In reference to figure 4, the understatement of charges against current earnings due to underdepreciation of assets, and understatement of inventory costs, was relatively minor in the 1960s and early 1970s. Beginning in 1973, however, when our rate of inflation increased dramatically, the significance of cost understatement assumed much greater

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importance. For 1974, the understatement was more than $43 billion, and for 1978, it was slightly over $42 billion.

Figure 4

Adjustment of Reported Profits of Nonfinancial Corporations
(billions of dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Profits Before Tax as Reported (1)</th>
<th>Income Tax Liability (2)</th>
<th>Profits After Tax as Reported (3)</th>
<th>Understatement of Costs (4)</th>
<th>Profits Before Tax as Adjusted (5)</th>
<th>Profits After Tax as Adjusted (6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>69.5</td>
<td>29.5</td>
<td>40.0</td>
<td>-1.7</td>
<td>71.2</td>
<td>41.7</td>
</tr>
<tr>
<td>1970</td>
<td>55.1</td>
<td>27.3</td>
<td>27.8</td>
<td>3.6</td>
<td>51.5</td>
<td>24.2</td>
</tr>
<tr>
<td>1974</td>
<td>102.9</td>
<td>42.7</td>
<td>60.2</td>
<td>43.4</td>
<td>59.5</td>
<td>16.8</td>
</tr>
<tr>
<td>1978</td>
<td>167.1</td>
<td>68.5</td>
<td>98.6</td>
<td>42.1</td>
<td>125.0</td>
<td>56.5</td>
</tr>
</tbody>
</table>

Figure 5 converts this information into effective tax rates on pretax profits as reported and as adjusted.

Figure 5

Effective Tax Rates on Pretax Profits of Nonfinancial Corporations

<table>
<thead>
<tr>
<th>Year</th>
<th>As Reported</th>
<th>As Adjusted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>42.4%</td>
<td>41.4%</td>
</tr>
<tr>
<td>1970</td>
<td>49.5</td>
<td>53.0</td>
</tr>
<tr>
<td>1974</td>
<td>41.5</td>
<td>71.8</td>
</tr>
<tr>
<td>1978</td>
<td>41.0</td>
<td>54.8</td>
</tr>
</tbody>
</table>

For the years 1966 and 1970, relatively little difference existed between the effective tax rates on profits as reported and as adjusted for inflationary elements. For 1974, however, the difference was dramatic. The effective rate on adjusted profits was nearly 72 percent, compared with a rate of 41.5 percent on reported profits. For 1978, the difference was also large: nearly 55 percent on adjusted profits compared with 41 percent on reported profits.

This analysis shows that the impact of inflation on aftertax corporate profits, and in particular on the amount of capital retained in the corporate sector, is dramatic. For example, if the effective rate on
reported profits for 1974 (41.5 percent) had been applied to adjusted profits ($59.5 billion), total taxes on earnings of these corporations would have been approximately $24.7 billion, rather than the amount reflected in the financial statements of $42.7 billion. This means that $18 billion of capital was taken from these corporations—and out of the pool of available investment capital—by taxation of inflated business profits. For the most recent year, 1978, similar calculations indicate that more than $17 billion was extracted from the pool of investment capital available to these corporations.

Why are these data significant? If indeed there is a capital shortage and a need to encourage capital investment, the preservation of present capital resources seems essential. Since the major source of capital to meet our needs is the capital cost recovery allowance for tax purposes, Congress should address this significant tax policy issue.

In periods of inflation, the simplest and most effective hedge against investment erosion caused by inflation is immediate write-off of capital investment, so that the tax benefits from invested funds are available immediately for further investment. A second hedge is indexation, so that cost recovery is geared to inflation adjusted cost rather than historical cost. Short of these approaches, systems that permit faster investment recovery appear to be the next best solution. In periods of high inflation, the timing of capital investment recovery becomes critical. The longer such recovery is delayed, the lesser is its value. The importance of the timing of capital recovery allowances is illustrated and discussed further in section 6.
A Brief History of Tax Depreciation in the United States

From 1913 to 1954

Ever since the Revenue Act of 1913, the U. S. income tax law has allowed taxpayers to deduct depreciation. For many years, however, only the straight-line depreciation method was acceptable.

Between 1913 and 1933, the Bureau of Internal Revenue deemed it impractical to prescribe the estimated lives of either individual properties or all properties of any given character or class and allowed taxpayers great freedom in selecting the estimated life of any productive asset. Consistently applied depreciation deductions were generally acceptable unless the bureau could clearly demonstrate that the deduction claimed was unreasonable. This tax treatment was consistent with generally accepted accounting practice in those years.

In 1933, as part of the Roosevelt administration's drive for new sources of revenue, the Bureau of Internal Revenue issued a revised Bulletin F, which, for the first time, prescribed the estimated lives of assets. At the same time the bureau shifted the burden of proof for depreciation to the taxpayer. In other words, after 1933 every taxpayer had to (1) submit detailed depreciation schedules with each tax return and (2) be prepared to prove that the deduction claimed was reasonable.
The next twenty years was a period of frequent conflict between taxpayers and the government in the matter of depreciation deductions. Taxpayers complained generally that the estimated lives assigned were unrealistically long. The reduction of investment in new plant and equipment during the period from 1933 to 1953 is sometimes blamed, at least in part, on these long estimated lives.

During this period there were some exceptions to the general rule of long estimated lives. For example, during World War II the tax code was revised to allow the cost of some property necessary to the war effort to be deducted over a sixty-month period, regardless of the estimated life of the asset. These same rapid amortization provisions were extended to certain grain storage facilities in the 1950s, and, in 1946, the bureau allowed the use of declining-balance depreciation in very limited circumstances, but only with prior approval.

**Adoption of Accelerated Methods**

Major revisions in tax depreciation were authorized in the Internal Revenue Code of 1954. The most important modifications involved the use of rapid, or accelerated, depreciation methods. Accelerated depreciation permits a taxpayer to claim larger deductions in the early years (and increasingly smaller deductions in later years) of an asset's useful life. The two most popular rapid depreciation methods introduced in the 1954 code were the double-declining balance and sum-of-the-years-digits.

**Adoption of Class Life System**

There have been two important changes in tax depreciation policy since the general acceptance of accelerated methods in 1954. In 1962, the Kennedy administration introduced depreciation guidelines to replace the old Bulletin F. And in 1971, the Nixon administration revised the guidelines and introduced the asset depreciation range system, which was the basis of the class life asset depreciation range system (commonly referred to as ADR) adopted by Congress in the Revenue Act of 1971. The depreciation guidelines issued in 1962 streamlined the old procedure by substituting a limited number of very broad assets classes for the many specific
properties listed in Bulletin F. For example, all office furniture, fixtures, machines, and equipment were combined into a single class and assigned a single estimated life. The useful lives suggested by the guidelines were generally from 30 percent to 40 percent shorter than those suggested in Bulletin F. This reduction in the estimated lives of fixed assets served to stimulate greater investment in the same manner that rapid depreciation had done eight years earlier.

The ADR system introduced in 1971 was intended to stimulate investment even more by authorizing a further 20 percent reduction in guideline lives. Actually, the ADR system substituted an estimated-life range for a specific life. For example, any asset class previously assigned a ten-year life in the guideline system was given an eight-to-twelve-year range of estimated life in the ADR system. Thus every taxpayer was given an option to extend or to shorten an estimated life by up to 20 percent. Most taxpayers elected the shorter life.

Although the Treasury Department has made relatively minor changes in the definition of various classes of assets and has established new lives for several classes, the ADR that went into effect in 1971 remains the basic depreciation system today. Throughout all of the changes described, however, a taxpayer has always been allowed to select an estimated life different from that provided by the Internal Revenue Service if it could be proven that another life was more reasonable. The difficulty of proving an alternative estimated life is sufficiently great, however, to discourage many taxpayers.

In summary, the history of tax depreciation in the United States can be divided roughly into three distinct periods. From 1913 to 1933 every taxpayer determined independently the estimated lives and, therefore, the rate of depreciation, of all fixed assets. Throughout the first period, only straight-line depreciation was generally accepted. From 1933 to 1954, the federal income tax provisions suggested estimated lives for thousands of specific assets, but except in very limited circumstances, continued to accept only straight-line depreciation. Since 1954, both rapid-depreciation methods and class lives have become generally accepted. Furthermore, since 1954 the changes enacted in tax depreciation have been based primarily on national economic policy objectives rather than the determination of financial income.
The Problem of Conformity Between Financial and Tax Accounting for Depreciation

Although profitable businesses have excellent economic reasons to accelerate depreciation for tax purposes, the same may not be true for financial accounting purposes. If a business is not growing or continually making capital investments at a constant rate, rapid depreciation may reduce reported profits in early years, sometimes to the confusion and detriment of stockholders and investors.

After 1954, many businesses wanted to take advantage of the economic incentive that Congress provided in rapid depreciation for tax purposes. They also wanted to continue traditional depreciation practices in reporting earnings to shareholders and to be in line with competitors' practices in reporting such earnings. Consequently, they elected to use entirely different depreciation methods for tax and financial accounting purposes. This apparently inconsistent treatment of depreciation, which is a major component in income determination (both tax and financial), was observed by many. Some individuals called for greater conformity in income reported to the IRS and the SEC. The accounting profession generally resisted moves requiring conformity, however, because of the fundamentally different objectives of financial reporting principles. In other words, sound tax policy often has little to do with financial accounting policy.

In today's environment of high inflation, many believe there is a pressing need for recognition of inflation in financial statements, and action has been taken by the Financial Accounting Standards Board; but the varied techniques for accomplishing this are beyond the scope of this paper.
Capital Investment Incentives Used by Other Major Industrial Countries

The tax systems of most developed countries provide a host of capital recovery incentives, including the following:

- Outright grants or low-interest financing
- Tax abatement for distressed regions
- Tax (investment) credits
- Immediate or fast write-offs
- Allowances in excess of cost
- Tax-deductible provisions to investment reserves
- Deferral of gain "rolled over" into subsequent investment
- Indexing, or other adjustment, of assets to compensate for inflation
- Indexation of gains

Many industrialized nations have instituted arbitrary (short-life) recovery periods in place of the traditional, estimated useful-life basis of computing depreciation. For example, the United Kingdom
permits full first-year write-off, and Canada provides for a two-year recovery period for productive equipment. Several countries, including Canada, Sweden, and Australia, as well as the United States, allow the combination of deductions and credits to exceed actual cost. Germany, Japan, and Sweden provide for tax-deductible provisions to certain investment reserves.

The Canadian "pooled-account" system is of special interest because of its simplicity and high acceptance there. This system has several characteristics that could help simplify the U.S. tax code. Its basic attribute is that all property of the same kind is placed in the same pool (class account), regardless of the year it was acquired, which eliminates the need for vintage accounts. Rates are assigned to the various classes, and depreciation is determined by application of those rates on a declining-balance basis. Appendix A contains a more detailed description of the Canadian cost recovery system. Appendix B consists of brief descriptions of the cost recovery systems of some other major industrial countries.
Policy Factors in the Capital Cost Recovery Debate

The Need for Investment Incentives

In section 1 we outlined the need for increased investment to improve productivity. Enhanced and accelerated capital cost recovery is widely cited as the most cost-effective means of spurring such growth; indeed, many of our nation's competitors have rejected the concept of useful lives and have chosen to provide rapid cost recovery of investment.

The Impact of Inflation

In section 1 we also noted that in a period of rising inflation businesses are unable to recover through depreciation sufficient funds to replace the assets being depreciated. In this way, inflation tends to cause the overstatement of profits. Taxation of these illusory profits and the higher replacement costs of capital goods limit the ability of businesses to generate internally the funds needed for capital outlays and replacement of inventories.

Simplification Considerations

Another important policy consideration, although unrelated to the macroeconomic issues of inflation and productivity, is tax simplification. Treasury Secretary Miller, testifying before the Sen-
ate Finance Committee on the proposed Capital Cost Recovery Act, noted that the present tax depreciation system is cumbersome, is complex, and needs simplification.

Adoption of a simpler cost recovery system could make the tax system markedly easier to understand and use. Many of the complexities in our present system are due to the concept of "useful life." Elimination of this, and other such complicating factors as salvage value, additional first-year depreciation, the placed-in-service rule, and the multiplicity of detailed methods of depreciation would greatly benefit our tax system. Repeal of the complex ADR system would obviate the need to understand such terms of art as "composite account" and "repair allowance property."

Simplification would benefit all businesses but particularly small businesses, because it would eliminate the need to make numerous choices. With certainty built into the system, time and resources could be devoted to more productive endeavors. With few decisions to make, taxpayers would need only to make some comparatively simple calculations. Compliance would be enhanced because of simplicity and certainty of application. The IRS would benefit, because the need for review of complex calculations would be eliminated. Further, there would be no more expensive and time-consuming arguments over useful lives determined by facts and circumstances.

Particular Concerns of Small Business

Each of the factors previously mentioned affects large businesses just as it affects small ones. However, the problems of capital recovery are probably more intense for small businesses than large ones.

All businesses obtain capital either through external financing or through internal capital generation and retention. But large businesses have easier access to external capital markets, while small businesses must depend more upon their own resources.

Also, a large business can probably afford expensive tax advice and depreciation studies—in fact, the cost of these may not be significant in relation to the tax benefits derived. This is not true for small businesses. Thus the complexity of the present law is much more a problem for small businesses than for large ones and is one of the major reasons that so few small businesses have elected to use the ADR system. It is significant that many small businesses use the
ADR class lives to determine the estimated lives of their depreciable assets, without electing to use the ADR system itself, and that these lives are generally accepted by the IRS. However, the burden of proving these lives remains on the taxpayer, who is subject to disallowance of his depreciation deductions at any time.
Proposals Currently Under Consideration

A number of alternative proposals that would change the U.S. capital cost recovery rules have been introduced in recent years. These range from completely new systems that are unrelated to useful lives to liberalization of the present ADR approach.

While modification of the present ADR system has been proposed by several leading members of Congress, including House Ways and Means Committee Chairman Al Ullman in 1979, little support for that concept has developed, and in our analysis of alternatives, this approach has not been considered. When measured against the criteria identified in section 4, a modified ADR system would in our view be less desirable than the alternatives being considered.

As indicated in the Introduction and in the section on importance of capital recovery, immediate expensing of capital investments would provide the best protection against the erosion caused by inflation. Further, this approach would greatly simplify record-keeping and reporting requirements and the tax accounting for such investments. This procedure would also neutralize tax factors in making return-on-investment calculations, which, in many cases, are critical to investment decisions.

In developing this policy statement, the AICPA Federal Taxation Division has concluded that current and foreseeable pressures for constraints in financing the federal budget preclude enactment of immediate expensing of capital assets now. While
depreciation can be viewed as merely a timing difference in the recovery of investment, the short-term tax revenue effects of immediate expensing would in our view be so large that, unfortunately, serious consideration of this proposal at present is not likely. Accordingly, in this study we have looked only at proposals that seem likely to receive serious consideration by Congress in the near future.

**Capital Cost Recovery System**
(H.R. 4646 and S. 1435)

A description of the Capital Cost Recovery Act of 1979 (CCRA) is included in Appendix C. The following sections will point out factors that we believe are significant in analysis and evaluation of the proposal commonly known as “10–5–3.”

The economic stimulus of CCRA stems from the interplay of accelerated methods and shortened recovery periods that are intentionally unrelated to useful lives. The percentage allowances proposed, reflecting both the 10–5–3 periods and accelerated techniques, are summarized in figure 6, below.

**Figure 6**

**Capital Cost Recovery Table**

<table>
<thead>
<tr>
<th>Year Held</th>
<th>Investment Classes</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10 10</td>
<td>20 20</td>
<td>33 33</td>
</tr>
<tr>
<td>2</td>
<td>18 28</td>
<td>32 52</td>
<td>45 78</td>
</tr>
<tr>
<td>3</td>
<td>16 44</td>
<td>24 76</td>
<td>22 100</td>
</tr>
<tr>
<td>4</td>
<td>14 58</td>
<td>16 92</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>12 70</td>
<td>8 100</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>10 80</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>8 88</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>6 94</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>4 98</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>2 100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

100 100 100
It is significant that 70 percent of the cost of buildings may be recovered in five years, and 76 percent of equipment expenditures may be expensed over three years. These are major increases over amounts currently deductible, particularly with regard to buildings (class I) and have provided the basis for criticism of CCRA's incentives as being too generous.

It should be noted, however, that the depreciation recapture features included in CCRA for buildings (class I) are more stringent than those under present law (section 1250). When buildings are held for relatively short periods of time, say five years, a taxpayer might actually suffer a tax detriment as compared with present law. This should tend to discourage short-term speculation in real estate, as well as creation of tax-shelter schemes designed to take advantage of the accelerated cost recovery available under CCRA.

CCRA's grant of a 10 percent investment credit for all machinery and equipment represents another major incentive to capital investment. Allowing a full 10 percent investment credit for class II assets (machinery and equipment) replaces current law, under which such assets qualify for credits of 3.33 percent or 6.66 percent if their lives are three to four or five to six years, respectively. Although less significant in the total picture, the 6 percent credit proposed for class III ($100,000 of autos and light trucks) may be compared to 3.3 percent now allowed for qualifying assets with a three-year life.

The more liberal rules proposed for investment credit recapture are summarized and compared with existing recapture provisions in figure 7, below.

**Figure 7**

**Investment Credit Recapture**

<table>
<thead>
<tr>
<th>Hold Less Than</th>
<th>I (10%)</th>
<th>II (10%)</th>
<th>1979 (7 yrs.)</th>
<th>III (6%)</th>
<th>1979 (3 yrs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>2 years</td>
<td>80</td>
<td>80</td>
<td>100</td>
<td>67</td>
<td>100</td>
</tr>
<tr>
<td>3</td>
<td>60</td>
<td>60</td>
<td>100</td>
<td>33</td>
<td>100</td>
</tr>
<tr>
<td>4</td>
<td>40</td>
<td>40</td>
<td>67</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>20</td>
<td>20</td>
<td>67</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>—</td>
<td>—</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>—</td>
<td>—</td>
<td>33</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

23
The basic 10–5–3 concepts are beneficial to needed capital formation. We believe that the combination of moving from the useful life concept to shortened recovery periods and granting broadened investment credits deserves maximum consideration, along with competing federal budget requirements. However, its components should be reassessed, with the treatment of various types of buildings (manufacturing, retail, office, hotel, and residential) determined by the extent to which they will lead to increased productivity.

CCRA would give the taxpayer the ability to deduct less than the full amount of depreciation allowable (together with carryover of the unclaimed portion). Although this provision initially appears novel, we foresee no serious administrative or computational problems. Some small businessmen may require instruction in the annual (vintage) account methodology and carryover computations, but we anticipate no significant difficulty with this.

Based on the policy criteria established earlier, we conclude that the principles embodied in CCRA would encourage investment in productive assets, partially offset the impact of inflation, and simplify both taxpayers' compliance and the Internal Revenue Service's administration in the area of capital cost recovery.

**Simplified Cost Recovery System (H.R. 7015)**

The simplified cost recovery system (SCR) included in the Tax Restructuring Act of 1980 (H.R. 7015) proposed by House Ways and Means Chairman Ullman includes provisions that would make substantial changes in our tax depreciation and investment credit rules. A description of these changes is included in Appendix D. In discussing these provisions, it should be kept in mind that Chairman Ullman proposed them as part of a major tax-restructuring effort and not as a separate legislative proposal.

The new system would generally be mandatory and would set up four asset classes for tangible personal property, to be recovered over three-, six-, nine-, or twelve-year periods. Taxpayers would have an annual election to use 200 percent, 150 percent, or 100 percent of the normal recovery period rate. Depreciable real estate would fall into three classes, with fifteen-, twenty-five-, and thirty-year recovery periods. A pooled-asset accounting system, some-
what like those followed in Canada and recommended as part of the AICPA small business proposals, would be used for tangible personal property, and a declining-balance write-off approach would be followed. Real estate depreciation would continue under present methods but would use the revised lives indicated previously.

By adopting the pooled-account concept, SCR offers a great deal of simplicity in operation. Not only are the accounting procedures relatively easy to understand and apply, but the handling of dispositions of property is greatly simplified. Of all the alternatives considered, this approach would be the simplest in operation.

The specific cost recovery periods selected for tangible personal property (three, six, nine, or twelve years) and the fifteen-to-thirty-year lives for depreciable real estate do not provide as much incentive for investment, or as much hedge against inflation, as the Capital Cost Recovery Act. This is caused both by assigning longer lives to assets and by the declining-balance recovery system, which would not permit full cost recovery until all assets in a given account are eventually retired.

By providing four classes for tangible personal property, rather than two under CCRA, SCR does retain closer relationships with existing depreciation lives. This could result in less disruption in the investment patterns that now exist for these types of assets. However, both SCR and CCRA represent major departures from the useful-life concept for tax depreciation.

**Indexation**

The concept of indexing financial measurements is based on the premise that statements of economic activity are meaningful only if the measurements that go into those statements are based on a standard unit of value. In the United States, virtually all financial measurements are expressed in dollars. Unfortunately, in recent years, the dollar has not been a stable unit of measure. Our rate of inflation exceeded 13 percent in 1979 and is predicted to exceed 12 percent again in 1980. Under these circumstances, traditional income measurements used as a basis for taxation may be distorted seriously in periods of rapidly changing prices.

Taxable income may be defined simply as the difference between gross income and deductions. Although most of the components of gross income are based on transactions completed during
the current tax year, many income tax deductions reflect expenditures made in earlier years. For example, the deductions for the cost of goods sold and for depreciation are usually based, at least in part, upon costs incurred several years earlier. During periods of rapid inflation, deductions for earlier (historical) costs tend to be understated in relation to current costs; consequently, "real" income is generally overstated.

Depreciation and the cost of goods sold are not, however, the only understated deductions. Personal and dependent exemptions, zero-bracket amounts, and even the basic tax brackets are quickly distorted by inflation. Deductions and tax brackets that seemed reasonable only a few years ago soon become inadequate with rapid inflation.

Indexation is an attempt to arithmetically adjust historical income and deduction measurements to current dollars. Complete indexation would adjust every element of revenue and expense; partial indexation would adjust only selected components. Proponents of partial indexation often support an adjustment of depreciation. During periods of inflation, indexation would result in larger depreciation deductions for most businesses and would, therefore, serve to stimulate capital investment in much the same way as either 10-5-3 cost recovery or the SCR system.

Because complete indexation involves an across-the-board adjustment of all items, economic models generally predict that it would have less impact on capital formation than would partial indexation. This is because partial indexation is usually recommended most strongly for those deductions that tend to result in an increased aggregate investment. Total indexation would more likely stimulate a greater degree of consumption spending than partial. Increased amounts of investment have a multiplier effect on economic activity, unlike equivalent increases in consumption.

Of the various capital cost recovery alternatives considered in this paper, indexation addresses the problem of inflation most directly and completely. And because indexation would generally allow greater deductions than the present system does, it also would act to stimulate capital investment. In regard to the objective of simplification of the tax law, it must be admitted that indexation would be a complicating rather than a simplifying measure. However, we believe the complexity of indexation is usually overstated — sometimes greatly. Furthermore, there seems no logical reason
why indexation could not be adopted in conjunction with other provisions that would simplify the tax code.

The AICPA has issued Statement of Tax Policy 6, entitled *Indexation of the Tax Laws for Inflation*, in which the Institute supports the general concept of indexation to minimize the consequences of inflation. This support is for the "general concept" of indexation and does not preclude support of alternatives that might address economic issues other than inflation in a better way. Rather than discuss additional details concerning indexation, we urge all interested parties to review this statement, which includes both AICPA recommendations and a summary of the indexation rules currently being implemented in other countries.

**AICPA Small Business Proposals**

The small business taxation subcommittee of the AICPA Federal Taxation Division is publishing *Tax Recommendations to Aid Small Business*, which addresses both the need to stimulate capital formation in small businesses and the need for a simplified system of depreciation. For a detailed discussion of those proposals and other small business tax recommendations, we refer the reader to that publication; the portion that deals with depreciation is discussed in Appendix E.

The small business simplified depreciation proposals have a fundamental similarity to SCR in that they both utilize a pooling concept. They also have a number of similarities to CCRA. All three alternatives effectively eliminate the "allowed or allowable" concept and permit the taxpayer to vary the amount of depreciation taken in any year, depending on how much can actually be used. All three eliminate salvage values and apply to both new and used assets.

Probably the biggest difference between CCRA and SCR, and the small business proposal, is that CCRA and SCR would have a static revenue impact much larger than the small business proposal. This is because the small business proposal would apply to a limited ($500,000) amount of property, while CCRA and SCR would apply to all depreciable property (except for CCRA's $100,000 limit on class III). Also, CCRA and SCR are intended to provide a major economic stimulus and, for this reason, they allow statutory cost recovery periods unrelated to useful lives, which significantly accelerate the recovery of the capital cost of productive assets. On the other
hand, the purpose of the small business proposal is simplification, and therefore, it does not provide the broader general investment stimulus of CCRA or SCR.

Although it would provide simplification for most small businesses, an obvious result of the dollar limits of the small business proposals is that companies with depreciable assets greater than the limits will have to cope with two systems. This does not create simplification for them.

The AICPA small business proposal would neither encourage general investment nor offset the impact of inflation to the extent of the three alternatives discussed above, but that is not its intent. It has been offered as a feasible way for Congress to help encourage small business without major revenue loss.
Mathematical Comparison of Capital Cost Recovery Proposals

One commonly used method for comparing alternative cost recovery proposals is to discount at an assumed rate the future tax benefits from each proposal. Since our current high rate of inflation is a significant policy issue in the need for a faster cost recovery system, this factor should also be considered in any mathematical comparison of results under alternative approaches.

Appendix F provides calculations summarizing such results under four alternatives. They are (1) current investment tax credit and depreciation rules, including ADR where applicable, (2) current rules but indexing depreciation by the assumed rate of inflation, (3) SCR, which is included in H.R. 7015, and (4) the CCRA proposal.

Immediate expensing of capital expenditures has not been included in this analysis for the reasons discussed earlier. Had such a proposal been included, the results would have been simple to present. The tax benefit from an immediate write-off, assuming a 46 percent tax rate, would be 46 percent of the investment, increased by any investment tax credit that Congress decided to retain in conjunction with immediate expensing of investments.

These calculations have been made at three assumed rates of inflation — 6 percent, 10 percent, and 14 percent — with discount factors three percentage points above the inflation rates. The results
have been developed for several different classes of assets, with varying lives, to show the impact of inflation on longer lived assets and the potential distortion in investment decisions between long- and short-lived assets.

The calculations assume a 3 percent differential between the discount factor (used to determine the present value of the stream of tax benefits) and the inflation rate (used in computation of depreciation adjusted by indexation). Although the relationship between the "cost of money" (which determines the discount factor) and the inflation rate varies from day to day, it is commonly believed that over longer periods of time, it averages out to be about 3 percent. This can be called the "real cost of money."

**Impacts on Various Asset Lives**

In reference to the data included in Appendix F, several interesting points emerge. One is the comparative impact of CCRA, SCR, and indexing on assets with different lives. Figures 8 and 9, based on an assumed rate of inflation of 10 percent, show this impact on four classes of assets in terms of the present value of the tax benefits derived, assuming a $10,000 investment in each class.

**Figure 8**

<table>
<thead>
<tr>
<th></th>
<th>Office Equipment (8 yrs.)</th>
<th>Heavy Machinery (10 yrs.)</th>
<th>Industrial Plant (20 yrs.)</th>
<th>Buildings (40 yrs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current rules</td>
<td>$4,386</td>
<td>$4,161</td>
<td>$3,339</td>
<td>$1,128</td>
</tr>
<tr>
<td>(including ADR</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>where applicable)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indexing</td>
<td>$5,278</td>
<td>$5,204</td>
<td>$4,863</td>
<td>$2,944</td>
</tr>
<tr>
<td>Percent increase</td>
<td>20%</td>
<td>25%</td>
<td>46%</td>
<td>161%</td>
</tr>
<tr>
<td>SCR</td>
<td>$4,564</td>
<td>$4,564</td>
<td>$3,745</td>
<td>$1,633</td>
</tr>
<tr>
<td>Percent increase</td>
<td>4%</td>
<td>10%</td>
<td>12%</td>
<td>45%</td>
</tr>
<tr>
<td>CCRA</td>
<td>$4,823</td>
<td>$4,823</td>
<td>$4,823</td>
<td>$3,198</td>
</tr>
<tr>
<td>Percent increase</td>
<td>10%</td>
<td>16%</td>
<td>44%</td>
<td>183%</td>
</tr>
</tbody>
</table>
Figure 9

Present Value of Tax Benefits Derived From $10,000 Investment Under Various Cost Recovery Schemes
(Assumes 10 Percent Annual Inflation Rate)

LEGEND
- CURRENT RULES
- CURRENT RULES WITH INDEXING
- ULLMAN SCR
- CAPITAL COST RECOVERY ACT
- X% INCREASE OVER CURRENT RULES

<table>
<thead>
<tr>
<th>TYPE OF ASSET (USEFUL LIFE)</th>
<th>CURRENT RULES</th>
<th>CURRENT RULES WITH INDEXING</th>
<th>ULLMAN SCR</th>
<th>CAPITAL COST RECOVERY ACT</th>
<th>X% INCREASE OVER CURRENT RULES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office Equipment (8 Years)</td>
<td>20%</td>
<td>7%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Heavy Machinery (10 Years)</td>
<td>25%</td>
<td>10%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial Plant (20 Years)</td>
<td>46%</td>
<td>12%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings (40 Years)</td>
<td>161%</td>
<td>45%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
As shown in figures 8 and 9, the increased benefits provided by CCRA, as compared to present law, range from 10 percent for office equipment with an eight-year life, to over 180 percent for a building with a forty-year life. It is significant that the actual dollar benefits from CCRA are the same for all types of equipment. This should eliminate the importance of differences in lives as a factor in investment decisions: whether to purchase a more sophisticated piece of machinery with the likelihood of a longer life, or a less efficient machine with a shorter life. This introduces an added element of neutrality in investment decisions.

A similar comparison of indexing with present law shows increased benefits for office equipment of 20 percent, and an increase for an industrial plant of 46 percent. The increased benefits for buildings from indexing and CCRA are 161 percent and 183 percent, respectively. These large increases are caused primarily by the long life now required for buildings and the tremendous erosion of benefits, under present law, resulting from inflation.

As indicated in the figures, SCR does provide increased benefits over present law, but the percentages are smaller than the other alternatives.

**Mitigating Inflation on Capital Cost Recovery**

A slightly different analysis demonstrates how CCRA, SCR, and indexing could mitigate the impact of inflation on capital cost recovery. Figures 10, 11, and 12 compare these results under present rules, both with and without indexing, and under SCR and CCRA. The present values of the benefits from depreciation of two classes of assets with differing lives are considered at three different rates of inflation.

As illustrated by figures 10, 11, and 12, for office equipment with an eight-year life, indexing provides a better answer than CCRA at all rates of inflation, with greater benefits at higher rates. Both systems provide an improvement over present rules. SCR also creates additional benefits, although not as great as the other two alternatives. For industrial plant with a longer useful life (twenty years), both indexing and CCRA offer significantly increased benefits, while those under SCR are considerably less.

The benefits provided by indexing would be gained only at the
Figure 10

<table>
<thead>
<tr>
<th>Assumed Inflation Rate</th>
<th>6%</th>
<th>10%</th>
<th>14%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Office Equipment (8 yrs.)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current rules</td>
<td>$4,684</td>
<td>$4,386</td>
<td>$4,135</td>
</tr>
<tr>
<td>Current rules with indexing</td>
<td>$5,267</td>
<td>$5,278</td>
<td>$5,289</td>
</tr>
<tr>
<td>Percent increase</td>
<td>12%</td>
<td>20%</td>
<td>28%</td>
</tr>
<tr>
<td>SCR</td>
<td>$4,782</td>
<td>$4,564</td>
<td>$4,304</td>
</tr>
<tr>
<td>Percent increase</td>
<td>2%</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>CCRA</td>
<td>$5,029</td>
<td>$4,823</td>
<td>$4,641</td>
</tr>
<tr>
<td>Percent increase</td>
<td>7%</td>
<td>10%</td>
<td>12%</td>
</tr>
<tr>
<td><strong>Industrial Plant (20 yrs.)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current rules</td>
<td>$3,774</td>
<td>$3,339</td>
<td>$3,021</td>
</tr>
<tr>
<td>Current rules with indexing</td>
<td>$4,839</td>
<td>$4,863</td>
<td>$4,885</td>
</tr>
<tr>
<td>Percent increase</td>
<td>28%</td>
<td>46%</td>
<td>62%</td>
</tr>
<tr>
<td>SCR</td>
<td>$4,105</td>
<td>$3,745</td>
<td>$3,467</td>
</tr>
<tr>
<td>Percent increase</td>
<td>9%</td>
<td>12%</td>
<td>15%</td>
</tr>
<tr>
<td>CCRA</td>
<td>$5,029</td>
<td>$4,823</td>
<td>$4,641</td>
</tr>
<tr>
<td>Percent increase</td>
<td>33%</td>
<td>44%</td>
<td>54%</td>
</tr>
</tbody>
</table>

cost of added complexity. Even though some of the existing complications of the ADR system could be reduced, new ones would be introduced by the indexing procedures. Furthermore, significant policy issues and problems could arise from the disposition of assets when total depreciation allowances under an indexing approach exceed the original cost of an asset. These factors are of special importance to small business entities and indicate why such entities might be more attracted to CCRA or SCR than to indexing.
Figure 11

Present Value of Tax Benefits Derived From $10,000 Investment Under Various Cost Recovery Schemes at Assumed Rates of Inflation
(Office Equipment — 8-Year Life)
Figure 12

Present Value of Tax Benefits Derived From $10,000 Investment Under Various Cost Recovery Schemes at Assumed Rates of Inflation
(Industrial Plant — 20-Year Life)
Conclusion

In previous sections of this paper, we reviewed the principal characteristics of the major approaches to increased capital cost recovery that are currently being considered: the Capital Cost Recovery Act (CCRA), the simplified cost recovery system in the Tax Restructuring Act of 1980 (SCR), and indexation. As indicated earlier, immediate expensing of capital investments would provide the best protection against inflation and the greatest simplification. However, due to its large immediate effect on tax revenues, immediate expensing is probably not politically feasible. An expanded ADR system, which has also been proposed, would in all respects be less attractive than the alternatives already mentioned.

In attempting to evaluate these proposals, the policy factors discussed in section 4 seem most relevant. In brief, these factors are creation of investment incentives, mitigation of the impact of inflation, simplification for both taxpayers and the Internal Revenue Service, and concerns of small business entities. In evaluating the investment incentive factor, it seems particularly important to consider the need to stimulate investment in machinery, equipment, structures, and other assets that would help improve productivity.

We have concluded that of the alternative approaches, CCRA and SCR are the most attractive. Both should create a significant incentive for investment in assets, which would assist U.S. business in improving productivity; both provide partial relief from the impact of inflation; and both are relatively simple in operation. By depart-
ing from the useful-life concept, and adopting cost recovery periods specified by statute, a great deal of simplification will have been achieved for both large and small businesses. As discussed earlier, the kinds of record-keeping and calculation procedures required of taxpayers would be greatly simplified, and much more certainty would be introduced into cost recovery for tax purposes, thereby almost entirely eliminating differences of opinion between taxpayers and examining agents.

Between CCRA and SCR, CCRA generally provides a greater investment incentive, while SCR provides greater simplification. This makes a choice between the two difficult. We consider the necessity for an investment incentive in the form of liberalized depreciation allowances to be self-evident. The advantages of a pooled-account approach, such as is suggested in SCR, include avoidance of the need to maintain vintage accounts, simplicity in accounting for retirements, lessening of the adverse effects of depreciation recapture when assets are sold, and understandability by persons who are not expert in tax and accounting concepts. A similar system was adopted in Canada a number of years ago, and it has achieved a high degree of acceptance by taxpayers, practitioners, and administrators.

In our view, the optimum solution would be to adopt the mechanics of the SCR system but to modify the recovery approach so that, at least for tangible personal property, the tax benefits from depreciation would approach those under CCRA. Among the modifications that might be considered are allowing additional flexibility and expanding the elective percentage each year to a range of, say, 0% to 300%; adopting a full-year, rather than a half-year, convention for assets acquired; and shortening the recovery periods.

With respect to CCRA, we recognize that not all class I assets, as presently defined, would have the same effect on productivity. Consequently, we recommend a modification of the class I category in order to concentrate the tax benefits on those types of structures most likely to result in productivity gains.

Of the alternatives considered, indexing cost recovery allowances would provide the best hedge against inflation. It would also provide significant incentives to invest. However, it would create additional complexity through the indexing techniques and procedures. Furthermore, the present depreciation systems, such as ADR, would likely be continued with many of their inherent complications.
It should be noted that indexing techniques could be combined with other cost recovery proposals, including CCRA or SCR. If Congress used indexation to eliminate the impact of inflation, it could then focus separately on the amount of investment incentive considered appropriate and incorporate that incentive into whatever cost recovery system it chose. This approach would, however, introduce added complexity into the cost recovery determinations, and would therefore make it less attractive to smaller businesses.
Canadian Cost Recovery System

Most tangible property, other than land, acquired for the purpose of earning income is depreciable for tax purposes. So is intangible property of a fixed duration such as rights, franchises, and licenses. In addition, one-half of the cost of goodwill and certain other intangible property may be amortized for tax purposes.

The Canadian system of capital cost allowances (depreciation allowed for tax purposes) operates in general on a pooled-account basis with separate classes provided for various types of property. Rates are assigned to the various classes, and annual allowances are determined, in most cases, on the “diminishing balance” basis. Capital cost allowances can be claimed on assets acquired but not put into use, and a full year’s allowance may be claimed in the year of acquisition.

The cost of individual assets is added to the appropriate pool in the year the assets are acquired. When a depreciable asset is sold, the lesser of the net proceeds from disposition or the original cost is deducted from the balance in the pool. Any excess of proceeds over cost ordinarily will be a capital gain, one-half of which is included in income.

Where the maximum allowance is determined on the diminishing balance basis, the prescribed rate of capital cost allowance is then applied to the balance in the pool at the end of the tax year to determine the annual deduction. The balance (undepreciated capital cost) left in each pool at the end of the year, after deducting the current year’s allowance, becomes the opening balance for that pool in the ensuing year.

The Canadian system does not follow the “allowed or allowable” concept; that is, a taxpayer may claim any amount from zero up to the maximum allowed in respect of each pool. Any unclaimed amount remains in the undepreciated balance, available to the taxpayer in subsequent years, but is subject generally to annual limits.

Examples of depreciation rates permitted on common types of property and a sample calculation are presented on the following page.

Source
**Type of Asset**

<table>
<thead>
<tr>
<th>Buildings and structures</th>
<th>5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property not otherwise provided for (mainly machinery and equipment)</td>
<td>20%</td>
</tr>
<tr>
<td>Automotive equipment</td>
<td>30%</td>
</tr>
<tr>
<td>Machinery and equipment for Canadian manufacturing and processing operations</td>
<td>Special two-year write-off</td>
</tr>
</tbody>
</table>

**Depreciation Allowance Calculation**

<table>
<thead>
<tr>
<th>Class 8 — 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
</tr>
<tr>
<td>1980</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Class 29 — Special Two-year Write-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
</tr>
<tr>
<td>$50,000</td>
</tr>
<tr>
<td>$30,000</td>
</tr>
<tr>
<td>$50,000</td>
</tr>
<tr>
<td>$50,000</td>
</tr>
<tr>
<td>$15,000</td>
</tr>
<tr>
<td>$15,000</td>
</tr>
<tr>
<td>$15,000</td>
</tr>
</tbody>
</table>

Provision is made for the recapture of depreciation where the amount to be deducted from the pool (on disposition of assets) exceeds the balance in the pool. Such excess must be added to the taxpayer’s income and is subject to tax at ordinary rates. Should the only or last property in a particular class be sold for less than the balance in the pool, the remaining amount may be claimed as a deduction (terminal loss) in the year in which the prop-
erty is sold. Where there is at least one property left, any balance after de-
ducting all sale proceeds is written off at the applicable annual rate regard-
less of whether the balance actually relates to the particular property on
hand.

The amount of capital cost allowance that may be claimed on rental or
leasing property is restricted. Generally, a taxpayer may not claim capital
cost allowance if the claim will create a loss for tax purposes that may be
deducted against income from other sources. However, exceptions to these
rules are provided in certain circumstances.

Each building acquired by a taxpayer after 1971 and costing $50,000 or
more must be included in a separate pool if the building was acquired prin-
cipally to earn rental income. This measure is intended to prevent tax-
payers from unduly postponing tax in respect of recaptured depreciation.

An investment tax credit of 5 percent (or 7-1/2 percent or 10 percent
depending on the region of Canada in which it is used) of the cost of certain
new buildings, machinery, and equipment acquired between June 24,
1975, and June 30, 1980, to be used in manufacturing and processing and
other specified activities may be applied against federal income tax. The
credit reduces capital cost for tax depreciation purposes.
Incentives and Cost Recovery Approaches Followed by Other Major Industrial Countries

Australia

Australia allows a grant of 60 percent (in certain circumstances 85 percent) of expenditures on machinery and equipment related to development. These grants are limited to $A125,000 per annum.

Depreciation in Australia is based on an estimate of ‘‘effective life,’’ and taxpayers may elect to use either the prime-cost (straight-line) method or the 150 percent diminishing-value (declining-balance) method. In addition, a 40 percent investment allowance for new property may be deducted from the tax base in the year that the property is ready for use. This investment allowance does not affect the undepreciated balance. The allowance is reduced to 20 percent for assets acquired pursuant to a contract entered into after June 30, 1978, or placed in service after June 30, 1979 (regardless of the date of the contract).

Belgium

Tax advantages are granted for investments relating to real estate. The investment must contribute directly to the establishment, extension, conversion, or modernization of an enterprise and be in the general economic interest of the country. Complete exemption from certain taxes on land, plant, and equipment is granted for a maximum period of five years following the occupation of the premises.

Regional aid is available for investments made in certain areas that contribute directly to setup, development, adaptation, or modernization of industrial or handicraft enterprises, public services, commercial services, enterprises rendering tourism management and organization, engineering, and research and development. Regional aid will be granted only for investments that contribute to the creation of new activities and employment.

Source
In special areas, annual depreciation equal to twice normal straight-line depreciation may be authorized for a maximum of three consecutive tax periods. This provision relates to investment in equipment, tools, and industrial buildings that are acquired for the promoted operation.

Depreciation rates are based on the estimated effective lives of assets and must be approved by the tax department. Depreciation is normally straight line over useful life. Gains on the sales of fixed assets are taxable as ordinary income, except when held for more than five years (reduced basic rate of 24 percent).

As a temporary measure to promote investments, a one-time special deduction of 15 percent is allowed on certain acquisitions of fixed assets made during 1979 and 1980. The special deduction will be allowed to the extent that 1979 or 1980 investments in fixed assets exceed the average annual investments for the years 1974 to 1975. The 15 percent deduction is only applicable to a maximum of 40 percent of the total new investments.

**France**

The government offers a comprehensive program of tax incentives and development subsidies to encourage foreign investors to establish or expand industrial, commercial, and headquarters activities in France.

While the straight-line method is generally required for buildings and automobiles, the declining-balance method is allowed for new machinery and equipment and other qualifying assets having a useful life of three or more years. All rates depend on service life, which may be reduced for multiple-shift operations.

Special accelerated depreciation of up to 50 percent of the cost of buildings used for scientific or technological research and up to 25 percent for buildings used for industrial or commercial purposes in underdeveloped regions may be allowed.

**Germany**

Incentives include the possibility of setting up tax-deductible reserves. The relief provided by these reserves is generally temporary and has to be reversed and restored to taxable income after certain periods of time have elapsed. In addition, tax sparing is recognized on certain income from developing countries.

Depreciation is normally calculated on either the straight-line or declining-balance method over the anticipated useful life. Apart from buildings for which building permission was filed before May 9, 1973, the declining-balance method may only be used at present for movable fixed assets, and the annual rate may not exceed twice the rate that would have applied under the straight-line method (not more than 20 percent). The residual (salvage) value of the asset need be taken into account only when it is material; gains on a sale are treated as normal business income.
In addition to normal depreciation, special depreciation is deductible for tax purposes on certain assets, such as new merchant ships or aircraft registered in Germany, fixed assets of businesses in areas bordering Eastern Europe, and water or air purification equipment. Tax depreciation must conform to book depreciation. Apart from depreciation on straight-line and declining-balance bases, other depreciation methods are allowed, including depreciation based on output.

**Italy**

In order to attract new industrial enterprises to certain depressed regions, nontax incentives take the form of low-interest loans and outright grants toward capital investments. These benefits are available for all qualifying investors, foreign or Italian.

Rates of depreciation of fixed assets are determined in accordance with a ministerial decree. Depreciation is deductible on a straight-line basis, starting from the first tax period in which the asset was or could have been used. Newly formed companies may defer depreciation until the first year in which there are sales. The depreciation claimed in the tax return may not exceed that shown in the income statement for financial reporting. Depreciation and amortization are calculated on the cost of the asset without deduction of any investment grants.

Any gain arising on the sale of depreciated assets is taxable as normal income, but the taxation may be deferred under certain circumstances.

**Japan**

A Japanese corporation that makes a qualified investment in a designated country may establish a tax-deductible reserve up to 30 percent to 100 percent of the invested amount. The reserve must be restored to income between the sixth and the tenth year after a five-year grace period.

Depreciation of tangible fixed assets is computed by use of either the straight-line or declining-balance method at the election of the taxpayer. The declining-balance method does not apply to intangible fixed assets. The law provides useful lives for various categories of fixed assets and rates of annual depreciation for both straight-line and declining-balance methods. Special accelerated depreciation, in addition to normal depreciation, may be allowed in the year of acquisition, depending upon the industry and type of asset. Tax depreciation is required to conform to book depreciation.

**Netherlands**

Depreciation may be computed on a straight-line or "reducing-balance" method, or in accordance with any other sound commercial basis. Depreciation is applied from the date that the asset comes into use.
Specific depreciation rates are not prescribed by law.

Accelerated depreciation of fixed assets is permitted. However, in the case of certain buildings, the allowance must be taken over two or more years.

A 7 percent premium for new investments in fixed assets is given in the form of an investment tax credit. If the total of the credits exceeds the tax liability, the excess of the premium over the tax liability is payable in cash to the taxpayer.

In addition, bonus premiums from 0.25 to 6 percent for small investments up to Dfl800,000 ($400,000) are available.

**Sweden**

Sweden allows an additional 25 percent depreciation allowance in the year of addition. This allowance, which does not affect the basis of the asset for depreciation purposes, is deductible for state corporation income tax purposes but not for municipal corporation income tax purposes. The result is an effective additional allowance of 18.2 percent.

Of a Swedish corporation's taxable income, 40 percent may be allocated to a reserve for future investment in fixed assets. Where acquisitions are deemed to have been made from this reserve, full cost recovery occurs before the investment is made.

Depreciation and depletion on other assets is available at rates varying from immediate full write-off for assets having an expected life of not more than three years to 1.5 percent per year on some buildings. Certain limitations are provided based on book values.

**United Kingdom**

The United Kingdom provides grants of 20 percent and 22 percent of capital expenditure on plant and machinery as an incentive to the development of certain geographic areas. These grants do not reduce the tax depreciation base. Other incentives are also available in development areas.

In general, the United Kingdom allows 100 percent first-year depreciation allowances on machinery and equipment (50 percent on industrial buildings).

The alternative to immediate write-off of machinery and equipment is zero depreciation in the first year and 25 percent on the declining balance thereafter. Varying rates for depreciation of other assets (tangible and intangible) and for depletion of natural resource properties are provided. Depreciation allowances are generally recaptured on disposal.
Description of the Provisions of the
Capital Cost Recovery Act of 1979
(H.R. 4646 and S. 1435)

Classes of Capital Investment Eligible for Cost Recovery

Assets would be classified into one of three groups, each having a different cost recovery period. Assets in class I, generally applicable to buildings and structural components, ultimately would be eligible for a ten-year recovery period. Class II assets, consisting primarily of machinery and equipment, would be recovered over a five-year period. Class III would apply to certain short-lived assets, such as automobiles and light-duty trucks, and costs would be recovered over a three-year period. There would be an annual limitation of $100,000 on the amount of investment qualifying under class III. The new system would not be applicable to investment in intangible assets, residential rental property, or land.

Capital Cost Recovery Allowance

The cost recovery allowance in any given year would be determined by applying the appropriate percentage to the amount of asset investment falling in each class. In determining the appropriate recovery percentages, accelerated principles and the so-called half-year convention would be followed. This convention would allow one-half-year's recovery for assets acquired during a particular year, regardless of the time during the year when they were actually acquired. The figure opposite shows the recovery percentage that would be allowable each year for the three classes of assets. These percentages would apply only when the new cost recovery system is fully implemented. For class I and class II assets, the system would be phased in over five years. Class III would be effective immediately.

System Not Elective

The proposed capital cost recovery system is generally not elective. It would apply to investments made on or after the effective date of the new rules and would replace both the present asset depreciation range (ADR) and “facts-and-circumstances” depreciation approaches. Certain other
methods, such as the unit-of-production and retirement-replacement-betterment methods, would continue to be permitted. Investment in public utility property would be eligible for the new system only if a taxpayer uses a normalization method of accounting.

<table>
<thead>
<tr>
<th>Ownership</th>
<th>Class of Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>I</td>
</tr>
<tr>
<td>1</td>
<td>10%</td>
</tr>
<tr>
<td>2</td>
<td>18%</td>
</tr>
<tr>
<td>3</td>
<td>16%</td>
</tr>
<tr>
<td>4</td>
<td>14%</td>
</tr>
<tr>
<td>5</td>
<td>12%</td>
</tr>
<tr>
<td>6</td>
<td>10%</td>
</tr>
<tr>
<td>7</td>
<td>8%</td>
</tr>
<tr>
<td>8</td>
<td>6%</td>
</tr>
<tr>
<td>9</td>
<td>4%</td>
</tr>
<tr>
<td>10</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

**Election to Deduct Less Than the Full CCR Allowance**

A taxpayer could choose to deduct all or a portion of the capital cost recovery (CCR) allowance for any given year. Any unused portion of the allowance could be carried forward and deducted in future years. This would permit flexibility for companies in loss positions or those with widely fluctuating income.

**Recapture on Disposition or Retirement**

The proposed system provides for "ordinary income" treatment of gain realized on disposition or retirement of assets eligible for the system, to the extent of prior CCR allowances.

**Used Property Would Be Eligible**

The distinction between investment in new and used property would be eliminated under the Capital Cost Recovery Act (CCRA) system. For investment tax credit purposes, however, the present $100,000 limitation would remain.

**Placed-in-Service Rule Would Be Dropped**

An investment would qualify for the CCRA system at whichever of the following is earlier: the date the taxpayer pays for the property or the date on which it is placed in service.
Salvage Value Would Be Eliminated

In determining the amount of capital investment eligible for recovery under the new system, salvage value would be ignored. The full amount of the investment may be recovered under the applicable cost recovery table.

Investment Tax Credit Rules

A full 10 percent investment tax credit would be allowed for investment in both class I and class II assets to the extent that such investment presently qualifies for investment credit treatment. A 6 percent credit would be allowed for investment in class III properties. Investment credit would be recaptured at the rate of two percentage points per year if assets are not held for five years for classes I and II, or three years for class III. For example, a class II asset would be permitted a 10 percent investment credit in the year acquired but, if disposed of at the end of three years, would require recapture of 4 percent.

Preference Considerations

For noncorporate taxpayers, the accelerated-method portion of the CCR allowance attributable to class II and III assets would be treated as a tax preference item. The preference amount would be determined by comparing the CCR allowance with the amount that would have been allowed straight-line recovery percentages and CCR lives.

Transition Approach

Because of the substantial amounts of tax revenues involved in this new approach, the proposed system would be phased in over a period of five years. For example, the cost of assets qualifying under class I would be recovered over an eighteen-year life if acquired during the first year of application of the new system. For assets acquired in the second year, a sixteen-year period would be used; for the third year, a fourteen-year life would apply, and so forth, so that after five years, the ten-year period applicable to class I assets would be fully effective. A similar phase-in would be adopted for class II assets commencing with a nine-year period, with an earlier transition for assets with present ADR lives of less than nine years.
APPENDIX D


A major part of the Tax Restructuring Act of 1980, introduced on April 2 by House Ways and Means Committee Chairman Al Ullman, is a proposal for a new simplified cost recovery system (SCR) for U.S. tax purposes. Its key features include a departure from useful lives and the use of a pooled-account approach for tangible personal property. As proposed, SCR does not offer as great an investment incentive as CCRA, but it would tend to offset the effects of inflation and to stimulate investment as well as provide considerable simplification. Following are some of the features of the Ullman cost recovery proposal.

Simplified Cost Recovery for Tangible Personal Property

With limited exceptions, the cost of all depreciable tangible personal property would be classified into one of four recovery accounts with recovery periods of three, six, nine, or twelve years. Excluded from the system would be public utility property, property subject to special amortization, certain leased property, and property depreciable under some basis other than the passage of time (for example, unit of production).

The Secretary of the Treasury would be required to assign assets to a recovery category that is at least 35 percent shorter than the current midpoint useful life under the ADR system.

Pooled-Asset Accounts. The cost of all assets of a designated class would be placed in an account for that class and, at the end of each year, a specified percentage would be applied to the ending balance in the account to determine the cost recovery allowance for the year. In this regard, the appropriate percentage could be elected by the taxpayer each year at 100 percent, 150 percent, or 200 percent of the equivalent straight-line rate. The proceeds of asset retirements would be credited to the account, and gain or loss from such retirements would, in effect, be deferred so long as other assets remain in the account. The amount of the cost recovery allowance each
year is subtracted from the account to determine the balance at the beginning of the following year.

The so-called half-year convention would be used so that only one-half of the cost of assets acquired during a given year would be charged into an account for determining the annual allowance. The remaining one-half would be treated as an addition in the following year.

Declining-Balance Approach. The mechanics of the SCR system are quite similar to the declining-balance method presently permitted for U.S. tax purposes except that taxpayers would not have the option of changing to a straight-line method in order to fully recover cost in a specified period of time. In other words, the percentage would apply to a declining balance each year, and so long as any assets remain in the account, the total cost will have been recovered.

Example of Recovery Allowances. The following table illustrates the maximum annual recovery allowances for assets in the three-, six-, nine-, or twelve-year classes. These allowances are based on an original asset cost of $10,000. The calculations have been carried through the appropriate term (three, six, nine, or twelve years), and the amount of cost unrecovered at the end of those periods is shown at the end of the table.

<table>
<thead>
<tr>
<th>Year</th>
<th>3 yr.</th>
<th>6 yr.</th>
<th>9 yr.</th>
<th>12 yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3333</td>
<td>1667</td>
<td>1111</td>
<td>833</td>
</tr>
<tr>
<td>2</td>
<td>4445</td>
<td>2778</td>
<td>1975</td>
<td>1528</td>
</tr>
<tr>
<td>3</td>
<td>1481</td>
<td>1852</td>
<td>1536</td>
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</tr>
<tr>
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<td>1234</td>
<td>1195</td>
<td>1061</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>823</td>
<td>930</td>
<td>884</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>549</td>
<td>723</td>
<td>737</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>562</td>
<td>614</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>437</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>340</td>
<td>426</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
<td>355</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td></td>
<td>296</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td></td>
<td>247</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total cost recovered</td>
<td>9259</td>
<td>8903</td>
<td>8809</td>
<td>8766</td>
</tr>
<tr>
<td>Cost remaining</td>
<td>741</td>
<td>1097</td>
<td>1191</td>
<td>1234</td>
</tr>
</tbody>
</table>

First-Year Depreciation Allowance. The first-year depreciation allowance under IRC sec. 179 would be continued and would apply to assets
with a recovery period of three years or more, rather than six years under present law.

*Effective Date.* The SCR system would apply to property placed in service in a taxable year beginning after December 31, 1980. Property placed in service prior to that time would be eligible for the new system at the taxpayer’s election in taxable years beginning after December 31, 1984.

**Depreciable Real Estate**

The bill would permit taxpayers to elect shorter “audit-proof” lives for depreciating buildings. Farm buildings would be eligible for a fifteen-year life, a twenty-five-year life would be permitted for buildings with a forty-five-year-or-less life under Rev. Proc. 62-21, and a thirty-year life would be permitted for assets with a life greater than forty-five years. If the taxpayer elects these shorter lives, component depreciation will not be available except where special amortization is provided. Once elected, these lives cannot be challenged by the Internal Revenue Service. These rules would apply to property placed in service in taxable years beginning after December 31, 1980.

The 150 percent declining-balance method would generally be available, and present depreciation recapture rules under IRC sec. 1250 would apply on dispositions of real estate.

**Public Utility Property**

For public utility property placed in service in years beginning after December 31, 1980, the present 20 percent variance from ADR lives is increased to 35 percent.

**Investment Credit Changes**

Presently qualified investment credit property with a useful life of six years or more under the new system would be eligible for the full 10 percent investment tax credit. For assets in the three-year category, a 6 percent investment credit would be permitted. Taxpayers would be given the option of electing a longer category for assets otherwise eligible for the three-year category in order to receive a higher investment tax credit.
Description of Depreciation Proposals
From the AICPA'S Tax Recommendations
to Aid Small Business

Recommendations

*Simplified depreciation for equipment.* A simplified ADR method should be allowed for a small business entity's (SBE) investment in new or used depreciable property (other than buildings) up to an aggregate year-end total adjusted basis (before current-year depreciation) of $500,000. This method should provide an open-end (multiple-year) multiple-asset account, with declining-balance method required, audit-proof class lives specified, and the salvage value estimate eliminated. The classes prescribed by the IRS for simplified depreciation should follow categories familiar to small businessmen, such as office equipment, motor vehicles, plant equipment, aircraft, and small tools.

*Simplified Depreciation for Buildings.* New or used buildings constructed or purchased by an SBE should be eligible for depreciation under the simplified system, within a separate $500,000 adjusted-basis ceiling, and the IRS should publish realistic audit-proof lives based upon broad categories of business-use buildings.

*Simplified Depreciation Accounting.* The first-year allowance under sec. 179 should not apply, a full-year's deduction should be allowed on all additions to the simplified account within the year, and no depreciation should be allowed on retirements during the year from a simplified account. The original cost of all assets retired (whether normal or abnormal, ordinary or extraordinary) should be eliminated from the simplified asset account and charged to the simplified reserve account at the original basis of the assets retired, and all retirement proceeds should be credited to the simplified reserve account.

*Simplified Depreciation Election.* Use of the simplified depreciation by an SBE should require an irrevocable election for equipment, buildings, or both, applicable to all property within the separate $500,000 ceilings for equipment and buildings. An electing SBE should reclassify all existing equipment and buildings as of the first day of its adoption year. Equipment
and building additions with costs in excess of the respective $500,000 adjusted-basis ceilings may be depreciated by the SBE under conventional, or a separately elected ADR, depreciation.

Flexible Deduction. The “allowed or allowable” rule should not apply to a simplified depreciation account; and the SBE should be allowed to record and deduct depreciation in any amount selected by the SBE for that year, up to the maximum permitted on the depreciation base (asset minus reserve), for the useful life involved, or no depreciation whatever, for that year.

Discussion

Most small business firms have not elected the ADR system, partly because of the complex regulations and requirement for estimated salvage amounts, but more importantly because of the requirement to maintain annual vintage accounts and other detailed records. In fact, some firms that reported under the depreciation guidelines system, inaugurated by Rev. Proc. 62-21, did not elect under ADR. The effect of the ADR complications is to discourage the use by a small firm of the audit-proof and shorter lives routinely utilized by the large public corporation, which utilizes the ADR system.

Provision should be made for a simplified system resembling the old depreciation guidelines, and providing open-end, multiyear, multiple-asset accounts for broad classes of depreciable property, such as office equipment, plant equipment, motor vehicles, and small tools. The unrecovered cost in these accounts (asset minus opening depreciation reserve) should be depreciated each year by use of an audit-proof IRS-published life, without salvage value, and with the declining-balance method.

Audit-proof lives should also be prescribed for broad classes of new or used buildings, such as repair shops, offices, factories, and warehouses, owned by an SBE. The IRS-prescribed lives for equipment should reflect the average of the lower-limit lives prescribed under the ADR system, and proportionately favorable lives should be published for buildings. Industry distinctions should be avoided. A maximum, “running,” year-end adjusted-basis ceiling of $500,000 (before current-year depreciation) should apply for all equipment, and the same amount for all buildings owned by an SBE.

The declining-balance method should be required for all assets (new or used) in a simplified depreciation account to prevent the exaggeration of the depreciation deduction available under an open-end, straight-line method account. Where only one building is held in the simplified depreciation account, an item depreciation computation will result.

All retirements from the simplified equipment account should be recorded by elimination of the original cost of the retired asset, both from
the asset and the reserve accounts, and crediting retirement proceeds, if any, to the reserve account. Depreciation recapture will not apply except to the extent the sale proceeds produce an excess balance in the depreciation reserve account.

A simplified convention should be allowed, to permit a full-year’s depreciation in the year of addition of an asset to a simplified account, with no depreciation in the year of retirement. Property added to a simplified depreciation account should be ineligible for the first-year depreciation allowance. The only detailed record required by an SBE that has elected simplified depreciation will be a listing at original cost of all assets on hand and composing the balance of the asset (control) account.

Separate-item or multiple-asset accounts must be established by the SBE for acquisitions of equipment or buildings that bring the cumulative investment, computed at adjusted basis, beyond the $500,000 ceilings for equipment and buildings. In some cases, the cost of a particular asset will be divided between the simplified account and the conventional account. The SBE frequently will acquire used assets, and the same method should apply to equipment and buildings, whether new or used. If the firm loses its SBE status in the future, depreciation should continue under the simplified depreciation system for existing assets. Any further additions must be depreciated under conventional or ADR methods.

In the event that retirements from the simplified asset account and depreciation provisions in the simplified reserve account bring the cumulative investment, at adjusted basis, below the $500,000 ceiling, assets or portions thereof being depreciated under conventional or ADR methods can be transferred to the simplified account up to such ceiling.

The flexible deduction procedure will be useful to an SBE that is sustaining operating losses and that may be unable to utilize its carryovers before their expiration. In addition, the flexible deduction may be attractive where the SBE anticipates higher income tax brackets in future years. The depreciation deduction must follow the SBE’s recording in the simplified depreciation amounts.

Illustration of Asset Classes and Lives

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Useful Life</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office equipment and furnishings</td>
<td>6 years</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>4 &quot;</td>
</tr>
<tr>
<td>Aircraft</td>
<td>5 &quot;</td>
</tr>
<tr>
<td>Shop and factory equipment</td>
<td>7 &quot;</td>
</tr>
<tr>
<td>Small tools</td>
<td>2 &quot;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Buildings</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Office</td>
<td>25 years</td>
</tr>
<tr>
<td>Warehouse</td>
<td>30 &quot;</td>
</tr>
<tr>
<td>Repair shop</td>
<td>20 &quot;</td>
</tr>
<tr>
<td>Factory</td>
<td>25 &quot;</td>
</tr>
<tr>
<td>Farm</td>
<td>20 &quot;</td>
</tr>
</tbody>
</table>
The office equipment life is taken generally from the present ADR lower limit for classes 00.11, 00.12, and 00.13. Vehicles are taken as the average of the lower limit for ADR classes 00.22, 00.23, and 00.24. Aircraft is taken from class 00.21.

Plant equipment reflects some incentive feature compared to typical class lives provided for various manufacturing industries. The farm building life is the same as class 01.3. No ADR classes or lives have been prescribed for other buildings. The lives shown are considered reasonable for the smaller buildings, which would be included in the simplified system.

A taxpayer who wishes to use a shorter ADR life can, of course, elect the ADR system.
APPENDIX F

Mathematical Comparison of Capital Cost Recovery Proposals

The sample assets and assumptions are as follows.

**Assets**

1. Vehicle — currently depreciated in three years — 200% declining balance with switch to sum-of-the-years-digits at optimum point. $10,000
2. Light machinery — currently depreciated in three years — 200% declining balance with switch to sum-of-the-years-digits at optimum point. 10,000
3. Heavy machinery — currently depreciated in ten years — 200% declining balance with switch to sum-of-the-years-digits at optimum point. 10,000
4. Industrial plant — currently depreciated in twenty years — 200% declining balance with switch to sum-of-the-years-digits at optimum point. 10,000
5. Office equipment — currently depreciated in eight years — 200% declining balance with switch to sum-of-the-years-digits at optimum point. 10,000
6. Building — currently depreciated in forty years — 150% declining balance with switch to straight-line at optimum point. 10,000

**Assumptions**

1. “Current ADR” assumes no change in the present tax laws. The asset lives given in the previous samples reflect the lower limit of the acceptable ADR range. The half-year averaging convention was used for all additions. Bonus depreciation has not been considered.
2. "ADR with Indexing" assumes the current law except that the depreciation calculated each year is increased to reflect inflation.

3. SCR is the simplified cost recovery system proposed in the Tax Restructuring Act of 1980 (H.R. 7015), and includes the following provisions.
   - The maximum write-off has been claimed: 200 percent of straight-line recovery (except for buildings where 150 percent of the straight-line rate has been used, with a switch to straight-line depreciation at the optimum time).
   - A 6 percent investment credit applies to the vehicle and light machinery, while a 10 percent credit is allowable for heavy machinery, industrial plant, and office equipment.
   - Because of the declining-balance feature of this system, in order to provide a reasonable comparison with other methods, it has been necessary to extend the calculations to a point in time beyond which the present value of the future tax benefits becomes nominal.

   - Vehicle depreciated over three years.
   - Light machinery, heavy machinery, utility plant, and office equipment depreciated over five years.
   - Building depreciated over ten years.
   - A 6 percent investment credit applies to the vehicle, while a 10 percent credit is allowable for light machinery, heavy machinery, industrial plant, and office equipment.

5. Calculations (page 60) have been made using a tax rate of 46 percent.
Capital Recovery Comparisons
Tax Benefit of Depreciation/Investment Tax Credit
Summary of Present Values

Discount Factor — 9%
Inflation Rate — 6%
Tax Rate — 46%

<table>
<thead>
<tr>
<th>Methods</th>
<th>Current ADR</th>
<th>ADR With Indexing</th>
<th>SCR (10–5–3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vehicle</td>
<td>$4,585</td>
<td>$4,815</td>
<td>$4,834</td>
</tr>
<tr>
<td>Light Machinery</td>
<td>4,585</td>
<td>4,815</td>
<td>4,834</td>
</tr>
<tr>
<td>Heavy Machinery</td>
<td>4,500</td>
<td>5,190</td>
<td>4,782</td>
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<tr>
<td>Industrial Plant</td>
<td>3,774</td>
<td>4,839</td>
<td>4,105</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>4,684</td>
<td>5,267</td>
<td>4,782</td>
</tr>
<tr>
<td>Building</td>
<td>1,488</td>
<td>2,901</td>
<td>2,065</td>
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</table>

Discount Factor — 13%
Inflation Rate — 10%
Tax Rate — 46%

<table>
<thead>
<tr>
<th>Methods</th>
<th>Current ADR</th>
<th>ADR With Indexing</th>
<th>SCR (10–5–3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vehicle</td>
<td>$4,453</td>
<td>$4,819</td>
<td>$4,700</td>
</tr>
<tr>
<td>Light Machinery</td>
<td>4,453</td>
<td>4,819</td>
<td>4,700</td>
</tr>
<tr>
<td>Heavy Machinery</td>
<td>4,161</td>
<td>5,204</td>
<td>4,564</td>
</tr>
<tr>
<td>Industrial Plant</td>
<td>3,339</td>
<td>4,863</td>
<td>3,745</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>4,386</td>
<td>5,278</td>
<td>4,564</td>
</tr>
<tr>
<td>Building</td>
<td>1,128</td>
<td>2,944</td>
<td>1,633</td>
</tr>
</tbody>
</table>

Discount Factor — 17%
Inflation Rate — 14%
Tax Rate — 46%

<table>
<thead>
<tr>
<th>Methods</th>
<th>Current ADR</th>
<th>ADR With Indexing</th>
<th>SCR (10–5–3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vehicle</td>
<td>$4,333</td>
<td>$4,823</td>
<td>$4,576</td>
</tr>
<tr>
<td>Light Machinery</td>
<td>4,333</td>
<td>4,823</td>
<td>4,576</td>
</tr>
<tr>
<td>Heavy Machinery</td>
<td>3,883</td>
<td>5,216</td>
<td>4,304</td>
</tr>
<tr>
<td>Industrial Plant</td>
<td>3,021</td>
<td>4,885</td>
<td>3,467</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>4,135</td>
<td>5,289</td>
<td>4,304</td>
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<tr>
<td>Building</td>
<td>916</td>
<td>2,985</td>
<td>1,353</td>
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</table>