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New IRS Depreciation Provisions Revenue Procedure 62-21

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On July 12, 1962 a long-time and controversial friend of tax accountants and taxpayers passed into history. Our old friend, "Bulletin F" was replaced by a new document entitled "Revenue Procedure 62-21."

During the next few years Revenue Procedure 62-21 will help taxpayers, accountants and tax agents to answer the vexing question, "What is a reasonable depreciation deduction?" Taxpayers have frequently complained that the Government has been too conservative and unrealistic in its viewpoint on guidelines of estimated useful lives of assets in determining depreciation deductions. Government agents, on the other hand, have claimed that, in many instances, taxpayers deducted unreasonable depreciation deductions and, upon disposition of the assets on which these deductions had been claimed, received unwarranted benefits because the sales of these assets resulted in substantial capital gains. Accountants, too, have been concerned because there were no guidelines or assurances that depreciation deductions they computed on returns would be accepted as shown. These widely diversified viewpoints have created one of the most troublesome areas in tax administration.

Because of technological changes in American industry and other factors directly affecting the lives of depreciable assets, the Treasury Department gave serious consideration to the revision of Bulletin F. However, as the project progressed it became clear that the revision of estimated useful lives of individual assets used in industry was not the most practical way to solve problems in the depreciation area. Some new means of measuring the reasonableness of depreciation deductions was needed.

The new Revenue Procedure introduces a revolutionary concept of depreciation deductions. It explains a new audit technique which will be used by tax agents to gauge the reasonableness of a taxpayer's depreciation deductions. Before proceeding to a discussion of the specific provisions outlined in the new Revenue Procedure, we should first note that it does not change the existing rules, outstanding arrangements, or established procedures concerning depreciation deductions. For example, it does not change the following:

1. The rules concerning who is entitled to claim a depreciation deduction.
2. The definition of depreciable property.
3. The computation of basis.
4. The methods of computing depreciation.
5. The requirements for computing salvage value.
6. The rules for computing depreciation on intangible assets.
7. The definition of useful life, although it liberalizes its application.

Further, the new document does not change depreciation procedures for those who wish to continue claiming depreciation deductions under current rules and regulations. This means that any taxpayer may justify his depreciation claim by outlining facts and circumstances which he believes support it.

At the same time that Revenue Procedure 62-21 became effective, Bulletin F became obsolete. Bulletin F can no longer be used as a guide by tax agents in examining tax returns. However, Revenue Procedure 62-21 applies only to tax returns due to be filed on or after July 12, 1962. It does not apply to tax returns on which extensions of time have previously been granted.

The new Revenue Procedure places emphasis upon a change in useful life guidelines. The guidelines for computing depreciation are no longer listed by individual assets but are listed for classes of depreciable assets. These are called guideline lives. For example, the useful lives as listed in Bulletin F for various types of office equipment ranged from 5 to 50 years. The new Revenue Procedure replaces this list of 46 categories with one guideline class called "Office Furniture, Fixtures, Machines and Equipment." The guideline life for the entire class is listed as 10 years. This means that if a taxpayer uses the suggested guideline life all office equipment, including assets such as desks, files, safes, typewriters, accounting, calculating and data processing machines, communications, duplicating and copying equipment, will have a class life of 10 years.

The new Revenue Procedure is divided into three parts:

1. Part I—Guidelines for Depreciation
2. Part II—Description of Procedures to be

followed in examining depreciation deductions, and

3. Part III—the Reserve Ratio Table and the Adjustment Table for class lives and instructions for their use.

PART I

Part I outlines the guideline lives which a taxpayer may use under certain circumstances. The guideline lives are divided into four groups:

1. Group 1 lists depreciable assets used by business in general. This group includes such items as office equipment, transportation equipment, land improvements, buildings, etc.
2. Group 2 describes class lives for non-manufacturing activities excluding transportation, communications and public utilities. Activities such as agriculture, fishing, mining, recreation and amusement are typical of Group 2.
3. Group 3 covers manufacturing industries. The aerospace industry, chemical manufacturing, fabricating of metal products, petroleum and natural gas industries are examples of this group.
4. Group 4 includes transportation, communications and public utilities. Guideline lives are described for air transportation, motor transportation, radio and television broadcasting, railroads, etc.

It is important to note that if a taxpayer elects to use the guideline lives in Part I of the new Revenue Procedure, the lives apply to all assets he owns in the particular guideline class. The taxpayer cannot carve out specific assets to depreciate separately.

The new guideline lives apply to all depreciable property of a taxpayer coming within each particular guideline class. This includes existing assets together with all subsequent additions.

In reviewing the guideline lives, you will note that the lives for machinery and equipment generally average 30 to 40 percent shorter than those previously suggested for use in Bulletin F. The guideline lives were approved on the assumption that Congress would pass legislation concerning the sale of personalty. Pending legislation would tax as ordinary income the gain on the sale of any personal property used in business to the extent of prior depreciation taken. In other words, if a taxpayer had claimed excessive depreciation on an asset used in business or for the production of income, the gain would be taxed as ordinary income upon enactment of the new legislation. The Government has proposed that this provision become effective for the taxable years ended after December 31, 1962.

Conversely, you will note that the guideline categories and estimated useful lives on real property have not been changed substantially from those shown in old Bulletin F. This position was based principally on the belief that the average lives for real property set forth in Bulletin F are reasonable and no changes or liberalization are necessary at this time. Another consideration, of course, was the fact that real property is not covered by the proposed legislation which would eliminate capital gains treatment or personal property to the extent of prior depreciation allowances. Therefore, no major adjustment was made to the useful lives on real property.

The new guidelines contain 75 broad classes of assets rather than a specifically detailed list as shown in Bulletin F. Generally, a single class life will cover all productive machinery and equipment in an industry. A single industry will probably require only three or four guideline classes for all of its business assets.

A taxpayer is permitted to use the guideline lives, or lives longer than the guideline lives initially, as a matter of right, and without question for three years. The guidelines will be accepted in the future unless there is an indication that the taxpayer's replacement practices do not conform to the depreciation claimed and are not even showing a trend in that direction.

The guideline lives are not considered to be minimums. If a taxpayer can show by facts and circumstances that shorter lives are warranted, he may use them.

Taxpayers are not required to initiate a new bookkeeping or accounting system to comply with the requirements. They may merely identify their assets according to the guideline classes. No actual rearrangement of records is required.

PART II

Part II of the new Revenue Procedure explains procedures to be followed in the audit of depreciation deductions. In other words, it outlines the audit technique to be followed by the tax agent. In addition, the procedure is designed to provide taxpayers with a greater degree of certainty in determining the amount of their depreciation deductions and to provide greater uniformity in the audit of these deductions by the Internal Revenue Service.

When depreciation claimed in an income tax return is examined under this procedure, the lives used by the taxpayer are compared with the guidelines set forth in Part I of the Revenue Procedure. The comparison of the class lives with the guideline lives will be

facilitated if the taxpayer's depreciation accounts correspond to the guideline classes. Any taxpayer depreciating his assets in item accounts or in multiple asset accounts which do not correspond to the guideline classes may regroup his assets for tax purposes into depreciation accounts corresponding to the guideline classes but he is not required to do so. Even though the taxpayer does not regroup his assets in accounts corresponding to the guideline classes, this Revenue Procedure may be applied by regrouping the assets annually solely for the purpose of this Revenue Procedure.

There are specific rules to be followed to compare the guideline life or any guideline class with the class life actually used. If the taxpayer actually depreciates assets in a depreciation account corresponding to a guideline class, the class life is the same as the life used by the taxpayer in computing the depreciation allowance. If the taxpayer depreciates assets in accounts which do not correspond to the guideline classes, the assets must first be regrouped into the guideline classes. The class life used by the taxpayer for each class must be determined by computing the weighted average of the lives used for the accounts coming within the guideline class. The weighted average is computed as follows: Compute the straight line depreciation based on the life used by the taxpayer with respect to each item account or multiple asset account coming within the guideline class. Divide the total depreciation so computed into the total basis of all the assets to obtain the class life. If salvage has been considered by the taxpayer, the class life is determined by dividing the straight line depreciation using the useful lives and salvage values considered by the taxpayer into the total basis of the assets without reduction for salvage value. Fully depreciated assets should be excluded from the total basis in the class life computation where item accounting is employed, but must be included where the composite method is used.

If the class life, as computed by the above formula, is equal to, or longer than, the prescribed guideline life, the depreciation deduction claimed by the taxpayer for the assets in that class will not be disturbed if the taxpayer's retirement and replacement practices for that class are consistent with the class life being used. The taxpayer may demonstrate this consistency either by facts and circumstances or by the reserve ratio test which will be discussed later. To give taxpayers an opportunity to adopt their retirement and replacement practices with class lives being used, the reserve ratio test will be considered to be met for the first three taxable years to which the Revenue Procedure applies. A class life equal to, or longer than, the guideline life will not be questioned for the first three years.

If the class life is shorter than the prescribed guideline life, the depreciation deduction claimed by the taxpayer for the assets in that class will not be disturbed under certain conditions. These are as follows:

1. If the class life is equal to, or longer than, the life used in the preceding year but shorter than the guideline life, the deduction will not be disturbed if the taxpayer has used approximately the same class life for a period of years equal to at least one-half the class life used in the taxable year under examination and the reserve ratio test is met. The taxpayer may also justify the class life by facts and circumstances.
2. If the class life used by the taxpayer is shorter than the guideline life and is also shorter than the class life used in the preceding taxable year, the depreciation deduction will not be disturbed if:
   (a) the class life is justified by the following factors:
      (1) The taxpayer's reserve ratio for the guideline class for the taxable year immediately preceding the year of examination was below the appropriate reserve ratio range.
      (2) The taxpayer has used approximately the same class life as the life used in the immediately preceding year for at least one-half of the class life used in the preceding year.
      (3) The shorter class life used in the year being examined is not shorter than that which can be justified by the adjustment table for class lives, or
   (b) the class life can be justified by other factors.
3. Where a class life used by a taxpayer is shorter than the guideline life and there were no assets in that class in the immediate preceding taxable year, the depreciation deduction claimed by the taxpayer will not be disturbed if the taxpayer can justify the life on the basis of all the facts and circumstances.
4. If the class life used by the taxpayer was examined by the Internal Revenue Service and accepted on audit, the depreciation deduction claimed by the taxpayer for the assets in that class in any later year will not be disturbed if the tax-

payer's retirement and replacement practices for that class are consistent with the class life being used. The document does not explain what is meant by a return "accepted on audit" so some further clarification of this statement will be necessary.

The taxpayer may always present appropriate facts and circumstances to justify the class life being used. Some of the factors which he may present are as follows:

1. Whether he is using the same depreciation deduction in computing his accounting records and financial records as he is using in computing his income tax return. (This would be a material factor if the stock of a corporation is publicly held.)
2. Whether there is an abnormally intensive use of assets.
3. Whether there are a number of assets in a guideline class which were not new when acquired by the taxpayer.
4. Whether there is *extra*ordinary obsolescence.
5. Whether the guideline class in his particular case contains a disproportionate amount of relatively short-lived assets.

There is an objective standard explained in the Revenue Procedure which a taxpayer may use to justify the class lives he is using, or his right to change to a more rapid depreciation writeoff. This standard is called the "Reserve Ratio Test." It establishes whether the depreciation reserve for assets in a guideline class bears a reasonable relationship to the basis of the assets. It can be used to demonstrate that the retirement and replacement practices being followed by the taxpayer with respect to a guideline class are consistent with the class life being used.

The reserve ratio tables in Treasury Publication No. 457 reflect upper and lower limits within which a taxpayer's reserve ratio should fall. The taxpayer meets the test if the reserve ratio for a guideline class does not exceed the upper limit of the appropriate reserve ratio range. Any taxpayer who has been retiring and replacing assets in the guideline class consistent with the life previously used, and continues to do so, will not exceed the appropriate upper limit.

The reserve ratios set forth in the publication vary according to the method of depreciation used by the taxpayer, the depreciable lives used, and the rate of growth of the taxpayer's assets. An important feature of the reserve ratio test is the latitude it gives the taxpayer in determination of depreciable lives provided that he meets certain standards. The margin of tolerance contained in the reserve ratio includes rates of replacement as much as 20 percent lower than the tax life used but only 10 percent faster. Thus, the reserve ratio test will more quickly indicate the taxpayer's right to faster depreciation writeoff than the possibility that increased lives should be used.

If a taxpayer's retirement and replacement practices for a guideline class have been inconsistent with the life previously used, the reserve ratio test for that class may exceed the upper limit of the appropriate reserve ratio range and thus fail to meet the general rule for applying the reserve ratio test. If this occurs with respect to any one or more of the first three taxable years to which this Revenue Procedure applies, there is a transition rule which the Internal Revenue Service will follow:

1. The reserve ratio test will be considered to be met for the first three years.
2. The taxpayer will be given a period of years equal to the guideline life for that class to bring the reserve ratio within the upper limit of the appropriate reserve ratio range provided his reserve ratio is moving toward the appropriate reserve ratio limit. So long as the reserve ratio is moving toward the limit, the reserve ratio test will be considered to be met.
3. The reserve ratio will be considered as moving toward the appropriate upper limit so long as the amount by which the reserve ratio exceeds the upper limit for any taxable year during the period is lower than it was for any one of the three preceding taxable years.

If a class life used by a taxpayer cannot be justified, the class life will be lengthened according to tables contained in the new Revenue Procedure. Specific rules govern the procedure to be followed in lengthening the lives.

Class lives will be lengthened only for a taxable year in which the reserve ratio test is not met and the class life cannot be justified by all the facts and circumstances. The class life will not be lengthened for any earlier year.

PART III

Part II of the Revenue Procedure utilizes the Reserve ratio test in a number of instances. Part III describes its computation. A reserve ratio is the ratio of depreciation reserves for the assets in any guideline class to the total basis of the assets. The reserve ratio test is made by comparing a taxpayer's reserve ratio for a guideline class with the appropriate reserve ratio range.

To apply the reserve ratio test we must first compute the taxpayer's reserve ratio. It

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is computed by dividing total depreciation reserves of all assets in a class by a total basis of the assets in the class. Fully depreciated assets are included in this computation. However, if any portion of the basis of any asset in a guideline class is subject to amortization under Sections 168 or 169 of the Internal Revenue Code, 1954, or is recovered through the additional first year depreciation allowance provided by Section 179 of the 1954 Code, that portion shall be excluded from the total basis of the assets and the amortization or depreciation deducted under these special sections shall be excluded from the depreciation reserve.

The second step in applying the reserve ratio test is to select the reserve ratio range from the printed tables. To do this it is necessary to know:

1. The method of depreciation used for the assets in the guideline class.
2. The test life.
3. The rate of growth.

Special rules for determining each of these items are outlined in Publication No. 456. Because of their complexity they will not be discussed here. When the appropriate reserve ratio range has been determined, it is compared with the taxpayer's reserve ratio. Where the rules indicate that a shorter class life used by a taxpayer may be justified, the appropriate class life is determined from the special adjustment table. A class life may also be lengthened. The table is also used to determine how the class life should be lengthened.

In summary we should note that this Revenue Procedure requires good faith by both the Internal Revenue Service and the taxpayer if it is to be effective. This is an administrative procedure which can be amended, changed or withdrawn, in whole or in part, whenever it does not fit a particular set of circumstances or where it is being used as a tax abuse device.

As Internal Revenue Service Commissioner Caplin pointed out when discussing the procedure, depreciation reform is not something that can be accomplished once and for all time. The Revenue Procedure reflects administrative policy dedicated to a continuing review and updating of depreciation standards and procedures to keep abreast of changing conditions and circumstances in our economy.

The Revenue Procedure is not a panacea for all depreciation problems but it should resolve many problems for both the taxpayers and the Government.

Opportunities for Women

In a memorandum to agency heads last July, President Kennedy set forth a new policy governing employment of women in the Federal Service. As a result, hereafter, appointments and promotions must be made without regard to sex, except in certain hazardous law-enforcement occupations. This should open up greater employment opportunities for women throughout Government.

The new policy seems especially appropriate in the Revenue Service. After all, women have been paying a good share of our nation's tax bill. It's only right they should have an equal chance to participate in the collection of revenue.

From time to time I propose to include in this letter brief write-ups about women employees enjoying professional careers with the Service, and I'll also be reporting on the status of the program, generally. I'd like to start out this issue with a "profile" on Lois C. Mottonen, Group Supervisor in Office Audit, in our Cheyenne District Office.

Born in Rock Springs, Wyoming, Lois graduated with honors from the local high school and won a scholarship to the University of Wyoming. There she carried off department honors in her major, accounting.

Faced with a job decision, Lois picked Internal Revenue because she felt she could move ahead faster under the Government's merit system than anywhere else. Events proved her right.

She started as office auditor in Cheyenne, was promoted in a year's time, and then became a Revenue Agent—the first woman ever to hold this assignment in Wyoming. Subsequent advancement brought her to her present position.

Miss Mottonen was nominated for the Federal Woman's Award for Outstanding Achievement by Women in Federal Career Service and was also commended by us for a booklet she authored on an Advanced Income Tax Course for Office Auditors.

The foregoing is an excerpt from Commissioner Mortimer M. Caplin's letter to his associates in the Internal Revenue Service, dated October 17, 1962.