

SUMMARY OF DISCUSSION DRAFT: COST RECOVERY REFORM AND SIMPLIFICATION

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Summary of the Discussion Draft

The cost recovery reform proposal outlined in the discussion draft would radically simplify one of the most complex areas of today's tax code and remove current barriers to businesses reinvesting in machinery and equipment on a revenue neutral basis, while maintaining accelerated depreciation. Today, there are \$40 trillion in capital assets in the U.S. economy, with more than \$2.5 trillion added every year. This includes everything from heavy machinery and manufacturing equipment, to computers and medical equipment. While capital investment is one of the key drivers of growth in our economy, the tax code imposes costs and complexity every time a business buys or sells a piece of equipment. In addition, the Congressional Budget Office (CBO) finds that today's cost recovery rules are one of the main drivers of bias between taxation of investments in different industries. This legislation would replace our current cost recovery system with a radically simplified Accelerated Mass Asset Cost Recovery and Reinvestment System (A-MACRRS).

The Ranking Member thanks the staff of the Joint Committee on Taxation and Senate Legislative Counsel for their valuable assistance with this draft.

Background

Today's cost recovery rules stem largely from the Tax Reform Act of 1986, which established the Modified Accelerated Cost Recovery System (MACRS). While businesses generally depreciate assets over their estimated useful life for financial accounting purposes, MACRS provides accelerated write-offs for tax purposes, through shorter recovery periods and an accelerated 200 percent declining balance method.¹ Under the MACRS system, business property is divided between real property (buildings) and personal property (generally machinery and equipment). Personal property is generally assigned to one of six depreciation lives (3, 5, 7, 10, 15, and 20 years). Residential rental property is depreciated over 27.5 years and nonresidential real property is depreciated over 39 years, both under the straight line method. Land is not depreciable. Certain foreign-use, tax-exempt use, tax-exempt bond financed, and imported property must be depreciated under the slower Alternative Depreciation System (ADS) via the straight-line method. In addition, corporate taxpayers must calculate earnings and profits (E&P) under the ADS method, and taxpayers must compute depreciation yet a third time for Alternative Minimum Tax (AMT) purposes under a hybrid method. As a result, a taxpayer may be required to calculate depreciation on the same asset three different ways every year. In addition, the tax code provides an array of variations on these rules, including certain taxpayer elections, as well as special requirements and prohibitions for certain industries and assets. In all, there are more than 100 depreciation schedules, and any single asset may be depreciated multiple ways depending on its use and the taxpayer's trade or business.

¹ For MACRS 15 and 20 year class lives, as well as certain farm property, 150 percent is substituted for 200 percent. All declining balance methods switch to the straight-line method when it yields a greater result.

Proposed Mass Asset Cost Recovery and Reinvestment System

This proposal would replace the current MACRS and ADS systems with a radically-simplified pooled depreciation system for personal property, replacing the more-than 100 current depreciation schedules with six pools on a revenue neutral basis as compared with MACRS. Under the A-MACRRS system, taxpayers would calculate depreciation, E&P, and AMT adjustments only once under a unified schedule. Assets would be assigned to pools based on their current MACRS property class assignments.

Pooled depreciation mechanics are extremely simple. Under the proposal, businesses would transition to the new system by transferring the remaining adjusted basis of all capital assets into each of the six respective pools. Each pool's balance would then be increased by the amount of any assets placed in service in such year assigned to each respective pool. In addition, each pool's balance would be reduced by the proceeds of any asset dispositions from the pool in such year, and by previous depreciation deductions. At year-end, each final pool balance is multiplied by its applicable declining balance percentage to determine the year's depreciation deductions.

This pooling system also significantly simplifies depreciation for businesses that manage large fleets of assets. Current tax rules generally require a taxpayer to annually calculate depreciation deductions on each capital asset separately. Regulations allow a taxpayer to use so-called "mass asset accounts" or "general asset accounts" to depreciate groups of similar assets, but these rules can impose extra tax on the disposition of assets. Thus, taxpayers face the untenable decision of paying additional tax under a simplified method, or incurring significant compliance costs for tax savings. The pooling system would expand a simplified version of mass- or general-asset accounting to all assets, while simultaneously easing the current tax consequences.

Asset Assignment

Under the current MACRS system, assets are generally assigned to six MACRS accelerated depreciation classes under a schedule based on their class life. The following table illustrates the current statutory classification framework, and the proposed pool rate assignments:

Current Asset Class Assignment			Proposal ²	
Class Life (Years)	MACRS Recovery Period		A-MACRRS Rate	
4 or less	3 years		Pool 1:	49 percent
5 to 9	5 years	→	Pool 2:	34 percent
10 to 15	7 years		Pool 3:	25 percent
16 to 19	10 years	→	Pool 4:	18 percent
20 to 24	15 years		Pool 5:	11 percent
25 or more	20 years		Pool 6:	8 percent

Current depreciation assignments are established partially by Treasury/IRS rulings and partially in statute. The bulk of these assignments occurred in Rev. Procs 87-56 and 88-22, issued under authority of the Tax Reform Act of 1986, which established the Office of Depreciation Analysis (ODA) within Treasury. After economic

² Pool rates have been determined by the Joint Committee on Taxation to provide revenue neutrality of the proposal, and are similar to present value equivalents of the tax benefit provided by MACRS under current law.

analysis, the agency classified nearly 200 asset useful lives. However, in the Miscellaneous and Technical Corrections Act of 1988, Congress revoked Treasury's authority to update class lives and disbanded the ODA.

This inability to administratively update class lives has caused numerous problems for taxpayers and the IRS. Current asset lives do not account for technologies developed after 1988, and do not account for the economic realities of the 21st century. In addition, certain emerging technologies may not fit within the current depreciation framework at all, which has required Congress at times to set statutory lives for those assets.

This proposal would reinstate Treasury's authority, subject to Congressional oversight, to update asset pool assignments based on economic assessments of an asset's useful life and technical obsolescence, under an accelerated depreciation schedule. In addition, it would require Treasury to conduct a review of the overall depreciation system and submit a report to Congress every 5 years.

Dispositions and Interaction with Like-Kind Exchange

Under current law, an asset's "adjusted basis" is reduced by the amount of previous depreciation deductions claimed. When an asset is sold, a taxpayer must reconcile the adjusted basis with the proceeds from disposition. If those proceeds exceed the asset's adjusted basis, that gain is taxable at ordinary rates up to the original purchase price, and treated as capital gain on any amount exceeding the purchase price.

The tax code provides an exception to this rule under certain circumstances, via so-called like-kind exchanges. In the case of personal property, a taxpayer may defer those gains on disposition only if he exchanges that property with another asset in the same "asset class" as defined in Treasury regulations. A number of additional strict requirements apply for the transaction to qualify, including specific identification of the replacement asset and acquisition within a certain time period. A taxpayer may also be required to utilize a "qualified intermediary" and establish an escrow account. Because of the complexity imposed by the tax code in these transactions, many smaller businesses are unable to benefit from the like-kind exchange exception, and many regional and national companies view this unnecessary complexity as one of their largest tax compliance costs.

Under the proposed pooling regime, dispositions would no longer be subject to the "recapture" tax. Rather, as stated previously, a taxpayer simply reduces the pool balance by the amount of disposition proceeds. As a result, the deferral currently provided under the extremely complex like-kind rules is available to all transactions involving depreciable personal property on a simplified basis, provided the acquired replacement property is in the same asset pool and the pool balance does not go below zero.

Simplified Placed-in-Service Rules

Under present law, a taxpayer is generally required to use the half-year convention on personal property placed in service in any given year. This rule allows a taxpayer to claim only half the depreciation deduction they otherwise would have claimed in the first year. In addition, assets placed in service in the last quarter of a year are subject to the mid-quarter convention, effectively reducing the first-year depreciation deduction to one eighth of the depreciation deduction otherwise available. These limitations not only reduce the economic benefit of new investment, but significantly increase the complexity of the depreciation system, and may introduce uncertainty for businesses trying to calculate the after-tax cost of an investment.

This proposal repeals both the half-year and mid-quarter conventions, allowing a taxpayer to claim a full first-year depreciation deduction. This not only increases the deduction for the year an asset is placed in service, but also simplifies tax compliance and increases certainty for business investment decisions.

Special Issues and Personal Use

The already-complex depreciation system is rife with additional special rules, particularly when it comes to assets that may be used partially for business and partially for personal use—an increasingly common situation in today’s economy. Under present law, a taxpayer may fully depreciate any asset that is predominantly used for business purposes. If an asset is used less than 50 percent for business purposes, it is subject to the slower ADS depreciation schedule, and the taxpayer is required to include the personal use portion of the asset in taxable income. For assets that may have varying levels of personal use each year, this can result in significant additional complexity as taxpayers may be required to recast previous depreciation deductions.

In the case of so-called “listed property” taxpayers are subject to much stricter rules. Listed property generally includes assets that could potentially provide a recreational or entertainment benefit to a taxpayer, including, televisions, passenger automobiles, cameras, and laptop or home-office computers. Under the listed property rules, taxpayers must specifically list all such property on their tax returns annually. In addition, the IRS requires the taxpayer to document and substantiate the use of each asset in a business purpose in the case of an audit.

The tax code imposes additional special rules for mixed-use passenger autos, termed “luxury autos.” Under these rules, certain passenger vehicles with less than 100 percent business use which cost more than \$16,000 are subject to depreciation limitations annually, prescribed by a specific schedule in the tax code. To add more complexity, these vehicles are also subject to various layers of complex personal-use and additional listed property requirements.

This proposal would replace many of these complex rules with a dramatically simplified framework. Assets with 50 percent or more business use would be eligible for depreciation under the normal rules. A taxpayer using a specific asset less than 50 percent for business use in any given year would continue to use the pooling system, but would only claim the proportionate business use of that asset’s depreciation deduction for such year. In addition, the complex “luxury autos” rules would be replaced with a simple limit on the depreciable basis of any such vehicle. Finally, the draft would remove laptop computers used primarily in a business from the list of “listed property,” providing a major reduction in compliance burdens for businesses in the modern economy.

Expiring Provisions

The tax legislation passed at the end of 2015 extended or made permanent a number of cost recovery provisions, including a five-year extension and expansion of bonus depreciation, permanent expansions of small business expensing and 15-year depreciation for certain restaurant property, and leasehold and retail improvement property. In addition, the bill extended for two years various depreciation preferences including those related to race horses, motorsports entertainment facilities, preferences for energy-efficient investments, and renewable energy. This proposal would preserve those provisions and their expirations as in current law. A number of provisions would be modified to conform to the pooling regime.

Request for Comment

Comments are requested on all aspects of the discussion draft as well as other areas of cost recovery and capital investment. The discussion draft sets aside broader questions with respect to rate reduction, base broadening, or extension of temporary provisions beyond those provided in present law. While the Ranking Member hopes the policies in the discussion draft will provide a basis for broader tax reform, he also believes

these proposals stand on their own merits. As such, comments on proposals in the discussion draft will be considered solely in the context of proposals contained in the draft, and no inference will be made with respect to those issues which have been set aside.

Comments on the additional issues listed below are of particular interest to the Ranking Member. All comments should be submitted to Cost_Recovery@finance.senate.gov or submitted to: Senate Committee on Finance, 219 Dirksen Senate Office Building, Washington, DC 20510.

Additional issues the Ranking Member is considering are listed below:

- **Transition Rules:** Businesses have made significant investment decisions based on current law, and the discussion draft aims to continue to make available and improve important policies, including accelerated depreciation, like-kind exchange, and mass asset accounting. The discussion draft applies the new pooling system to all personal property, including existing capital. Previous cost recovery reforms have at times applied such changes only to new investment, or have provided electability of application. As a result, previously, taxpayers have been required to calculate depreciation on numerous systems, each with its own unique rules on useful lives, depreciation methods, asset classifications, disposition rules, and other special rules based on when the asset was originally placed in service. The Ranking Member requests comments on transition rules and the electability of application, and how alternative proposals may interact with the goals of tax simplification.
- **Abandoned and Certain Low Disposition Value Property:** The discussion draft proposes to replace the current depreciation recapture provisions with a pooling concept. Instead of taxpayers paying tax on the excess of disposition proceeds over adjusted basis in the year of disposition, the discussion draft provides that a taxpayer must reduce pool balance by the gross proceeds of the disposition. While this deferral provides a tax benefit for most assets, some personal property may have no or little resale value. The Ranking Member requests comments on proposals to provide relief for such property.
- **Small Business Expensing:** Section 179 provides that businesses with sufficiently small capital investment may expense such costs in the year incurred, increasing cash flow for those businesses and simplifying tax compliance. The discussion draft continues to make available small business expensing as it exists in current law; however, it does not extend pooling treatment to assets expensed under section 179. The Ranking Member requests comments on proposals to extend pooled depreciation to section 179 property by, for example, establishing a 100 percent rate pool for such investments, or other options.
- **Alternative Minimum Tax:** Currently, both corporations and individuals are subject to the alternative minimum tax (AMT). The hybrid cost recovery method for AMT calculation is one of the largest contributors to AMT liability for taxpayers. The discussion draft proposes to replace the alternative depreciation method for AMT with a unified pooled cost recovery system. The Ranking Member request comments on the need to maintain the AMT given the unification of depreciation methods.
- **Like-Kind Exchanges:** The pooling system proposed in the discussion draft provides tax deferral benefit similar to that of like-kind exchanges on a simplified basis. However, the discussion draft also maintains like-kind exchange rules for pooled property. The Ranking Member requests comments on the need to maintain like-kind exchange rules under a pooled depreciation system.
- **Broader interactions in the tax code:** The cost recovery system sits at the core of the U.S. tax system. While it provides a framework for tax depreciation, the cost recovery system is also considered in a

myriad of other tax policies, including determinations of the alternative minimum tax, earnings and profits, and interest allocation, among others. The ranking member requests comments on broader interactions of the pooling system on the tax code.

- **Other Opportunities for Simplification:** Other opportunities for simplifying the cost recovery and capital investment system consistent with the proposed changes.