

Summary of Staff Discussion Draft: Cost Recovery and Accounting

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U.S. Senate Committee on Finance**

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Overview

As part of his work towards tax reform, Chairman Max Baucus is releasing a staff discussion draft today on certain aspects of business tax reform. The Chairman and his staff are grateful to the Joint Committee on Taxation (JCT), Senate Legislative Counsel and the Congressional Budget Office (CBO) for their assistance with this draft. This staff discussion draft covers the following topics:

- Cost recovery, including:
 - Depreciation of tangible property
 - Section 179 expensing
 - Amortization of intangible property
- Tax accounting, including:
 - Cash method of accounting
 - Uniform capitalization
 - Last in, first out (LIFO) inventory method
 - Lower of cost or market inventory valuation
 - Completed contract method of accounting

The last major overhaul of our country's tax code occurred in 1986. Since then, there have been more than 15,000 changes to the tax code, and the tax law has become increasingly complex. Individuals and businesses now spend an estimated \$168 billion annually on income tax compliance. As more and more special provisions have been added to the tax laws, large disparities have resulted in the tax treatment of different types of business investment. Such disparities distort business investment choices, and inhibit the efficient allocation of resources within the economy. In addition, the number of temporary provisions has increased from 25 in 1985 to close to 100 in 2013, which creates uncertainty and added costs for businesses trying to comply with the tax law. All of these issues drive up the cost of doing business in the United States and serve as a drag on economic growth and employment.

In recent years, the Finance Committee has held a number of hearings related to cost recovery and accounting provisions, and issued a paper on tax reform options under consideration in these areas. These efforts highlighted the following problems and opportunities for reform:

- Current tax law prevents U.S. corporations from competing effectively in a global economy and diminishes our ability to attract more foreign investment. The U.S. statutory corporate tax rate is the highest rate in the developed world. Many tax policy experts believe that lowering the statutory corporate tax rate will result in more investment in the United States by both U.S. and foreign multinational companies, leading to a stronger economy and more jobs. As a result, many support the idea of broadening the U.S. business tax base, including cost recovery and tax accounting reforms, as a way to create a more efficient and fair tax system while also paying for a lower statutory corporate tax rate. As part of this effort, however, the larger business community needs to be considered since passthrough businesses will not benefit from a corporate tax rate reduction but could suffer increased tax burdens from broadening the business tax base.
- Current law is riddled with provisions that encourage companies to make business decisions based to a large extent on tax, rather than business, considerations. Such provisions create large tax disparities among different industries and often inefficiently and unfairly encourage investment in one industry over another.
- Current law is unnecessarily complex. Frequent, sometimes temporary, and occasionally retroactive changes to the law create uncertainty and complicate strategic planning for U.S. businesses. The high compliance and administrative costs of our tax system siphon off business resources that could be invested much more productively.

Cost Recovery

The accounting concept of depreciation was introduced in the 1800's as capital intensive business activities grew and investors demanded a more sophisticated measure of business income. Depreciation contains two elements, useful life and salvage value, which are based on estimates and, accordingly, have been a source of disagreement between taxpayers and the IRS since the beginning of our income tax system. Prior to 1981, taxpayers could select how to depreciate their assets. In 1981, Congress made tax depreciation a more objective exercise with the introduction of the Accelerated Cost Recovery System (ACRS), which prescribed how companies had to depreciate different classes of assets. ACRS reduced the number of controversies and permitted companies to write off their assets at very accelerated rates, in part to help offset the effects of rampant inflation. However, the significantly accelerated depreciation deductions permitted under ACRS, and the wide differences in effective tax rates

that it applied to assets in different industries, led to excessive tax shelter activity and other perceived abuses.

As part of the Tax Reform Act of 1986 (the 1986 Act), the Modified Accelerated Cost Recovery System (MACRS) was adopted to address these abuses. Under MACRS, a ten class cost recovery system was designed to more closely approximate the economic depreciation of assets. Nonetheless, the MACRS system did retain a significant amount of acceleration in excess of economic depreciation but was less accelerated than ACRS. The 1986 Act also established the Alternative Depreciation System (ADS), which applies a straight-line method of depreciation and which taxpayers can elect instead of MACRS. Under current law, businesses that elect MACRS are often required to also re-compute depreciation under the ADS rules for a number of purposes. The result is a complex system that requires companies to compute depreciation using multiple methods for income tax purposes.

The 1986 Act also instructed the Treasury Department to establish a new office to study the depreciation of assets and granted Treasury the authority to adjust existing asset classifications or class lives and to prescribe class lives for assets that had no class lives in order to keep the depreciation schedules up to date. Pursuant to this authority, Treasury issued Revenue Procedures 87-56 and 88-22, detailing the recovery periods for numerous different asset and industry classes. However, Congress repealed this authority in 1988. Since that time, there have been no significant revisions of the asset classifications or class lives to reflect technological change and the emergence of new industries. As a result, many new industries lack rationally developed depreciation rules. In addition, no adjustments have been made to reflect the significant decline in inflation since 1986 when the MACRS rules were adopted.

Over the last quarter century, the MACRS rules have grown ever more complex as Congress has introduced numerous special rules for a variety of assets. Congress has also introduced temporary bonus depreciation and certain expensing rules for smaller businesses at various rates and points in time. In response to granting more accelerated depreciation, Congress has also passed various anti-abuse rules that, in turn, slow that same accelerated depreciation down under certain circumstances. To make things even more complex for companies, bonus depreciation and expensing have led many states (that previously followed the federal depreciation rules for simplicity) to de-couple from the federal tax rules to avoid a significant loss of revenue. As a result, companies are now forced to re-compute depreciation separately by state in most of the 50 states.

Prior to 1993, another area of tax controversies surrounded how taxpayers allocated the purchase price for businesses among intangible assets they acquired (e.g., goodwill, patents, copyrights, and customer lists). Since goodwill was not deductible, taxpayers went to great lengths to identify and assign value to intangible assets, other than goodwill, that could be

amortized. The Omnibus Budget Reconciliation Act of 1993 (the “1993 Act”) eliminated this controversy by permitting acquired goodwill to be amortized over 15 years and requiring (with some limited exceptions) other intangibles acquired in the same transaction to also be amortized over 15 years.

Even with the changes made in the 1986 Act and the 1993 Act, significant concerns remain about the treatment of expenses to create or purchase intangible or tangible assets. In some cases, taxpayers are allowed to deduct expenditures as they are incurred regardless of the fact that economic benefits have been created that last well beyond a single tax period. In other cases, an expenditure incurred in one industry can be treated substantially differently than an arguably equivalent expenditure in another industry. Sometimes, the tax treatment of a particular expenditure will depend on some measure of the taxpayer’s size or organizational structure.

Our current system of cost recovery violates the principles of neutrality, fairness, and simplicity. The tax code today rewards specific industries to the detriment of others, creates uncertainty with provisions that are temporary, and adds unnecessary complexity to business tax compliance. At the same time, there is no mechanism in place to improve and update the underlying economic assumptions of the cost recovery rules, or to account for technological change and the emergence of new technologies.

Tax Accounting

Under current law, businesses must navigate a maze of tax accounting rules to determine their taxable income. Similarly situated businesses are often subject to substantially different tax accounting rules. For example, the ability to adopt the cash method of accounting hinges on a myriad of factors, such as whether the business is a corporation or a partnership with a corporate partner, the business is a farming or personal service business, inventory is a material income producing factor in the business, average annual gross revenues meet certain thresholds, or the business is considered a tax shelter. Even assuming the business owner is able to qualify for the cash method of accounting, there are lots of exceptions to the general rules.

Inventory accounting is another particularly complex area of tax accounting. If the production, purchase, or sale of goods is a material income-producing factor for a business, then the business generally is required to use inventory accounting for the goods. The rules for deducting inventory costs vary depending on the type of cost (e.g., direct material costs, overhead costs) and whether such costs already are capitalized for other purposes such as for financial statement purposes. While the tax law generally requires the capitalization of direct and certain indirect costs, the so-called UNICAP rules go further and require the capitalization

of additional costs, such as overhead. Businesses can deduct the costs of inventory that are required to be capitalized when the inventory is sold. The UNICAP rules do not apply to all taxpayers. In particular, taxpayers that purchase goods for resale and have average annual gross receipts of \$10 million or less are not subject to the UNICAP rules, whereas taxpayers that produce their own goods have no such exception.

Our current tax accounting rules are thus highly complex and force taxpayers, and especially small businesses, to spending precious capital on outside advisors to help with their tax compliance challenges.

Goals of the Staff Discussion Draft

This staff discussion draft proposes a modern, simpler, and fairer cost recovery and tax accounting system that promotes tax neutrality when it comes to business decisions. Specifically, it is intended to promote the following objectives:

Cost Recovery

- Establish a system of cost recovery that better approximates the decline in the economic value of assets. This includes establishing a process to update the cost recovery system to take into account technological changes and the emergence of new industries.
- Provide a stable set of cost recovery rules that allow companies to plan better for the future.
- Treat similar investments similarly so that companies make investment decisions based on the needs of the business, rather than on tax planning.
- Simplify the cost recovery system to reduce the costs of tax compliance and enforcement.

Tax Accounting

- Simplify the tax accounting rules to lessen the costs of tax compliance and enforcement, which fall disproportionately on smaller businesses.
- Improve tax neutrality by eliminating the use of certain accounting methods that allow taxpayers in some industries to significantly defer or otherwise distort income measurement.

Summary of the Staff Discussion Draft

The staff discussion draft advances these goals through the reforms described below. While the Chairman believes tax reform as a whole should raise significant revenue for deficit reduction, the package of reforms in this staff discussion draft is intended to be coupled with a significant reduction in the corporate tax rate that, on net, is revenue-neutral in the long-term (i.e., in a steady state). The Chairman's staff believes that the revenue raised in the long-term from corporations by the proposals in this draft could finance a significant cut to the corporate tax rate. These proposals are meant to be considered as a package and not as stand-alone proposals.

Cost Recovery

Depreciation of Tangible Assets. The staff discussion draft repeals the current MACRS and ADS rules and replaces them with the following simplified cost recovery system that better approximates economic depreciation. The new system results in a single set of depreciation rules that apply to all business taxpayers. It also eliminates the need for businesses to calculate depreciation separately for each of their individual assets. This proposal draws upon S. 727 (112th Congress), the Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich, which proposes moving closer to economic depreciation, and S. 2100 (109th Congress), Tax Depreciation and Modernization, and Simplification Act of 2005, sponsored by Sens. Smith and Kerry, which proposes a mass asset approach.

- The new depreciation system for tangible personal property (other than personal use automobiles) and computer software is comprised of 4 pools, with 3 designated for short to mid-term property and 1 designated for mixed-use structures and other longer-term personal property. These pooled assets are depreciated at prescribed rates using a 100% declining balance method, meaning that each year a business can deduct an amount equal to the pool balance multiplied by the depreciable percentage for that pool.
 - Generally, at year-end each pool balance for determining depreciation equals: the prior year's ending pool balance, increased by the current year's asset purchases (including additions and improvements), and decreased by proceeds from the current year's asset sales and other dispositions. Ordinary income is recognized to the extent, if any, that a pool balance is driven negative at year-end by asset dispositions.

- Real property is depreciated, as under current law, on a straight-line basis, but over 43 years.
- The pools and their depreciable percentages were determined based on data from the Bureau of Economic Analysis (BEA) on the decline in value for different types of assets, in consultation with the Congressional Budget Office (CBO) and JCT staff. JCT assisted CBO in mapping this data based on the asset classifications in current law. CBO and JCT then used the BEA data to group these asset classes into pools based on their estimated economic rate of decline and, in limited circumstances, asset type.¹ Finally, CBO calculated a weighted average depreciable percentage for each pool and a weighted average recovery period for real property based upon the BEA data. For real property, CBO calculated a straight line recovery period with a present value equal to the economic rate of decline. The Chairman's staff has requested that CBO produce a letter detailing their analysis, which is forthcoming.
- Treasury is authorized, subject to Congressional review, to reassign assets to different pools (or to reassign as real property) and to create new asset classes to account for technological changes and the emergence of new industries.
- Certain taxpayers are eligible to elect to use their financial accounting placed-in-service date for tax depreciation.
- The like-kind exchange rules are repealed. For pooled assets, the like-kind exchange rules are replaced by the inherent deferral mechanism of the pooling regime.
- The involuntary conversion rules are revised to provide that, in cases where an involuntary conversion would otherwise trigger a gain as a result of a negative balance in a pool, a taxpayer may defer the recognition of the gain to the end of the second tax year after the year of the involuntary conversion.
- The current depreciation recapture rules are repealed with respect to pooled assets. For pooled property, the new recapture rules treat all gains (including those associated with depreciation recapture) as ordinary income.
- For real property, the recapture rules are revised to recapture all depreciation claimed through the date of disposition at ordinary income tax rates.

¹ There are two cases in which the Chairman's staff asked CBO not to assign assets with a class life to a pool based on their estimated economic rate of decline. These exceptions were for asset classes 44 (assets other than vessels used in water transportation and related land improvements) and 49.14 (assets used in electricity transmission and distribution), which were instead assigned to the pool that included all other land improvement and transmission property.

- The maximum amount that can be depreciated for personal-use automobiles is limited to \$45,000, recovered ratably over 5 years. Automobiles used entirely for business purposes are pooled assets and not subject to this limitation.

Cost Recovery for Certain Taxpayer-Created Intangible Assets.²

- Expensing for research and experimental expenditures under Section 174 is repealed. Research and experimental expenditures are capitalized and amortized ratably over 5 years.
- Half of advertising expenses may be expensed immediately. The remaining 50% must be capitalized and amortized ratably over 5 years.
- “Qualified extraction expenditures” are treated in the same manner as research and experimental expenditures. “Qualified extraction expenditures” are defined as tertiary injectant expenses, geological and geophysical expenses paid or incurred for the development of oil or gas, intangible drilling and development costs related to oil and gas wells and geothermal wells, mining development expenditures, and mining exploration expenditures. This proposal is based, in part, on S. 258 (112th Congress), Close Big Oil Tax Loopholes Act, sponsored by Sens. Menendez, Boxer, Durbin, Lautenberg, Leahy, Merkley, Nelson, Reed, Rockefeller, Sanders, Schumer, and Whitehouse.

Miscellaneous Other Cost Recovery Provisions.

- The percentage depletion rules of Section 613 are repealed and all taxpayers are permitted to use cost depletion. This proposal draws upon S. 307 (113th Congress), Close Big Oil Tax Loopholes Act, sponsored by Sens. Menendez, Boxer, Brown, Cardin, Durbin, Franken, Gillibrand, Klobuchar, Lautenberg, Leahy, McCaskill, Merkley, Nelson, Reed, Schumer, Shaheen, Stabenow, and Whitehouse.
- The rules for expensing start-up expenditures and organizational costs are consolidated into a single rule. The combined amount that can be immediately expensed is increased from \$5,000 to \$10,000, phased out for expenses in excess of \$60,000. Any costs that are not expensed must be amortized over a period of not less than 20 years.

² The 5-year recovery periods and the 50% figure for advertising expenses in this section are intended to reflect empirical evidence on the decline in value over time of expenditures for research, advertising, and natural resource extraction. See Corrado, Hulten and Sichel, Intangible Capital and Economic Growth, Finance and Economics Discussion Series 2006-24, Federal Reserve Board, Washington DC. The Chairman’s staff requests comments on whether and how these amounts should be adjusted.

Section 179 Expensing. The staff discussion draft permanently expands and modifies Section 179 to reduce tax burdens and compliance costs for small businesses. This proposal draws upon S. 727 (112th Congress), Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich, S. 1085 (113th Congress), Small Business Tax Certainty and Growth Act of 2013, sponsored by Sens. Collins and Casey, and S. 12 (112th Congress), Job Creation Act of 2011, sponsored by Sen. Portman.

- For years beginning after 2014, the maximum amount that may be expensed is increased to \$1,000,000, phasing out for qualifying property exceeding \$2,000,000, with both thresholds indexed for inflation.
- The definition of qualifying property is greatly expanded to include all pooled assets (including off-the-shelf computer software), research and experimental expenditures, advertising costs that are required to be capitalized and amortized, and qualified extraction expenditures.
- The special rules for qualified disaster assistance property are repealed.

Amortization of Intangibles. The staff discussion draft modifies the current rules governing expensing and amortization of intangible assets to better reflect the decline in their economic value.³

- The amortization period for Section 197 intangible assets is increased from 15 years to 20 years.
- Mortgage servicing rights are classified as Section 197 intangibles subject to the new 20 year amortization period.
- Treasury is directed to revise their safe-harbor regulations with respect to certain intangible assets such that qualifying intangible assets may not be recovered over a period of less than 20 years.
- The anti-churning rules of Section 197(f)(9) are repealed.
- The income forecast method of amortization is modified to increase the recovery period to be 15 years with the 5th and 10th years being re-computation years.
- Facilitative amounts related to tax-free acquisitions can be amortized ratably over 20 years.

³ The 20-year recovery periods in this section are intended to reflect changes in the real rate of return since the 15-year period was established in 1993. The Chairman's staff requests comments on whether and how these periods should be adjusted.

Tax Accounting

Cash Method of Accounting.

- All businesses (other than tax shelters) with average annual gross receipts of \$10 million or less based upon the prior three years (the “gross receipts threshold”) may:
 - Elect to adopt either the cash method or accrual method of accounting, regardless of whether inventory is a material income producing factor in the business, and
 - Immediately deduct the cost of inventory even if it is a material income producing factor in the business if the cash method of accounting is adopted.

This proposal draws upon S. 1085 (113th Congress), Small Business Tax Certainty and Growth Act of 2013, sponsored by Sens. Collins and Casey.

- All businesses that do not meet the gross receipts threshold must adopt the accrual method of accounting, including those engaged in farming and personal service businesses.
 - Businesses that do not satisfy the gross receipts threshold may not change their method of accounting (from cash to accrual or vice versa) without the permission of the Secretary of Treasury more frequently than every five years.
- The special method of accounting for farming businesses under Section 447 is repealed.
- The gross receipts threshold is indexed for inflation in \$1 million increments.

Uniform Capitalization Rules.

- Businesses below the gross receipts threshold are exempt from the requirements to capitalize direct and indirect costs of inventory acquired or produced by the taxpayer.

LIFO.

- The LIFO method of accounting for inventory is repealed.
- Taxable income resulting from this change in accounting method is included in income at the new tax rate ratably over 8 years.

Other Accounting Provisions.

- The lower of cost or market rule for inventory is repealed. This proposal comes from S. 727 (112th Congress), Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich.
- The completed contract method of accounting is repealed, except for small construction contracts.

Unaddressed Issues and Request for Comments

Comments are requested on all aspects of the staff discussion draft as well as other areas of cost recovery and accounting. Comments on the additional issues listed below that the Chairman's staff is considering are of particular interest. All comments should be submitted to tax_reform@finance.senate.gov. While comments will be accepted at any time, the staff requests comments by January 17, 2014 in order to be able to give them full consideration.

The additional issues that the Chairman's staff is considering are listed below:

- The staff discussion draft focuses on developing a set of cost recovery and accounting rules that more accurately reflects economic income. It is not intended to address incentives in other areas of the tax code for activities such as innovation, energy production, and manufacturing. For example, while the staff discussion draft proposes capitalization and amortization of research and experimental expenditures, the Chairman's staff is considering expanding and making permanent the research and development credit, which is otherwise set to expire at the end of 2013. Similarly, while the staff discussion draft slows down the cost recovery of certain energy assets, the Chairman's staff is considering improving and making permanent certain energy tax credits set to expire in 2013. Comments are requested on whether and how tax incentives – such as the research and development credit, the Section 199 deduction for manufacturing, and credits for clean energy – should be adjusted in light of the proposals in the staff discussion draft.
- The staff discussion draft does not address whether the corporate alternative minimum tax (AMT) should be repealed. The new cost recovery and accounting provisions in the staff discussion draft eliminate many of the items that cause taxpayers to be subject to the corporate AMT. Comments are requested regarding whether the corporate AMT should be repealed and, if so, how unused alternative minimum tax credits should be treated.

- Businesses have made significant decisions based on current law. Comments are requested regarding appropriate transition rules and effective dates. For example, the provisions are generally effective for taxable years after December 31, 2014, but comments are requested regarding whether more time would be necessary to effectively implement any provisions of the staff discussion draft.
- The staff discussion draft proposes to repeal the like-kind exchange rules. For pooled assets, the like-kind exchange rules are replaced by the inherent deferral mechanism of the pooling regime, but no such analog exists for real property or intangible property in the draft. Comments are requested regarding whether the like-kind rules should be retained in some fashion for real property and intangible property and whether, if retained, the rules should be revised to require a "similar use" concept (such as in the involuntary conversion rules) in place of the "like-kind" concept.
- The staff discussion draft proposes a single method of depreciation for each class of assets and no longer permits taxpayers to choose between different methods of computing depreciation. As a result, normalization rules provided for in current law are no longer operable. Comments are requested regarding whether new normalization rules should be included and, if so, how such rules could work.
- Comments are requested regarding whether small producers should continue to be eligible for percentage depletion (limited to cost basis) and, if so, how small producer eligibility should be determined and to what extent, if any, depletion rates should vary among resources.
- The staff discussion draft proposes that the conversion of a real property asset from more than 50% business use to a principal residence is exempted from the rule that otherwise would require the asset to be deemed sold at fair market value but does not provide any exemption for a business-use property converted into a vacation home. Comments are requested for whether such an exemption should be included and how such an exemption would be designed.
- Other opportunities for simplifying the cost recovery and accounting rules consistent with the proposed changes.