Senate Finance Committee Chairman Baucus releases staff discussion draft on cost recovery and tax accounting reform

November 21, 2013

In brief

Senate Finance Committee Chairman Max Baucus (D-MT) on November 21, 2013, released a cost recovery and tax accounting reform discussion draft ("discussion draft") prepared by his committee staff. This release, the third in a series of Finance staff tax reform discussion drafts, follows the international tax reform discussion draft and tax administration reform discussion draft, issued on November 19, 2013, and November 20, 2013, respectively. Introducing the release today, Chairman Baucus stated that "America today is using a bloated tax code that was built for businesses close to 30 years ago" that acts "as a brake on economic growth." He commented that the discussion draft "proposes a modernized set of cost recovery and accounting rules that are simpler, fairer, and lessen tax burdens on small businesses."

The release states that the proposed reforms would "raise enough revenue from corporations in the long-term to finance a significant reduction in the corporate tax rate." Chairman Baucus does not propose a specific lower corporate tax rate, but he previously has expressed support for reducing the corporate rate below 30%.

The discussion draft focuses on cost recovery reforms to certain depreciation and amortization provisions, and other tax accounting reforms. Under the cost recovery reforms, the discussion draft proposes to replace the current modified accelerated cost recovery system (MACRS) and alternative depreciation system (ADS) with a new system that better approximates economic depreciation based on estimates provided by the Congressional Budget Office. Moreover, the discussion draft proposes to reduce the number of major depreciation rates from more than 40 to 5, and eliminate the need for businesses to depreciate each asset separately.

The discussion draft proposes to increase the amortization recovery period for Section 197 intangibles from 15 years to 20 years, includes mortgage servicing rights in the definition of a Section 197 intangible, and repeals the anti-churning rules under Section 197.

Finally, the discussion draft proposes significant changes to a number of tax accounting methods, such as repealing the last-in, first-out (LIFO) inventory method of accounting and the like-kind exchange rules. In addition, the proposal limits the use of the overall cash method of accounting to certain taxpayers.

Chairman Baucus has requested public comment by January 17, 2014, on the discussion draft and other issues not addressed in the draft.

In detail

Depreciation of tangible property

The discussion draft contains several provisions that are designed to simplify the existing general MACRS and ADS rules in order to create a new cost recovery system that better approximates economic depreciation. Specifically, these provisions would:

- Replace the existing MACRS and ADS rules with a pooling cost recovery system for "pooled property" (e.g., most tangible property and computer software) and a straight-line cost recovery system for "straight-line property" (i.e., real property and personal-use passenger automobiles);
- Eliminate the need for businesses to calculate depreciation separately for each individual asset;
- Reduce the number of depreciation rates used for computing annual depreciation expense; and
- Result in a single set of depreciation rules that apply to all taxpayers.

Pooled property is divided into four categories based on existing asset classifications included in Revenue Procedure 87-56. In the case of pooled property, costs are recovered by multiplying the applicable recovery rate for each pool by the pool balance at year-end. Applicable recovery rates for the four pools are 38%, 18%, 12%, and 5%, respectively.

Generally, the pool balance at year-end equals the prior year's pool balance, increased by current year additions, and reduced by proceeds from current year sales and other dispositions. To the extent a pool balance is reduced below zero due to dispositions, ordinary income is recognized as Section 1245 recapture. With respect to any pooled property that is disposed of or transferred to a related person, the amount of the reduction to the pool should not exceed the recomputed tax basis with respect to such asset, and the excess of the fair market value of such asset over the recomputed basis is treated as gain from Section 1245 property (i.e., ordinary income).

Observation: The discussion draft would require gain from Section 1245 property which is pooled to be treated as ordinary income and recognized currently. It appears that the requirement to recognize gain currently would even apply in the case of transactions otherwise qualifying as non-recognition transactions (e.g., Sections 351 and 721 transactions). Transfers among members of a consolidated group are excepted from this rule.

The discussion draft also provides that real property is depreciated on a straight-line basis over a 43-year recovery period.

Observation: Contrary to most transition rules, the discussion draft would apply not only to property placed in service after the enactment date, but also to property placed into service prior to the date of enactment. That is, taxpayers will be required to include the adjusted basis of existing assets in the pool for the first taxable year beginning after December 31, 2014, and recover the remaining basis using the applicable recovery rate for the pool.

Observation: The proposed cost recovery system simplifies cost recovery for taxpayers in a number of ways. Assets would no longer be individually tracked, and taxpayers would no longer analyze whether assets are required to be depreciated under a general rule or an alternative system.

Observation: The Internal Revenue Service and Treasury Department have lacked the authority to update the asset classifications of Revenue Procedure 87-56 resulting in lack of clarity in classifying assets and recovery periods that are not reflective of the anticipated useful lives of assets. While the proposed cost recovery system also relies on the classifications in the revenue procedure for purposes of allocating pooled property to the four pools, it authorizes the Treasury Department to issue guidance to reclassify assets to different pools and modify asset classes described in the revenue procedure or create new categories of assets to take into account changes in the anticipated useful lives of such assets.

Like-kind exchange rules

Under current law, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is held for productive use in a trade or business or for investment. The non-recognition provisions in a like-kind exchange apply only to the extent that like-kind property is received in the exchange. The discussion draft repeals the like-kind exchange rules, on the premise that these rules are replaced by the inherent deferral mechanism of the new proposed pooling regime.

Section 179 expensing

A taxpayer may elect under Section 179 to expense the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation. The discussion draft proposes to increase the expensing limitation under Section 179 from $500,000 to $1 million. Moreover, the discussion draft proposes to make permanent such increase in the limitation and expands the definition of qualifying property.

Note: The current temporary $500,000 Section 179 limitation amount expires at the end of 2013, and is set to revert to $25,000 in 2014 absent action by Congress.

Amortization of intangible assets

The discussion draft extends the amortization period for Section 197 intangible assets from 15 years to 20 years. In addition, mortgage servicing rights are included in the definition of a "Section 197 intangible" subject to a 20-year amortization period. Finally, the discussion draft also repeals the anti-churning rules under Section 197(f)(9).

Observation: Increasing the recovery period of Section 197 intangibles from 15 years to 20 years not only applies to property placed in service after the enactment date, but also to Section 197 intangibles placed into service prior to the date of enactment. That is, taxpayers will be required to increase the remaining recovery period of existing Section 197 intangibles by 5 years and amortize the remaining basis over such period.

Observation: Including mortgage servicing rights in the definition of a Section 197 intangible is a significant change from current law. Under current law mortgage servicing rights are explicitly excluded from Section 197, and amortized under Section 167 over a 108-month period. The discussion draft effectively extends the recovery of mortgage servicing rights by 11 years.

Observation: As each year passes, the purpose of the anti-churning rule diminishes, but it still adds a significant amount of complexity to the tax law. Repeal of the anti-churning rules under Section 197 would greatly reduce the burden placed on taxpayers to determine whether any pre-1993 Section 197 intangibles exist, which likely represent a small percentage of the total fair market value of property acquired.

Amortization of advertising expenditures

Under current law, advertising expenses generally are deductible as ordinary and necessary business expenses in the year in which they are paid or incurred. The discussion draft proposes to require taxpayers to capitalize and amortize 50% of its advertising expenditures over a 5-year period. The remaining 50% of a taxpayer's advertising expenditures may continue to be deducted in the year paid or incurred.

Observation: This is a significant change from current law and, contrary to the other simplification provisions of the discussion draft, may increase complexity by requiring taxpayers to track advertising expenditures separately from other related costs that remain currently deductible.

Amortization of research and experimental expenditures

The discussion draft repeals expensing of research and experimental expenditures under Section 174. Research and experimental expenditures would be capitalized and amortized ratably over a 5-year period. The optional 10 year recovery of these costs for alternative minimum tax (AMT) purposes under Section 59(e) is also repealed.

Amortization of oil, gas, and mining expenditures

Qualified extraction expenditures, which are defined in the discussion draft to include geological and geophysical costs, tertiary injectants, intangible drilling and development costs, and mining exploration and development costs, are required to be capitalized and amortized over 5 years.

In addition, the discussion draft would repeal the use of percentage depletion.

Amortization under the income forecast method

The discussion draft also extends the income forecast recovery period from 10 years to 15 years and modifies the recomputation years to be the 5th,10th, and 15th (previously the 3rd and 10th). Moreover, Section 181, which provides for an election to deduct the cost of any qualifying film and television production in the year the expenditure is incurred rather than capitalizing and recovering the cost generally under an income forecast method, is repealed under the discussion draft.

Other tax accounting provisions

In an attempt to address tax accounting methods outside of the cost recovery regime, the discussion draft proposes to repeal a number of significant tax accounting provisions.

Inventory accounting methods

The repeal of the LIFO inventory method of accounting has been considered in a number of tax reform proposals. Consistent with those proposals, the discussion draft repeals the use of the LIFO inventory method on the basis that it does not clearly reflect income.

Similarly, the discussion draft repeals the use of the lower-of-cost-or-market (LCM) method to value ending inventory below cost and prohibits any write-down for subnormal goods (i.e., goods that unusable or unsalable in the normal way).

In the case of any taxpayer required to change its method of accounting from LIFO, LCM or from any method valuing inventory at a "bona fide selling price," the discussion draft proposes to allow any net positive Section 481(a) adjustment to be taken into account over 8 taxable years.

Observation: In general, a net positive Section 481(a) adjustment is taken into account over 4 taxable years. Many taxpayers were hopeful that any requirement to change from LIFO would be spread over an extended Section 481(a) adjustment period. The inclusion of a special provision allowing taxpayers to spread a net positive Section 481(a) adjustment over 8 years should provide some relief for taxpayers that would be required to recapture their LIFO reserve that has been increasing for a number of years. Although a Section 481(a) adjustment period of 8 years is more favorable than 4 years, the discussion draft's proposal is less than the 10 year period proposed in the President's FY 2014 budget.

Overall cash method of accounting

Under the discussion draft, all businesses (except tax shelters) with average annual gross receipts of $10 million or less (based on the prior 3 taxable years) may elect to adopt either the overall cash method or overall accrual method of accounting, regardless of whether inventory is a material income producing factor in the business (if applicable). The proposal allows such taxpayers to take into account inventory costs currently if the cash method of accounting is adopted. All businesses that do not meet the gross receipts test (as well as tax shelters) are required to use an overall accrual method of accounting.

Observations: The requirement for taxpayers with average annual gross receipts in excess of $10 million to use the accrual method regardless of entity form or business activity is consistent with a similar proposal included in a March 2013 small business tax reform discussion draft released by House Ways and Means Committee Chairman Dave Camp (R-MI). Unlike the special provision for a change from certain inventory methods, it appears that taxpayers required to change to an overall accrual method of accounting must take into account any net positive Section 481(a) adjustment in accordance with the general rules (i.e., over 4 taxable years).

Start-up and organizational expenditures

The discussion draft combines start-up expenditures and organizational costs into a unified rule, which provides that a taxpayer may elect to deduct up to $10,000 (subject to a phase-out) of the sum of these amounts in the taxable year in which the active trade or business begins. The remainder of any start-up and organizational expenditures may be amortized over a period of not less than 20 years, beginning with the midpoint of the taxable year in which the trade or business begins.

Percentage-of-completion method

Under current law, the taxable income from home construction contracts and small construction contracts are not required to be accounted for using the percentage-of-completion method of accounting. These long-term contracts may be accounted for under the taxpayer's exempt contract method (e.g., the completed contract method). The discussion draft repeals the home construction contract exception from the use of the percentage-of-completion method. The exception for small construction contracts is retained. Accordingly, taxable income from home construction contracts must be accounted for using the percentage-of-completion method (unless the exception for small construction contracts applies).

The discussion draft also repeals the use of the percentage-of-completion capitalized cost method (PCCM) for residential construction contracts and certain ship construction contracts. The PCCM allows a certain percentage of a contract to be accounted for using the taxpayer's exempt contract method and the remainder using the percentage-of-completion method. These contracts are now required to use the percentage-of-completion method (unless in the case of a residential construction contract the small construction contract exception applies).

The takeaway

It is important to note that Chairman Baucus released these proposals as part of a series of tax reform discussion drafts and has stated that these proposals should be considered as a package rather than standing alone. Chairman Baucus notes that the proposed reforms in the discussion draft "raise enough revenue from corporations in the long-term to finance a significant reduction in the corporate tax rate."

Overall, the discussion draft provides simplicity for taxpayers seeking to comply with an overly burdensome depreciation system, focuses on provisions to provide relief for certain small businesses, and seeks to add certainty around provisions that are often temporarily or retroactively extended. Still the discussion draft repeals certain provisions that will significantly impact businesses and likely require taxpayers to recognize revenue earlier or defer deductions later than under their current methods of accounting.

As Chairman Baucus advises, stakeholders should provide the Senate Finance Committee with feedback on the discussion draft, and should consider carefully the request for comments on issues not addressed in the current draft. We expect the discussion of tax reform options to continue into 2014, as reflected in Chairman Baucus' request for comments by January 17 of next year. The comprehensive tax reform bill currently being developed by House

Ways and Means Committee Chairman Camp will be an important part of this ongoing discussion.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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