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Car Depreciation

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CAR DEPRECIATION

INTRODUCTION

Every businessperson is concerned about his or her taxable deductions. Depreciation is one of those deductions. Depreciation is the reasonable allowance deducted every year for the exhaustion and wear and tear as property becomes obsolete.¹ In 1988, there are many depreciation methods in use. A businessperson must be familiar with all of these methods in order to be able to be in full compliance with the tax law. The average businessperson is in awe of the tax code and will more than likely call up on a qualified tax professional to do his or her taxes. The accountant, CPA, or tax attorney must be knowledgeable of the changes in the tax law. When a new client comes in, however, it is difficult for a professional to know how a prior professional treated the depreciation of an asset.

HISTORY

In 1954, there were a variety of depreciation methods. Each of these methods had a separate purpose. Some of the most popular methods were straight-line, double-declining balance, and sum-of-the-year's digits.²

Straight line depreciation is the easiest to understand. The businessperson (B) deducted equal amounts every year for the useful life of the asset. B, on his or her own, could determine the useful life. B would consider salvage value (what the property was worth at the end of the useful life). The useful life concept allowed B to depreciate for only the number of years B intended to use the property.³ For example, if B purchased a new car for \$10,000, B might estimate the useful life of the car to be ten years. The salvage value at the end of ten years might be \$500. B would depreciate \$950 every year either for ten years or for as long as B owned the car.⁴

The other two methods, double-declining balance and sum of-the-year's digits, are accelerated methods. These methods depreciate more heavily in the early years, therefore, B has greater deductions, less income, and less tax liability.⁵

The double-declining balance method takes the straight-line ratio and doubles

¹ Prentice Hall 1985 Federal Tax Course, Chapter 10 Deductions-Depreciation, p. 397.

² S. SURREY, W. WARREN, P. McDANIEL & H. AULT, FEDERAL INCOME TAXATION 396-98 (1972) (hereinafter S. Surrey).

³ *Massesy Motors, Inc. v. United States*, 364 U.S. 92 (1960).

⁴ See Appendix A. straight-line depreciation example.

⁵ S. SURREY, *supra* note 2, at 398.

it.⁶ For example, if the useful life were ten years, the straight-line ratio would be 1/10 and the double-declining ratio would be 2/10 or 1/5. The double-declining method does not take salvage value into consideration. If the businessperson were using the double-declining method under the same facts as before he or she would have the following depreciation:

YEAR 1 \$10,000 X 1/5 = \$2200
 YEAR 2 BALANCE = \$11,000 - \$2200 = 8800
 \$8800 X 1/5 = \$1760
 YEAR 3 BALANCE = \$8800 - \$1760 = \$7040
 \$7040 X 1/5 = \$1408
 ECT⁷

The sum-of-the-year's digits develops a fraction for the ratio. The numerator is the years the asset has remaining to depreciate. The denominator is the sum of the years of the useful life. In the example, the denominator would be the sum of 10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1 which equals to 55. Again, B would not have to determine the useful life.⁸

In 1942, the U.S. Treasury simplified depreciation. The businessperson would not have to determine the useful life because the Treasury issued Bulletin F which gave an item-by-item listing of useful lives.⁹

In 1962, the IRS abandoned Bulletin F and adopted specific guidelines.¹⁰ B had broader individual classes of assets from which to choose the useful life of assets. The assets useful lives were divided into seventy-five broad classes. The lives were shortened thirty to forty percent. These guidelines helped to reduce the taxpayer-agent controversies over asset lives. Congress used the Reserve Ratio Test in order to try to make sure the taxpayer was not depreciating the asset faster than the actual use of the asset. The Reserve Ratio Test assumed that the actual useful life of the assets could be determined by a comparison of the amount of the depreciation reserve to the actual cost of acquiring the asset being depreciated.¹¹ The Reserve Ratio Test did not work well and, therefore, was not used from 1962 to 1969. In 1965 the Treasury came up with the Modified Reserve Ratio Test, but in 1971, Congress stopped using this Test.

In 1971, the Treasury enacted the Class Life System (CLS).¹² B would look up the asset under the description of class column and find a range of where the useful

⁶ *Id.*

⁷ See Exhibit A for a full view of depreciation methods.

⁸ 25 Commerce Clearing House 1987 Depreciation Guide ¶ 215.

⁹ *Id.* at ¶ 1.

¹⁰ *Id.*

¹¹ Rev. Proc. 62-21, 1962-2 CB 418.

¹² Rev. Proc. 83-85, 1983-2 C.B. 604.

life would be set. If B looked up “automobile,” B would find a lower limit of 2.5 years, an asset guideline period of 3 years, and an upper limit of 3.5 years. B then could expect to depreciate the car over a three year average. B used the same methods as before, but the IRS specified the time period.

Congress then tried to assist taxpayers by enacting the Vintage Accounts which were a way of lumping a group of assets under one account and depreciating them at one time.¹³

Congress also enacted the Class Life Asset Depreciation Range system (ADR) that sets out various class lives for property.¹⁴

Another idea Congress had was clarifying when to start taking depreciation.¹⁵ There were two conventions when Congress first issued this rule: the half year convention and the modified half year convention. Under the half year convention, B would start depreciating the asset at the beginning of the year, if B purchased it -- during the first half of the year; if B purchased the asset during the second half of the year, B would only be able to take half year of depreciation. Under the modified half year convention, B would take the depreciation expense for the whole year if the asset was purchased during the first six months, but if it was purchased during the second half of the year, B would take depreciation starting the next year. Once Congress answered the taxpayer’s question of when to depreciate an asset purchased during the year, Congress furthered the use of conventions. Congress adding the mid-month and the mid-quarter conventions; further confusing the taxpayer.¹⁶

In 1980, depreciation was changed to the Accelerated Recovery System (ACRS).¹⁷ This system allows for recovery of capital costs for most tangible depreciable property using accelerated methods of cost recovery over a predetermined number of years.¹⁸ ACRS did away with the useful life and the class life.¹⁹ The Treasury set the recovery periods at 3, 5, 10, and 15 years and did away with the salvage value. Therefore one could depreciate the entire cost. Instead of calculating the amount of depreciation under the various methods, ACRS assigned a percentage of depreciation B could take each year according to the recovery period. For example, if the recovery period was three years, each of those years would have a percentage that applied to each year. The Treasury also decided that B could start depreciating an asset when the property is placed in service.²⁰ The property is placed in service at the time when it is ready and available for the specific reason it was

¹³ S. SURREY, *supra* note 2, at 404.

¹⁴ CCH 1987 DEPRECIATION GUIDE, *supra* note 8, at ¶ 1.

¹⁵ *Id.* at ¶ 232,

¹⁶ *Id.*

¹⁷ FEDERAL TAX COORDINATOR 2D, § 228 (1988).

¹⁸ S.SURREY, *supra* note 2, at 403.

¹⁹ FEDERAL TAX COORDINATOR 2D, *supra* note 17, at § 228.

²⁰ *Id.*

purchased for.²¹ B could not use ACRS on any assets purchased before ACRS was enacted.²²

So B buys a car in 1981 for \$10,000. B looks up the recovery period of a car and uses the specified percentage in determining the depreciation expense for the year. B could still elect to apply alternative methods, namely, straight-line. B could choose the number of years but half year conventions would still have to apply and there will be no deductions in the year B disposes of the car. But, B must use the alternative method for all assets in the same class.

In 1962, the investment credit was introduced.²³ B would be allowed to expense a portion of the cost at the time B purchased the car. According to the enactment, B could take a \$5000 depreciation expense, if B purchased it in 1982, or 1983, \$7500 if purchased in 1984 or 1985, and, after 1986, \$10,000. B would subtract the investment credit from the basis of the car and then depreciate the adjusted basis over the three year period. Congress terminated the investment credit in 1969, and then reinstated it in 1971 with a more liberal interpretation.²⁴ The investment credit allowed for a large portion of the asset to be deducted in the year of the purchase.²⁵ In the Tax Reform Act of 1986, Congress repealed the investment credit for property acquired after 1985.²⁶

In 1984, Congress introduced the luxury car rules.²⁷ These rules were enacted to stop B from buying an expensive car in order to take a big write-off.²⁸ Under the luxury car rules B had to take a limited investment tax credit and slow down depreciation if B purchased a car costing over \$16,000. In 1985, Congress changed the luxury car provisions to limit B to depreciating a maximum of \$12,800 over a five year period. But only if B used the car for business purposes 50 percent or less of the time.²⁹

In 1986, Congress brought into existence yet another depreciation method. The Modified Accelerated Recovery System (MACRS).³⁰ MACRS added two recovery periods. Under MACRS the recovery periods are 3, 5, 7, 10, 15, and 20 year periods. Under this method B would depreciate a car over a five year period. B would look under the five years period to find the percentage of depreciation B would be allowed to take in each year.

²¹ *Id.*

²² FTC § 188(f)(5).

²³ J. FREELAND, S. LIND, AND R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 751-52 (1987).

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Cars and Computers: Write-offs that Stand Up*, CHANGING TIMES 70 (1985).

²⁸ *Id.*

²⁹ *Id.*

³⁰ CCH 1987 DEPRECIATION GUIDE, *supra* note 8, at § 7.

CONGRESSIONAL INTENT

Depreciation has gone through many changes in the past decades. The laws have changed regarding useful life, depreciation methods and percentages of depreciation.

Congress' reasons for change usually are an answer to economic problems: stimulating the economy and/or business and inducing sociological improvements and ecological advancements.³¹ Some examples of ways Congress intended to induce sociological improvements and ecological advancements were:

The Tax Reform Act of 1969--Congress tried to stimulate investment in rehabilitating low income housing.

In 1969, Congress gave companies rapid write-offs if they installed pollution control facilities.

The Tax Reform Act of 1971--Congress allowed companies to amortize capital expenditures over a sixty month period if they acquired, constructed, or rehabilitated on-the-job training and child care facilities.³²

In 1934, the IRS became strict regarding the useful life issue. The IRS required taxpayers to actually prove the appropriateness of a useful life.³³ B would have to show that the car purchased in 1934 would only last ten years. This was a difficult task. The reason behind this scrutiny was that the government needed revenues in order to pay for the public works program during the Great Depression. The IRS would show that the taxpayer had an unreasonable useful life and, therefore, would increase the useful life and revenues in that year.³⁴

If B could depreciate over a shorter period of time, B's deduction would be greater and, therefore, B's tax liability would be lower in that year.

Example: $\$10,000 / 10 \text{ years} = \$1000/\text{year depreciation}$
 $\$10,000 / 5 \text{ years} = \$2000/\text{year depreciation}$

In 1981, Congress decided to enact ACRS (Accelerated Cost Recovery System) to simplify cost recovery.³⁵ Cost recovery was not simplified because of ACRS. In some ways, it was more cumbersome to the taxpayer because would have

³¹ S. SURREY, *supra* note 2, at 412.

³² *Id.*

³³ CCH 1987 DEPRECIATION GUIDE, *supra* note 8, at ¶ 1.

³⁴ *Id.*

³⁵ FEDERAL TAX COORDINATOR 2D, *supra* note 17, at § 228.

to keep records for each asset from the time the asset was placed in service.³⁶ Since assets were placed in service in different years, different depreciation methods would apply. Congress enacted ACRS as a way to increase spending on capital investments and this is why they developed the anti-churning rules.³⁷ Under the anti-churning rules, B could not use ACRS for old assets.³⁸ Individuals, such as B, would buy an item they needed now in order to expense it over a shorter time and, therefore, lower B's tax liability.

In 1984, Congress wanted to stop taxpayers from cheating on taxes.³⁹ Congress tried to enact contemporaneous records for car expenses, but after a great number of complaints from accountants and the business community they repealed the act.⁴⁰ W. Murray Bradford, the President of the Reduction Institute in Washington, D.C., wrote an article after Congress repealed the bill entitled "Congress Approves Cheating on Business Autos."⁴¹ He stated in the article that by watering down the recordkeeping rules Congress would lose \$150 million per year.⁴² Congress wanted B to keep up to date records of business trips and also advised that B keep evidence of business activities.⁴³ Under the *Conan*, rule if B does not have corroborating evidence, B may still be able to take the deduction because the court will allow B to estimate.⁴⁴

Congress' reasons for change have effected on the economy, but even as far back as the 1970's, Congress was concerned with the complexity of the rules (the policy of continually enacting new rules).⁴⁵

SIMPLIFICATION AND COMPLIANCE

Generally, people do not like change. The public seems Confused by congress' continuing changes to tax laws other than depreciation. The public's confusion could also explain the low rate of tax compliance.

Taxpayers are willing to pay their share of taxes, but they tend to quit when the forms are too complicated to read and the methods too cumbersome and confusing to keep track of. According to the ABA Commission on Taxpayer Compliance, 81 percent of the United States citizens voluntarily reported and paid their income

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Write-offs that Stand Up*, *supra* note 27, at 69.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ S. SURREY, *supra* note 2, at 404.

taxes.⁴⁶ This leaves 19 percent, which may seem like a small portion of the citizens, but in reality, this 19 percent makes up a tax gap of about one hundred billion per year.⁴⁷ The tax gap is the difference between what was actually paid and what would be paid if all the taxpayers filed accurate returns and paid all their taxes.⁴⁸

The laws are changing too much and too quickly. For example, the luxury auto rule that was enacted in 1984, limiting depreciation to \$16,000 was changed to \$12,800 in 1985.⁴⁹ The change was probably due to Congress' repeal of the recordkeeping rules on cars. That change cost them \$150 million.⁵⁰

The depreciation methods that Congress has enacted have simplified computing depreciation. The ABA Compliance Commission has stated in its report that the "ability for the taxpayer to comply with the complex revenue laws . . . would be improved if those laws remained relatively stable."⁵¹ If these methods were not additive as they are they would probably simplify tax preparation and increase compliance.⁵² In order to increase compliance Congress should make the laws apply to all assets on the books at the time.⁵³ The taxpayer would not have to recompute each asset but instead would take the asset basis at the time and compute depreciation from there.⁵⁴ If the asset's recovery period had already expired the taxpayer should be able to take the rest of the depreciation in that year. This may lower tax liability in the immediate year and therefore lower revenues for IRS but in the long run compliance would probably be higher. Increased compliance would increase revenues and probably decrease IRS cost of enforcing compliance."⁵⁵

If the taxpayer could depreciate for shorter periods of time it would help the recordkeeping problem. Taxpayers do not like to keep many records for each asset they own. The shorter the period, the less recordkeeping for the taxpayer and the higher the compliance.⁵⁶

The ABA has made some positive and important suggestions.⁵⁷ The ABA Compliance Commission suggested that the IRS and the government should try to educate the public on the tax laws because "information and assistance programs can reach far more taxpayers than direct enforcement efforts and can also be used to set a tone of helpfulness and cooperation that will minimize taxpayer disaffection

⁴⁶ Report and Recommendations on Taxpayer Compliance. ABA Association Commission on Taxpayer Compliance. *Tax Lawyer*, Volume 41, No. 2, July, 1987. P. 329-30.

⁴⁷ *Id.* at p. 330.

⁴⁸ *Id.*

⁴⁹ *Write-offs that Stand Up*, *supra* note 27, at 70.

⁵⁰ *Id.*

⁵¹ *Taxpayer Compliance*, *supra* note 46, at 330.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* at 329.

with the tax system."⁵⁸ The education of the public should begin with the students in junior high and high school. The ABA also suggested ways the IRS can accomplish this.⁵⁹ Some examples are call-in radio and television shows IRS informational articles on problems and procedures and increasing district outreach programs.⁶⁰ Educating of the public is the best way to increase compliance, especially among specific groups such as the small businessperson and the self-employed.⁶¹

Another ABA suggestion was to simplify forms and educate the public on the use of these forms.⁶² They gave two reasons for the forms: 1) to help the taxpayer in organizing the taxpayers information in a correct and simplified manner to determine tax liability, and 2) to give the IRS a means of monitoring taxpayer compliance.⁶³

CONCLUSION

The tax law as it is now only confuses and makes it difficult for the taxpayer to comply with the law. If Congress would not continue with its additive law policy in depreciation, the laws of depreciation would be less cumbersome and therefore easier for the public to comply with. In addition to simplifying the law, Congress and the IRS should educate the public in this area. The public would in turn be more willing to comply and therefore increase compliance from 81 percent to 100 percent.⁶⁴

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⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

APPENDIX A

B purchased a car for \$10,000. B expected the car to last ten years because B does not use it excessively for business purposes. It will only be used for business purposes. B has another car used exclusively for personal use. In ten years B hopes to sell the car for \$500.

Straight-line Depreciation

PURCHASE PRICE - SALVAGE VALUE = BASIS
 BASIS / USEFUL LIFE = DEPRECIATION
 $\$10,000 - \$500 = \$9,500 / 10 \text{ years} = \$950/\text{year}$

Double-Declining Balance

STRAIGHT-LINE RATIO X 2 = RATIO
 $1/10 \times 2 = 1/5$

<u>YEAR</u>	<u>COMPUTATION</u>	<u>BALANCE</u>
1	$\$10,000 \times 1/5 = \2000	$\$10,000 - \$2,000$
2	$\$8,000 \times 1/5 = 1600$	$8,000 - 1,600$
3	$\$6,400 \times 1/5 = 1280$	$6,400 - 1,280$
4	$\$5,120 \times 1/5 = 1024$	$5,120 - 1,024$
5	$\$4,096 \times 1/5 = 819$	$4,096 - 819$
6	$\$3,277 \times 1/5 = 655$	$3,277 - 655$
7	$\$2,621 \times 1/5 = 524$	$2,621 - 524$
8	$\$2,097 \times 1/5 = 419$	$2,097 - 419$
9	$\$1,678 \times 1/5 = 335$	$1,678 - 335$
10	$\$1,342 \times 1/5 = 268$	$1,342 - 268$

SUM-OF-THE-YEARS-DIGITS

DENOMINATOR = $10+9+8+7+6+5+4+3+2+1 = 55$

<u>YEAR</u>	<u>COMPUTATION</u>
1	$\frac{9}{55} \times 10,000$
2	$\frac{8}{55} \times 10,000$
3	$\frac{7}{55} \times 10,000$
4	$\frac{6}{55} \times 10,000$
5	$\frac{5}{55} \times 10,000$
6	$\frac{4}{44} \times 10,000$
7	$\frac{3}{55} \times 10,000$
8	$\frac{2}{55} \times 10,000$
9	$\frac{1}{55} \times 10,000$
10	- 0 -

ACRS

<u>YEAR</u>	<u>COMPUTATION</u>
1	
2	
3	

MACRS

<u>YEAR</u>	<u>COMPUTATION</u>
1	
2	
3	
4	
5	

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