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## Senate Finance Chair's Accounting-Related Reform Proposals Would Repeal Favorable Provisions

On November 21, 2013, Senator Max Baucus (D-Mont.), Chairman of the Senate Finance Committee, released a Staff Discussion Draft containing tax reform proposals relating to several accounting-related provisions of the Internal Revenue Code. With a stated objective of simplifying the tax accounting rules and making them more uniform among taxpayers in different industries, the proposals would repeal or change a number of favorable provisions of the Code. Among the discussion draft's more significant proposals are:

- Repeal of MACRS and bonus depreciation.** Citing outdated assets classifications, the discussion draft would replace the current accelerated depreciation rules of the Modified Accelerated Cost Recovery System (MACRS) and traditional individual asset-based depreciation with a mass asset-type depreciation structure that classifies almost all tangible personal property (except computer software) into one of four pools. Depreciation would be computed annually as a fixed percentage of the pool balance: 38 percent for Pool 1, 18 percent for Pool 2, 12 percent for Pool 3 and 5 percent for Pool 4. Each year, the amount of the pool would be increased by new purchases and reduced by the proceeds of disposition of assets within the pool. Real property would be depreciated on a straight-line basis over 43 years, rather than 39 years as under current law. The new system, like MACRS, would result in larger depreciation deductions in the earlier years of asset lives, and should reduce administrative complexity. The tradeoff, however, will be longer recovery periods for many depreciable assets, as the new system is intended to better track their economic depreciation than does MACRS.
- Changes to amortization rules.** Similarly, the period for recovery of costs relating to certain acquired intangible assets under Section 197, as well as for business startup and organizational expenses, would be extended to 20 years from the 15 years allowed under current law. Mortgage servicing rights would no longer be excepted from Section 197.
- Repeal of the LIFO method and lower of cost or market inventory methods.** Taxpayers, including many retailers, that have used LIFO for many years likely have accumulated "layers" of inventory cost deductions that would have to be recaptured (as additional income). For many taxpayers the income inclusion would be quite large. Taxpayers would be allowed to take the income into account over an eight-year period.
- Repeal of Section 1031's "like-kind exchange" gain deferral.** The discussion draft speculates that the impact of repeal on many taxpayers may be ameliorated by the new mass asset-type depreciation system for tangible personal property. That will not be true, however, in the case of taxpayers exchanging real property, who are among the most frequent users of Section 1031. Further, an entire industry of businesses serving as qualified intermediaries for such exchanges would be adversely impacted.
- Limits on use of the cash method.** Use of the cash method of accounting would be prohibited for all businesses except those with gross receipts of

\$10 million or less. This provision would affect many partnerships, S corporations and personal service corporations that currently are permitted to use the cash method regardless of their size.

- **Repeal of current expense deductions for R&D.** Research and development costs would no longer be currently deductible, but instead would have to be capitalized and amortized over five years.
- **Limits on deductions for advertising expenses.** Taxpayers would be permitted to deduct currently only 50 percent of advertising costs; the remaining 50 percent would be capitalized and amortized over five years.
- **Repeal of percentage depletion.** Percentage depletion, currently allowed under Sections 613 and 613A, would be repealed, although Section 611 cost depletion would remain in place.
- **Provisions affecting home and shipbuilders.** Taxpayers would be required to use the percentage of completion method, rather than the completed contract method, for many home construction contracts and ship construction contracts.
- **Repeal of several other favorable industry-specific provisions.** Taxpayers in a number of industries, including oil and gas, mining, farming, TV and film, and others would be affected by the repeal of various favorable provisions regarding certain costs specific to their businesses. Current deductions for the following costs are repealed in their entirety without any new special provision for capitalization (and recovery) of costs:
  - clean-fuel vehicles,
  - qualified refiner property,
  - energy-efficient commercial building property,
  - qualified advanced mine safety equipment,
  - farmers' fertilizer purchases,
  - certain TV and film production,
  - reforestation and
  - pollution control facilities;

The current expensing of the following costs would be repealed, but taxpayers would be allowed to recover capitalized costs over a newly provided amortization period:

- costs for certain geological and geophysical activities, qualified tertiary injectants, intangible drilling, and mining and exploration development, all of which would be amortizable over five years; and
- soil conservation and endangered species recovery expenditures, which would be amortizable over 28 years.

## Observations

Sen. Baucus, and Rep. Dave Camp (R-Mich.), chairman of the House Ways & Means Committee, have now each released discussion drafts on tax law changes, signaling that the two chairmen, at least, are serious about tax reform. However, there continues to be significant differences between Republicans and Democrats as to the direction of tax reform, and no clear path forward (substantively or procedurally)

has emerged. Even if tax reform is revenue-neutral overall (an issue that is far from settled), the push to reduce the corporate rates will force lawmakers to look to other Code sections for additional revenue. This need for additional revenue, under even the most conservative scenarios, is likely to involve changes to the tax accounting and cost recovery rules. Thus, Sen. Baucus's tax accounting reform proposals must be considered seriously.