

## To Guideline or Not to Guideline

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# TO GUIDELINE OR NOT TO GUIDELINE\*

CLEMENT J. SCHWINGLE\*\*

Revenue Procedure 62-21<sup>1</sup> came into existence on July 11, 1962. Although murmurs of change had been heard as far back as January 1962, it was the actual release of the Procedure which emphasized the relative impact of guideline class, class life, dies, jigs and fixtures, fully depreciated assets, and composite life change under the sum-of-the-years-digits (SYD) method of depreciation. The subject has been somewhat clarified by ensuing Technical Information Releases (TIR's), the many writings and discourses on various phases of the subject, and the thinking and studying of its problems and significance.

## *Broad Objective*

The purpose of Revenue Procedure 62-21 is to make available a simple approach to depreciation, with consistency of lives within classes of facilities, initially liberalized over a fair transition period to encourage reinvestment, and susceptible to an established check medium through reserve ratios. While reserve ratio tests have been used for many years, they lacked consistency and published uniform procedure.

The Procedure offers an initial three-year moratorium and subsequent freedom from life change, provided that reserve ratios comply or, if they are high, reflect a decrease from the indicated allowable ratios in any one year of a three-consecutive-year period.<sup>2</sup>

## *Current Results*

Fifteen months after publication of the Procedure, what are its effects and where do they point? What were its effects on business generally and on individual enterprises specifically? Who went on guidelines; who didn't; and what were the reasons for or against adoption?

The Procedure allows an average composite life for machinery and equipment of twelve years, compared with the average lives which had been used of fifteen years and the average life allowed by Bulletin "F" of nineteen years. Statistics show that many taxpayers took advantage of these shortened allowable lives and other procedural provisions. Total corporate depreciation provisions in 1962 amounted to 10 per cent more than such amounts would have been in the absence of the new guidelines.<sup>3</sup> Depreciation charges for manufacturing and mining cor-

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\* This article is based on a lecture given at the Fourteenth Annual Marquette University Institute on Taxation.

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<sup>1</sup> 1962-2 CUM. BULL. 418.

<sup>2</sup> 1962-2 CUM. BULL. 436.

<sup>3</sup> OFFICE OF BUSINESS ECONOMICS, U.S. DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS 4 (1963).

porations alone totaled \$13.6 billion for 1962—\$1.7 billion higher through the use of guidelines than they would have been without them. The total increase in provision for all corporations, due to guidelines, was \$2.4 billion, yielding a tax reduction of \$1.2 billion. Still, there were many corporations who elected to compute depreciation as they had done previously, not taking advantage of the Procedure.

While the total number of corporations using guidelines accounted for \$14.8 billion, or about 54 per cent of the \$27.7 billion total corporate 1962 depreciation allowance, there were still \$12.9 billion claimed by those corporations not using guidelines.<sup>4</sup>

There were many factors to be weighed by management of each of these corporations before deciding how to compute depreciation provisions for 1962, and these decisions must also be considered in planning for the future.

One of the primary factors would be the possibility of dollar advantage in immediately increased cash flow. Usually, the largest initial provision will be gained by computing depreciation on a composite or multiple asset basis; the inclusion of fully depreciated assets in the base increases the allowable provision under the straight line and SYD methods. The existence in the accounts of many fully reserved assets provides an incentive to adopt a multiple asset basis under the guidelines.

Of course, the longer the lives currently in use in comparison with the guideline lives, the more pickup there will be. Indeed, those larger firms whose depreciation provisions have come under closer scrutiny by revenue agents than those of smaller firms, thus forcing them over the years to use longer service lives, probably enjoyed a larger percentage pickup than their smaller brothers. The increase in depreciation charge for large manufacturers (those with over \$100 million in assets) was about 18 per cent of their potential deduction without guidelines, whereas for companies with from \$10 to \$100 million, and for those with under \$10 million, the pickups were 15 per cent and 7 per cent respectively.

Since the machinery and equipment category is the most significantly affected by the new guideline lives, non-manufacturing companies, where structures are the bulk of the assets, might not find quite the same magnitude of advantage as the manufacturing companies.

Approximately one-half of the companies who did not go on guidelines were using service lives about equal to or less than guideline allowable lives.<sup>5</sup> For some companies, depreciable assets were too insignificant or the advantage was not great enough to warrant the effort

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<sup>4</sup> *Id.* at 4 (Table 1).

<sup>5</sup> *Id.* at 5 (graph).

<sup>6</sup> *Id.* at 6-7 (graph).

involved in changing from their present system for tax purposes, while others felt that further study was needed. This reluctance to expend the effort to make the necessary study may apply more to the smaller rather than the larger corporations. In this connection, it is the author's opinion that all companies would be well advised to adjust their present systems to an extent that will permit judgment as to whether the lives used are equal to or greater than the Procedure allowable lives.

Also, it seems that all taxpayers will be required to have cost and reserve segregated by major guideline classes and depreciation methods within those classes.<sup>7</sup>

There are those who did not go on guidelines because they did not approve of faster write-offs than their experience would justify in principle, those who preferred their individual item control system to a composite system, those who did not want to destroy the comparability of their records between accounting periods, those who wished to continue procedures established by regulatory bodies, and finally those who simply were not making enough profit to absorb the greater expense.<sup>8</sup>

Another group, comprising about 10 per cent of the companies who did adopt the guidelines, did so even though their total provision was some \$50 million below their potential provision computed as they had done previously. This position might well be supported where current lives are shorter than guideline lives, but the prospect of substantial fully depreciated assets lies immediately ahead.

#### *Position by Classes*

The advantages or disadvantages of using composite procedures and guideline lives for the principal classes of assets might logically be examined at this point.

*Land Improvements.* These usually represent relatively small investment, and average lives in use do not differ greatly from guideline lives; hence, there is little or no advantage.

*Railroad Sidings.* Since railroad sidings are not separately mentioned in the Procedure, they are assumed to be included with the machinery and equipment class.

*Buildings.* Guideline lives are too long for modern plants, considering the high investment for mechanical building equipment such as electric lighting, heating and air conditioning, and plumbing. The proportion of investment in building equipment in relation to total building cost has increased sharply over the past twenty years. Rapid improvement and resulting obsolescence in these areas suggests lives much shorter than any over-all guideline life.

It is understood that Bulletin "F" lives for buildings were held over pending further review when and if Congress changes the current

<sup>7</sup> 1962-2 CUM. BULL. 430.

<sup>8</sup> OFFICE OF BUSINESS ECONOMICS, *op. cit. supra* note 3, at 6-7.

basis for taxation of gain on the sale of real estate.<sup>9</sup> For the present, facts and circumstances appear best adapted to the determination of depreciation for buildings.

*Machinery and Equipment.* Most of the benefits, if any, will be for this class. As a broad average for manufacturing corporations, this class represents about two-thirds or more of the total plant investment; and the guideline lives permitted for the three-year moratorium—and longer if qualified—are generally substantially shorter than those in Bulletin "F" or those in prior use. A further very important factor is that fully depreciated assets, if any, are usually in this account to the extent they exist in use. Their addition in multiple asset accounts, where an equivalent rate is applied to gross cost, obviously increases the provision over any prior item or lapse schedule method where these fully depreciated assets were excluded.

*Special Purpose Structures.* According to the Procedure, these take the same life as machinery and equipment and have been fairly well defined.<sup>10</sup> As a practical matter, this group may be intended to embrace only those structures which are integral with the mechanical facility. Typical of such are coal washers, sintering plants, or similar structures where the major structural members are mainly machine supports. The test mentioned is whether the economic life of the structure is definitely integrated with that of the equipment facility it houses.<sup>11</sup> This rules out structures which, although special in purpose, permit replacement of equipment without material change in, or retirement of, structural elements.

*Office Furniture, Fixtures, Machines and Equipment.* Generally, this is advantageous, as average life is usually about fifteen years and guideline life ten years.<sup>12</sup> Here again, fully depreciated assets can be a factor in increasing the benefit.

*Transportation Equipment (Automobiles).* The advantage here depends upon the actual period of use by the taxpayer. If the time is relatively short, depreciation may have to be stopped because of salvage. If average lives are used, problems may arise in determining unrecovered cost on trade-ins. Another factor, due to short term turnover, is that gain contributed by depreciation since January 1, 1962, is subject to tax as ordinary income.<sup>13</sup> Item lives based on actual experience appear more logical for this class.

*Dies, Jigs, Fixtures, Molds, Tooling, and Other Similar Special Facilities.* There is no guideline life, and depreciation must be judged and supported by facts and circumstances.

<sup>9</sup> The Revenue Act of 1964 has since changed the basis for taxation of gain on the sale of real estate by adding §1250 to the INT. REV. CODE OF 1954.

<sup>10</sup> 1962-2 CUM. BULL. 419-20, 479-80.

<sup>11</sup> *Ibid.*

<sup>12</sup> 1962-2 CUM. BULL. 419.

<sup>13</sup> INT. REV. CODE OF 1954, §1245(a).

*Options and Their Relative Effect*

The taxpayer is required to advise whether he wishes his depreciation claim to be judged by Revenue Procedure 62-21 or on a facts and circumstances basis.<sup>14</sup> He can make different elections for different classes of assets.

If judged by Revenue Procedure 62-21, the taxpayer is required to group assets according to the guideline classes.<sup>15</sup> He can compute depreciation on unit, group, or composite basis; and as long as total depreciation claimed is not greater than that allowable by the Procedure, the depreciation claimed will be accepted, at least for the three-year moratorium period.<sup>16</sup>

If judged on a facts and circumstances basis, reserve ratio tests can be applied immediately (not applicable to buildings) and depreciation will be judged accordingly.<sup>17</sup> However, if the depreciation claimed is less than that allowable by guideline lives, or if the other tests mentioned in the Procedure are met, the three-year moratorium applies.<sup>18</sup>

Excessive increased depreciation will result in lower taxes now and increased taxes in the future, payable over the actual life of the assets; in other words, it results in an interest-free loan. This benefit probably has motivated some companies to take advantage of the guideline lives under the three-year moratorium.

While the Service, in TIR Number 503, has warned against adopting multiple accounts and guideline lives unless the taxpayer intends to conform his retirement and replacement practices thereto, it would appear that disciplinary increases in lives are deferred until the expiration of the three-year period.

For many companies, the Procedure has provided the opportunity to take what their foresight supports as a realistic depreciation without battling with the Internal Revenue Service. In these cases, there seems little support for not recognizing the revised depreciation and reflecting it in the corporate statements as well as in the tax returns. If the allowable tax depreciation is considered excessive, it would seem that corporate statements should reflect a realistic depreciation.

It should be understood that, except for new properties, once the three-year moratorium has passed, the key to the Procedure and to all tax depreciation policy related to it is the reserve ratio test. A further point for the future is that the tests are clearly set forth with built-in corrections for growth, whether through uniform or inflated dollars. Only turnover reflected by capitalized replacement measures the equivalent actual life.<sup>19</sup>

<sup>14</sup> 1962-2 CUM. BULL. 430-31.

<sup>15</sup> 1962-2 CUM. BULL. 430.

<sup>16</sup> 1962-2 CUM. BULL. 431.

<sup>17</sup> 1962-2 CUM. BULL. 433.

<sup>18</sup> 1962-2 CUM. BULL. 431-34.

<sup>19</sup> 1962-2 CUM. BULL. 435-37.

It must always be recognized that the reserve ratio test is based on the past. To the extent that characteristics affecting life expectancy for current acquisitions vary either way from those for past acquisitions, the reserve ratio approach may be in error. Increasingly rapid technological developments urge vigilance in these areas in order that depreciation reflect facts and circumstances, rather than history.

In any event, prudent depreciation policy and the significance of adequate corporate and tax depreciation make it imperative that facts and circumstances be at hand, even though guideline lives appear at the time to be most advantageous.

#### *Conversion of Double Declining Balance to Straight Line*

The Revenue Act of 1954 permitted conversion from the double declining balance (DDB) method of depreciation to the straight line method at any time the taxpayer desired.<sup>20</sup> At about the midpoint of life, it usually becomes advantageous mathematically to so convert if the life has not changed and there is no expected salvage. The regulations, however, state that the remaining life must be redetermined and salvage considered.<sup>21</sup>

Converting to straight line under guideline procedures involves some contradictions. The guideline life is fixed and cannot be changed except as provided in the Procedure, and no part of the costs of a class can be segregated, except that costs amortized under certificates of necessity are excluded.<sup>22</sup> As the regulations provide that the remaining life must be redetermined when converting, it would appear, on one hand, that depreciation thereafter would have to be judged on a facts and circumstances basis, and the benefit of the three-year moratorium would be lost; on the other hand, some writers imply that mere transfer of cost and accrued reserve is possible with absorption into the straight line group.

#### *Varying Rates Within Classes*

In studying the various approaches to grouping that are permissible under the Procedure, there might appear to be some advantage to separate group lives within a guideline class, particularly where the later additions are on a DDB or SYD basis. This advantage appears transient as, if the group identities are continued, tests will be made on this premise, and the advantages of continuing fully depreciated assets in the base under the composite will be lost.

#### *SYD Assets*

For SYD assets, the Procedure provides that an allowable remaining life be computed when the prior life is changed to guideline life.<sup>23</sup>

<sup>20</sup> INT. REV. CODE OF 1954, §167(e).

<sup>21</sup> Treas. Reg. §1.167(e)-1(b) (1956).

<sup>22</sup> 1962-2 CUM. BULL. 439.

<sup>23</sup> 1962-2 CUM. BULL. 480 (Question 58).

This is based on a straight line method computation involving the use of the gross cost.

Under the SYD method, the Procedure and multiple asset account approach offer a distinct advantage, as the shorter remaining life develops when fully depreciated assets exist and are included. An example follows:

	<i>Cost</i>	<i>Unrecovered Cost SL Method</i>	<i>Unrecovered Cost SYD Method</i>
Not fully reserved	\$10,000	\$8,000	\$6,400
Fully reserved	2,000	-0-	-0-
	<hr/>	<hr/>	<hr/>
Total	\$12,000	\$8,000	\$6,400

Assuming a guideline life of ten years, the allowable straight line provision would be:

Not fully reserved	\$1,000
Fully reserved	200
	<hr/>
Total	\$1,200

The allowable remaining life would then be:

For the not fully reserved  $\$8,000 \div \$1,000$  or 8 years

For total of fully reserved  
and not fully reserved  $\$8,000 \div \$1,200$  or 6.7 years

Except for the special privilege for any taxable year beginning in 1963, SYD assets can be changed only by permission.<sup>24</sup> It seems likely that under the regulation augmenting the 1962 law when issued, the change may require inclusion of all SYD acquisitions to date of change. Advantages will then depend on ages and the procedures set forth in the regulations.

Considering the matter as a whole, however, it would seem far better to elect to be judged on the Procedure initially, thus enjoying the minimum penalty for the second three years if tests are not met and avoiding the possibility of facts and circumstances after the three-year moratorium.

Examination for the first three years will be on the premise of life used related to guideline life.<sup>25</sup>

#### *Examples*

Analysis, actions, and motives of several actual companies are examined below.

Company A, with \$39 million of machinery and equipment in one guideline life class, computed an increase of \$800,000 over a prior provision of \$3.6 million based upon the life previously used—an increase

<sup>24</sup> INT. REV. CODE OF 1954, §167(e).

<sup>25</sup> 1962-2 CUM. BULL. 436.

of 22 per cent. Depreciation was determined by the straight line method for the older assets and by the DDB and SYD methods for the assets eligible.

There were about \$2.7 million of fully depreciated assets, and about \$1.9 million of assets which had been converted from the DDB method to the straight line method. As of the end of the 1961 year, the gross cost of the straight line assets was \$18 million, and that of the accelerated assets, \$21 million.

The increase for the straight line assets was \$635,000, or 64 per cent more than that attributable to this group under the prior method; for the accelerated, \$165,000, or a 6 per cent increase. The reason for the larger increase on the straight line assets was due to the removal of penalty rates imposed on the older assets and the inclusion of assets fully depreciated, but excluded in the prior method.

At the revised depreciation provision, the straight line asset group will become fully reserved in about four years. The average life of the newer assets being depreciated by accelerated methods was not changed materially. The weighted average life previously used for the class was sixteen years, and the allowable guideline life was twelve years. Obviously, close to twelve years was being used for the newer assets.

Projecting the effect of the revision into the future, it would appear that reserve ratios will increase each year for the first three years, obligating a life extension in the fourth year to fifteen years (12 years plus 25% = 15 years). This may prove to be a realistic life for this class. If the facts are expected to ultimately justify a shorter life, the company may wait until reduced reserve ratios so justify, or an analysis of facts and circumstances may be made to support a shorter life at an earlier date.

Company *A* decided to claim the additional depreciation permitted by the Procedure for tax purposes, but not for corporate purposes, electing instead to continue the combination unit and group lives previously used. The additional capital for facilities investment provided by the interest-free loan was the deciding factor.

Company *B* could, if Revenue Procedure 62-21 were to be adopted for its machinery and equipment and office furniture and equipment classes, have an increase in the annual depreciation provision from \$970,000 to \$1,300,000, or 34 per cent. The gross cost for these accounts was \$6,000,000.

About one-half of this increase was related to straight line assets, the balance of assets being depreciated by the SYD method. The straight line assets would become fully reserved in three-and-one-half years at the revised provision.

Company *B* decided not to take advantage of the allowable increased depreciation. Two interacting reasons motivated this decision. First,

they maintained a detailed property record in which depreciation was computed on the basis of unit lives, adjusted as required to reflect changing conditions. This record had proven to be a valuable management tool in financial planning, replacement decisions, and other corporate matters, besides providing facts to substantiate the depreciation provisions. Management felt that these depreciation provisions were factually determined and well controlled, and they were reluctant to lose this control for what appeared a transient tax saving.

The second reason was that in their judgment the guideline lives were shorter than expected replacements would justify. The company desired but one basis, and the increased depreciation for corporate purposes would distort product costs.

Company C is an integrated business segregated into seven different industry classes in Revenue Procedure 62-21. The gross cost of the production equipment totaled \$330 million, and use of guideline lives indicated an increase in depreciation of almost \$5 million, or 31 per cent.

The weighted prior average life used was nineteen years, and the weighted guideline life was fourteen years. About 50 per cent of the costs were depreciated by the straight line method and the balance by the SYD method. The average life in use for the newer costs was about sixteen years, and for the older assets, twenty-two years.

The large amount of older costs is brought about because a substantial proportion of the production equipment had been rehabilitated and modernized through expense, rather than treated as capitalized replacements. The age of the capitalized costs therefore indicated a long life. The probabilities are that, in the future, modernization will be achieved through replacements rather than through rehabilitation, and a shorter future average actual life will result.

The company elected to take all the depreciation allowable by Revenue Procedure 62-21 for tax purposes, but to continue corporate depreciation on the prior basis. The company had a detailed property record and computed depreciation on the basis of unit lives adjusted for changing facts and circumstances. They recognized that in possibly six years tax depreciation might have to be adjusted and reduced. Because full data will be available from the corporate property record tabulating cards, the allowable depreciation for tax purposes or any adjustment can be determined readily.

#### *Item Depreciation*

The author does not subscribe entirely to the seemingly negative viewpoint implied in the Procedure with regard to item depreciation.<sup>26</sup> Properly set up, this has definite advantages in many instances. For companies where obsolescence is a major factor, item accounting pro-

<sup>26</sup> COMMERCE CLEARING HOUSE, NEW DEPRECIATION RULES WITH EXPLANATION A18 (1962).

vides a better measure of depreciation and is susceptible to much better control than composite accounting. These companies face the problem of determining special losses which, with composite accounts and average rates, can easily result in difference of opinion as to the rate to be used in measuring accrued depreciation for computing the claim for special loss.

It would seem best, then, for companies whose business suggests the likelihood of sudden change to give serious consideration to continuing item records if they have them, at least for corporate purposes. Such companies, in any event, would do well to examine their position before switching to composite depreciation for tax purposes. Measurement as to compliance with the guideline lives or class lives, supported by test with the asset reserve ratios, can always be accomplished with these item records and with a minimum of effort.

### *Conclusions*

Revenue Procedure 62-21 is, in this author's opinion, a definite step forward, properly liberal in its context, and, with reasonable interpretation, susceptible to fair and not unduly cumbersome administration. In this connection, it must be remembered that any change now must reckon with the accelerated methods, and this necessarily presents some complications. However, these are largely in the clerical area and do not comprise adequate grounds for questioning the intent, efficacy, or advantages of the Procedure. The general attitude implied by the Revenue Procedure and the subsequent TIR<sup>27</sup> dealing with dies, jigs, and fixtures clearly indicates a spirit of understanding on the part of the Treasury which the author hopes will be followed in its administration.<sup>28</sup> Questions will arise, but a fair appraisal of the whole situation suggests that these will not be significant as compared with the audit problems which have arisen in the past, particularly those of 1960 and 1961.

It seems that the former concept of lives or rates was not in keeping with the rapid rate of improvement and development in our industrial facilities. It is fallacious to measure lives for the future entirely in terms of the past. The liberalized lives and structures of the Procedure permit some catch-up in this area, but only temporarily, as facts and circumstances are the ultimate measure.

There is no question but that many plants are over-age, more so than is realized, and new concepts of depreciation and recovery of capital are needed. The significance of depreciation in providing cash flow is important, but good management also dictates more rapid re-

<sup>27</sup> 1962-2 CUM. BULL. 420.

<sup>28</sup> See, *e.g.*, the statement by Mortimer M. Caplin, Commissioner of Internal Revenue, in connection with the release of new depreciation guidelines and rules on July 11, 1962, in COMMERCE CLEARING HOUSE, *op. cit. supra* note 26, at A21.

covery of capital regardless of taxes, and a correspondingly vigorous replacement policy.

The reserve ratio tests should not be viewed as unduly burdensome and certainly, as stated earlier, there is now a uniform tool for all to use on a consistent basis. If any element of the Procedure can be improved, the Treasury Department has stated that it will listen. IRS administration, of course, is important, but here again pressure has been alleviated by the three-year moratorium.

The Procedure offers much, and its adoption in the majority of cases is very much in the interest of the national economy and progress.