A number of people have predicted that Congress will include depreciation reform within its next package of tax legislation. The present system of depreciation was created in 1981, so it is perhaps time for Congress to examine depreciation. The most notable feature of the 1981 legislation was its requirement that an asset be placed into one of eight categories. These categories stipulate the time over which a business can recover through depreciation the cost of an asset. Six of these categories were for ordinary commercial assets, which could be depreciated over 3, 5, 7, 10, 15, or 20 years. The final two categories were for real estate: 27.5 years for residential real estate and 39 years for commercial real estate.

A second feature of the 1981 legislation was the selection of a method by which depreciation must be computed. For assets up to ten years of life, the method of double declining balance is used. For assets in the 15 and 20-year categories, 150 percent declining balance must be used. For real estate, only straight-line depreciation is allowed. There is no need to get into the mechanics of computing depreciation. It is necessary only to recognize that different methods of depreciation will affect the present value of a firm’s tax liabilities. A firm will have a lower tax liability if it can use double declining balance than if it must use 150 percent declining balance. It will face the highest tax liability of all if it is forced to use straight-line depreciation.
The time period over which cost must be recovered also affects tax liability. A firm will bear a lower tax liability if it can depreciate an asset over five years than if it must take seven years. Both the method by which depreciation is computed and the period of time over which an asset must be depreciated can affect a firm’s measured net income and, hence, federal tax liability. The same pattern of cash flows into and out of a business during a year will generate different computations of net income, depending on how assets are depreciated. Changes in the tax treatment of depreciation can thus create significant changes in tax liability.

It is no wonder that depreciation is one of those obscure topics that generates intense interest among the affected participants. Depreciation is an obsolete remnant of an earlier, slower-moving age. Depreciation fits nicely within a picture of some static, unchanging commercial environment. A firm buys some equipment, uses that equipment until it wears out, and then replaces it. The cost of the equipment is depreciated over the life of the asset, less any salvage value.

The key feature of contemporary commercial life is innovation through competition within an increasingly global marketplace. Such competition can quickly render obsolete previous purchases of assets. Obsolescence and not depreciation is the economically relevant consideration in our intensely competitive world. A firm might spend $50,000 on computer software that allows its sales people to keep track of their customer’s needs and requirements. The firm would now be allowed to recover that cost over five years.
But what if market competition generates superior software in two years? The firm faces a dilemma. Its old software is no longer competitive in the marketplace. Yet through depreciation the firm is being taxed as if the software is still making a valuable contribution to the firm’s income. The reality, however, is that the firm will lose customers unless it adopts new software. Obsolescence through competition has overwhelmed former notions of static depreciation. The depreciation that comes with aging is economically irrelevant. What is economically relevant is the obsolescence that comes with competition.

The more static the society and the slower the pace of competition, the less the damage that might be attributed to any particular set of depreciation provisions. With the increasing globalization of competition and the quickened pace of progress that has resulted, the economic life of an asset is governed by the pace of competition and the obsolescence that comes with it.

There are plenty of good reasons to abolish business taxation because of the double taxation that results, as income is taxed both when it is earned by the business and taxed again when it is distributed as dividends to shareholders (and also when retained earnings promote capital gains). So long as we retain some form of business taxation, however, there is good economic reason to adopt commercial obsolescence in place of static depreciation as the framework for computing business income. Among other things, this would allow businesses fully to expense their purchases of assets should they choose to do so.