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DEPRECIATION IN THE COURTS

Depreciation is a seemingly simple concept. Law students usually get their only contact with depreciation in their tax courses. There they learn that depreciation is a deduction in figuring taxable income and they are taught the various depreciation methods. Beyond this, it is generally assumed that depreciation has little relevance or that it is part of that body of understanding called common knowledge.

Accounting students learn about depreciation in their first accouting course. They are taught that when a company purchases a depreciable asset, it is actually purchasing a "quantity of usefulness"[1] that will increase production over a period of time. Depreciation is merely the process of charging the cost of this "quantity of usefulness" to the time periods benefited by the asset's use. The year-end adjusting entry which accomplishes this is a debit to Depreciation Expense and a credit to Accumulated Depreciation.[2] In journal form the entry would look like this:

Depreciation Expense	XXX	
Accumulated Depreciation		XXX

The dollar amount of depreciation that would go into the entry would be a function of four factors: the cost of the asset, its useful or productive life, its salvage value, and the depreciation method used.[3] Thus, the asset's depreciable base (cost minus salvage value) is expensed over its useful life in accordance with the formula of the depreciation method used. For instance, if an asset cost $650, had a useful life of six years, a salvage value of $50, and the straight line method was used, the above journal entry would be made each year for the next six years with a $100 figure inserted in it.[4] The debit to Depreciation Expense would appear on the income

1. PYLE & WHITE, FUNDAMENTAL ACCOUNTING PRINCIPLES 311 (6th ed. 1972).
2. *Id.* at 63.
3. The more frequently used depreciation methods used today include: the straight-line method, the units-of-production method, the declining balance method, and the sum-of-the-years'-digits method.
4. The formula for the straight line method is $\frac{\text{cost - salvage value.}}{\text{useful life in years}}$
In this case, when figures are inserted the formula becomes:
$\frac{650 - 50}{6} = 100.$

statement along with the other expenses for the year, while the credit to Accumulated Depreciation would be shown on the balance sheet as a deduction from the cost of the asset.

However, for being such a simple concept, depreciation is constantly being misconstrued. The courts have often times twisted the purposes and functions of depreciation into curious forms bearing little resemblance to reality. This "body of common knowledge," it turns out, is actually a misconception in most cases.

THE ACCOUNTANT'S THEORY OF DEPRECIATION

From an accountant's point of view, the most widely held concept of depreciation is the one set forth by the American Institute of Certified Public Accountants (AICPA). It states that:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.[5]

In other words, depreciation is the process of spreading the initial or historical cost of a capital asset over the several periods which will benefit from the acquisition of the asset. It is not a process of trying to place some market value on an asset, nor is it a process of creating a fund to replace the asset when its usefulness is used up. The accountant perceives depreciation as merely a cost spreading device and nothing more.

This concept or definition of depreciation is based upon two of the principles which form the basic foundation of accounting theory: the cost principle and the matching concept.[6] The cost principle holds that, with very few exceptions,[7] assets are valued at their historical or acquisition cost.

5. AICPA, ACCOUNTING TERMINOLOGY BULLETIN NO. 1 25 (1961).
6. PYLE & WHITE, *supra* note 1, at 565-70.
7. An example of an exception to the cost principle would be the donation of an asset from someone not associated with the company. If this happened, the asset would be valued on the company's books at its fair market value not at its cost which would be zero.

Thus, in the case of capital assets, this would mean that depreciation would have to be based only upon the acquisition cost. The matching concept says that expenses, such as depreciation, should be matched to the periods which benefited by their being incurred. It is the interplay of these two principles which makes depreciation a system of allocating the cost of a capital asset over its useful life.

It should be noted that the accounting definition does not tell us *how* to allocate the cost of the asset over its useful life. Any "systematic and rational manner" will suffice. The AICPA has always held that straight-line and similar methods met this test. Then in 1954, immediately after the Internal Revenue Code permitted the declining balance and the sum-of-the-years-digits methods of depreciation for tax purposes,[8] the AICPA approved these so-called accelerated methods as also meeting the "systematic and rational" criteria for accounting purposes.

The argument for the use of these accelerated methods was based upon the premise that the benefits derived from the use of an asset are generally greater in the earlier years than in the later years. As time goes by, output from an asset may decrease because of obsolescence, greater repairs, and more down time.[9] Thus, the argument goes, because the "quantity of usefulness" is greater in the earlier years, depreciation should also be greater in these years. There is, however, no reason to assume that the economic benefits of an asset decline in the ratio given by the accelerated methods.

Critics have argued that by sanctioning the accelerated methods, the AICPA has gotten away from its concept that depreciation is nothing more than a cost apportionment based on time. By tying the amount of depreciation expensed to the amount of benefit derived, they argue that a new concept similar to valuation has been added and that this new concept is a total departure from the idea that depreciation "is a process of allocation, not of valuation."[10]

8. INT. REV. CODE OF 1954, § 167(b).
9. MEIGS & JOHNSON, ACCOUNTING 411 (2nd ed. 1967).
10. SOLOMON, LAWYER'S HANDBOOK OF ACCOUNTING THEORY AND PRACTICE 27 (1971).

The AICPA, however, has steadfastly held that the accelerated methods are merely alternative ways to allocate cost, that they are not used to value assets, and that they do not violate their definition of depreciation.[11]

There has also been a vocal minority of the accounting profession who would change the AICPA's view of depreciation because they feel that it is unrealistic in times of rising prices. They would make depreciation totally a valuation process by using current replacement or appraisal costs instead of historical or acquisition costs as the basis for depreciation. They argue that this would give a better indication of the true "expense" incurred in the economic use of an asset.[12]

There has been, however, no massive force within the accounting profession to change its accepted definition of depreciation. The minority view of tying depreciation to valuation has been looked upon as too radical and too far reaching to be given much consideration. The concept that depreciation is nothing more than a cost spreading device is too deeply entrenched within accounting theory to be changed within the foreseeable future.

THE COURT'S VIEW OF DEPRECIATION

The courts have been generally called upon to give their views on depreciation in two separate classes of cases: rate making cases, and income tax cases. Their views have differed depending on the type of case involved.

A. The Rate Making Cases

The majority of the decisions of the Supreme Court in the depreciation area have concerned public utility company rate cases. Here, the Court has been called upon to determine whether or not the rates established by a governmental regulatory agency are confiscatory. In other words, it has had to determine whether or not a company is being allowed to earn a reasonable profit. Since this concerns the fourteenth

11. AICPA, ACCOUNTING RESEARCH BULLETIN NO. 44 1 (1954).
12. *See, e.g.*, Edwards, *Depreciation Policy Under Changing Price Levels*, 29 ACCOUNTING REVIEW 67-80 (1954).

amendment and the deprivation of property without due process of law, this is a constitutional problem.

A company must be allowed to earn income sufficient to cover its expenses and to return a reasonable profit to its owners. The depreciation issue comes into play in figuring the expenses of the utility. In this regard the Court has changed its position from one of not allowing any depreciation to be taken into the expenses of the company, to one of allowing depreciation based on the replacement cost of the depreciable assets, to the present position of allowing depreciation only on the historical or acquisition cost of the assets.

In the earliest cases in this area, the Court refused to approve the accounting practice of periodically including a depreciation charge in the operating expenses of a public service company. The Court reasoned, "Only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings."[13] As depreciation was not a current outflow of cash, it could not be charged as an expense during the period.

The Court, in 1897, changed this position and established the "fair value" doctrine of *Smyth v. Ames*.[14] In this case, the Court held that the asset basis to be used for rate making purposes was to be the "fair value" of the firm's property. This meant that in most cases rate making was to be based on the replacement cost of assets and not historical cost. Depreciation was also to be based upon this replacement cost. Thus, in times of rising prices, the actual cost of an asset could be less than the total depreciation taken on that asset. Here, the Court was concerned with the ability of the company to restore its property after it had worn out and had become useless. They allowed a company to earn extra income by increasing the depreciation expense so that it could make provisions to replace its assets.

The "fair value" doctrine was followed well into the 1930's. Justice Sutherland gave the reasoning behind this

13. United States v. Kansas Pacific Railway Co., 99 U.S. 455, 459 (1878).
14. 169 U.S. 466 (1897).

doctrine when he stated in *United Railway & Electric Co. v. West*:[15]

> One of the items of expense to be ascertained and deducted is the amount necessary to restore the property worn out or impaired, so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public service. The amount set aside periodically for this purpose is the so-called depreciation allowance. Manifestly, this allowance cannot be limited by the original cost, because, if values have advanced, the allowance is not sufficient to maintain the level of efficiency. . . . It is the settled rule of this Court that the rate base is present value, and it would be wholly illogical to adopt a different rule for depreciation.[16]

At no time, however, did the Court make it clear as to how the "fair value" or replacement cost of an asset was to be determined. The Court did say that certain factors were to be considered, but these ranged from the cost of reproduction[17] to such things as the probable earning capacity of the property and the market value of the company's stocks and bonds.[18] The difficulties in trying to determine "fair value" were tremendous. Governmental agencies who had the responsibilities to determine rates and the accounting methods to be used began to urge that depreciation be limited to historical cost. At the same time, the courts also began to back away from the "fair value" doctrine.[19]

The "fair value" doctrine was finally buried in the Hope Natural Gas Co. case.[20] In this case, the Court said that rates were not confiscatory if they allowed the company "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed . . . even though they might produce ony a meager return on the so-called 'fair value' rate base."[21] The Court based its decision on the fact that reproduction cost was "too conjec-

15. 280 U.S. 234 (1930).
16. *Id.* at 253-54.
17. *Id.* at 253.
18. *Id.* at 251.
19. *See, e.g.*, Lindheimer v. Illinois Bell Tel. Co., 292 U.S. 151 (1934); Dayton Power and Light Co. v. Public Util. Comm'n. of Ohio, 292 U.S. 290 (1934).
20. Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).
21. *Id.* at 605.

tural and illusory to be given any weight" and upon the feeling that a company was getting windfall profits when it could take more expenses than its outlay of cash.[22]

Today the issue appears settled. For rate making purposes, depreciation is to be based only on historical cost. In other words, the courts in this area have adopted the accountant's view of depreciation.

B. Income Tax Cases

When we enter the area of income taxation, the constitutional problems of the rate making cases disappear. Here the courts are strictly guided by the intent of Congress. For it is well-established that deductions from gross income (whether they be depreciation or anything else) are allowed solely as a matter of congressional discretion.[23] This is because the sixteenth amendment has conferred upon Congress the power to lay and collect taxes on incomes. Thus Congress has the sole power to decide how property subject to income taxation will be treated.

The present Code says that the basis for depreciation will be the same as the basis for determining gain on the sale or other disposition of property,[24] the cost of the property (with some unimportant exceptions).[25] A history of the prior Codes shows that this is the way depreciation has always been handled.[26] The basis for depreciation has always been tied to the basis for determining gains on disposition of property and this has always been cost. Thus, unlike the rate making cases, the courts in the income tax area have treated depreciation consistently. The cases are uniform that cost is the only basis for depreciation since this has always been the intent of Congress.

In the income tax area, Congress has consistently adopted the view that depreciation is nothing more than a cost spreading device. This is the same as the accountants' view of depreciation. However, Congress has used this theory of de-

22. *Id.* at 597.
23. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).
24. INT. REV. CODE OF 1954, § 167(g).
25. INT. REV. CODE OF 1954, § 1012.
26. 3A MERTENS, LAW OF FEDERAL TAXATION § 21.278 (1973).

preciation to allow for a recovery of a firm's invested capital. This congressional outlook was reaffirmed when the 1954 Code was adopted:

> Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is used in the business. The annual deduction is computed by spreading the cost of the property over its estimated useful life.[27]

Congress also adds that treatment of depreciation is in conformance with "sound accounting principles."[28]

Thus, the theory today behind depreciation is the same in both the rate making cases and the income tax cases. The courts agree with the accountants that depreciation is merely a cost spreading device. Even though the uses of depreciation in the legal profession (to set rates and to define taxable income) may differ from its uses in the accounting profession (to more accurately report financial conditions), the theory behind depreciation is the same. With the exception of the court's divergence under the "fair value" doctrine, where depreciation was not a cost spreading device but a means to provide for the replacement of assets, the concepts of the two professions have been consistent.

MISCONCEPTIONS ABOUT DEPRECIATION

Courts have frequently misconstrued the theory and reasoning behind depreciation. In the income tax area, where courts should be guided by the intent of Congress, depreciation has sometimes taken on characteristics totally alien to congressional intent. These misconceptions can be divided into three main groups: those concerning valuation, those concerning replacement, and those concerning funds.

A. The Valuation Misconception

Courts have often tried to tie the concept of depreciation to the valuation of an asset. They seem to feel that the amount of depreciation expensed during a period represents the de-

27. H.R. REP. No. 1337, 83rd Cong., 2d Sess. 22 (1954).
28. *Id.* at 23.

crease in the fair market value of that asset. Thus, if depreciation of $1000 is taken during a period, the courts seem to feel that the asset should be worth $1000 less at the end of the period than at the beginning of the period. As the court in *Detroit Edison Co. v. Commissioner*[29] said, "The end purpose of it all [depreciation] is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets."[30] Even the Supreme Court in *Massey Motors, Inc. v. United States*[31] "recognized that this decrease in value—depreciation—was a legitimate tax deduction as [a] business expense."[32]

This belief that depreciation is used to value an asset may stem from the accounting practice of placing an asset on a balance sheet at its cost and then subtracting out the total depreciation taken to date to arrive a a net figure. For instance, a portion of the asset section of a balance sheet may show this:

Building	$200,000
Less: Accumulated Depreciation	80,000
	$120,000

In this example, a building which originally cost $200,000 has had $80,000 worth of depreciation taken on it to date. Some people may interpret the net figure of $120,000 as representing the value of the building. However, the $120,000 figure does not show the value of the building at this point in time; it only shows the amount of undepreciated cost that remains in this asset.[33] In other words, this building still has $120,000 of its cost that can be depreciated in future periods. No attempt is made to value the asset.

In any case, the theory behind depreciation is not to place some market value on an asset. This can readily be seen in today's times of rapidly rising prices. Due to the increased costs of labor and materials, an asset such as a building may

29. 319 U.S. 92 (1942).
30. *Id.* at 101.
31. 364 U.S. 92 (1960).
32. *Id.* at 96.
33. PYLE & WHITE, *supra* note 1, at 317.

actually increase or appreciate in value as time goes along. Yet, even if an asset has appreciated in value, an entry recording the depreciation expense for the period will still be made. This entry will reduce the net figure of the asset on the balance sheet, and it will also form the basis for a depreciation expense deduction that will be taken and allowed in figuring taxable income.

Depreciation is totally unconcerned with fluctuations in the market value of an asset.[34] Since depreciation is merely a cost spreading device, later changes in the value of an asset are of no relevance.[35]

B. The Replacement Misconception

Courts have sometimes tried to introduce the replacement concept of depreciation into income tax cases. Courts, in this area, have failed to distinguish between the rate making cases and the income tax cases. They forget that the reasons behind depreciation may differ depending on the type of case involved. One class of cases deals with constitutional issues while the other deals with the discretionary power of Congress.

It must be remembered that, today, depreciation is treated the same under both kinds of cases. The replacement theory of depreciation was used under the "fair value" doctrine for a period of about fifty years in the rate making cases; yet the courts have been oblivious to the fact that the *Hope Natural Gas Co.* case ended the replacement theory as far as rate making was concerned. For instance, the court in *Koelling v. United States,*[36] an income tax case, quotes this statement from a 1909 rate making case as the theory behind depreciation:

34. The Supreme Court indicated this when they overturned the rule in Cohn v. U.S., 259 F.2d 371 (6th Cir. 1958). Under this rule the Internal Revenue Service tried to disallow the depreciation deduction in the year of the sale of a capital asset to the extent that selling price exceeded its estimated salvage value. The Supreme Court felt that depreciation should not be tied to the actual decrease in value. S & A Co. v. U.S., 218 F. Supp. 677 (D. Minn. 1963); Motorlease Corp. v. U.S., 215 F. Supp. 356 (D. Conn. 1963).
35. Changes in the market value may change the salvage value of an asset. If this happens, the depreciation rates would have to be revised since an asset cannt be depreciated below its salvage value. *See, e.g.,* PYLE & WHITE, *supra* note 1, at 341-42.
36. 171 F. Supp. 214 (D. Neb. 1957).

> Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The Company is not bound to see its property gradually waste without making provision out of earnings for its replacement.[37]

The idea that depreciation should be used to provide for the replacement of assets has no basis in income tax cases. Its short life under the rate making cases dealt with problems not encountered in income taxation. Congress, in its discretion, has never given depreciation this purpose. This being the case, the courts should not try to add this concept by changing the intent of Congress.

C. The Fund Misconception

Some courts have tried to suggest that depreciation is used to create a fund either to replace the property when it becomes useless or to repay the owners for their investment at the end of their business venture. Thus, the court in *Idaho Power Co. v. Commissioner*[38] asserted that "the purpose of the depreciation deduction is to create a fund to restore the property to the extent of the investment of the taxpayer at the end of its useful life. . . ."[39]

Statements like this and the outdated accounting practices of using terms like "Reserve for Depreciation" in place of the term "Accumulated Depreciation,"[40] have led people to believe that a cash reserve is set aside every time depreciation is recorded. They seem to feel that as each depreciation is taken, this cash fund or reserve is automatically increased.

The recording of depreciation creates no cash fund. Depreciation is nothing more than an accountant's entry upon a set of books. There is no way that a stroke of a bookkeeper's pen can create funds sufficient to replace an asset or to repay the investors.

37. *Id.* at 226.
38. 477 F.2d 688 (9th Cir. 1973).
39. *Id.* at 691.
40. *See, e.g.,* FINNEY, PRINCIPLES OF ACCOUNTING, INTRODUCTORY 140 (rev. ed. 1940).

It is primarily this misconception that led the AICPA to do away with the use of the term "reserve" in connection with depreciation.[41] The accounting profession through this terminology change has attempted to lessen part of the misunderstanding in this area.

The courts' erroneous concept that a fund is created may be caused by a confusion between the purposes and the tax consequences of depreciation. Under the present Code,[42] depreciation is a deduction used to arrive at taxable income. This deduction may reduce taxable income and may result in a savings of tax dollars. The courts may assume that these tax savings are placed in a fund to provide for the invested capital. However this is not the case; depreciation alone will not create this type of fund. It would take a decision on the part of the firm's management to invest some of its assets in a cash reserve to create this fund. This would entail managerial decisions unrelated to depreciation. Even if such a fund were created, tax savings would not be large enough to completely provide for the capital invested in the depreciable assets. This is because depreciation is a deduction used to figure taxable income and not a tax credit.[43] Also, if the firm earns no income over its lifetime, the largest depreciation deduction will not generate any tax savings, let alone create a fund to provide for the invested capital.

Depreciation should not be thought of as a device used to establish a cash reserve or fund to provide for the replacement of assets or to repay investors. Depreciation may genrate tax savings but the saving of taxes in no way puts these savings into a fund. Other factors unrelated to depreciation must occur for this to happen. Depreciation is used to allocate the cost of a capital asset over its useful life; it does nothing more.

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41. AICPA, *supra* note 5, at 26-28.

42. INT. REV. CODE OF 1954.

43. As depreciation is a deduction used to arrive at taxable income, only a portion of this deduction will show up as a tax savings. For example, if a corporation is already in a 48% tax bracket, depreciation on an asset costing $1,000 with no salvage value, will generate only $480 in tax savings over the asset's life time.

THE COST DETERMINATION PROBLEM

Besides the conceptional problems with depreciation, the courts have also been concerned with the issue of determining the cost of a capital asset. Cases involving cost determination usually result when a firm constructs depreciable assets for its own use. When this occurs, the court must determine which expenditures should be capitalized into the cost of the asset and which expenditures should be expensed for the period. There is no question that such items as material and labor, directly attributable to the new construction, become part of its cost. The issue stems from the treatment of other expenditures such as interest. taxes, or research and experimental costs, associated with the new asset.

The Internal Revenue Service has argued that these items should be capitalized and not expensed. The agency feels that if these amounts are expensed, this portion of the firm's business will have incurred losses before its business operations have even begun; as the asset is in the construction stage, there can be no business expenses because there is no business activity going on.[44]

The courts have generally not followed this line of reasoning. They have felt that "deductions expressly granted by statute are not to be deferred even though they relate to inventory or capital items."[45] In other words, if a deduction was specifically given by Congress, it would be allowed even though it was connected with the acquisition of a capital asset. However, if an outlay only fits the general section 162[46] business deduction, it would be capitalized if it was associated with a capital asset. For example interest, taxes, and losses would be deductible under sections 163, 164 and 165[47] regardless of the reason they were incurred,[48] while amounts paid for accounting services during construction would come under section 162 and would have to be capitalized.[49]

44. *See, e.g.*, New Quincy Mining Co. v. Comm'n., 36 BTA 376 (1937).
45. All-Steel Equip. Co. v. Comm'n., 54 T.C. 1749, 1759 (1970).
46. INT. REV. CODE OF 1954, § 162.
47. INT. REV. CODE OF 1954, §§ 163, 164 & 165.
48. Spring Valley Water Co. v. U.S., 5 BTA 660 (1926); Joe W. Stout v. Comm'n., 31 T.C. 1199 (1959).
49. Herbert Shainberg v. Comm'n., 33 T.C. 241 (1959).

This reasoning on the court's part was restated in *Idaho Power Co. v. Commissioner.*[50] In this case the Service argued that depreciation on equipment used to construct new capital assets should be capitalized as part of the construction cost of the new asset. It relied on Revenue Ruling 59-380[51] which stated that:

> Depreciation sustained on construction equipment owned by the taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to and made part of the cost of the capital improvements.[52]

The court, however, could see no reason for carving out a special exception for depreciation in this area. As depreciation is listed as a specific deduction under section 167,[53] it is deductible regardless of how it is incurred. The court overruled Revenue Ruling 59-380, and reaffirmed its position that deductions which are expressly allowed by statute are to be permitted irrespective of the reason for their occurrence.

As this is an area of congressional discretion, the intent of Congress should be followed. Neither the Code nor the Regulations in any way indicate that the specific deductions granted by statute are to be treated differently when they relate to the acquisition of depreciable assets. Therefore the courts' interpretation appears to be correct. In order for the Internal Revenue Service's position to be justified, some different indication as to the intent of Congress would be required.

CONCLUSION

Today, both the accounting profession and the legal profession are in basic agreement that depreciation is a process of spreading the cost of an asset over its useful life. Even though the uses of depreciation may differ depending on individual professional needs (for example, income measuring as compared to income taxation), the theory behind depre-

50. *Supra* note 38.
51. Rev. Rul. 59-380, 1959-2 Cum. Bull. 87.
52. Rev. Rul. 59-380, 1959-2 Cum. Bull. 87.
53. INT. REV. CODE OF 1954, § 167.

ciation remains the same. The misconceptions surrounding depreciation could be avoided if people really understood the concept of depreciation. Both professions should be more concise in their statements concerning depreciation to remove the confusion which surrounds this simple concept. Depreciation is a cost spreading device and nothing more.

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