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Federal Income Taxation--Deductibility of Construction-Related Depreciation--Commissioner v. Idaho Power Co.

Federal Income Taxation —DEDUCTIBILITY OF CONSTRUCTION-RELATED DEPRECIATION — *Commissioner v. Idaho Power Co.,* 94 S. Ct. 2757 (1974).

The taxpayer, Idaho Power Co., is a public utility engaged in the production, transmission, distribution, and sale of electricity. During 1962 and 1963 the taxpayer used certain transportation equipment that it owned to construct capital improvements. On its books, the taxpayer capitalized the portion of the depreciation on its equipment that related to such construction, as required by the Federal Power Commission.[1] For income tax purposes, however, the taxpayer deducted depreciation on the construction-related equipment over the depreciable life of the equipment, in reliance upon section 167(a) of the Internal Revenue Code of 1954.[2] The Commissioner disallowed the deduction, principally on the grounds that, pursuant to section 263(a), depreciation on such equipment is a nondeductible capital expenditure.[3] The Tax Court upheld the Commissioner's determination,[4] but the Ninth Circuit Court of Appeals reversed, reasoning that depreciation is specifically deductible under section 167(a) and is not "an amount paid out" within the meaning of section 263(a).[5] The United States Supreme Court reversed the decision of the Ninth Circuit, holding that depreciation on equipment used to construct capital improvements must be capitalized and deducted over the depreciable lives of the capital improvements.[6] In so holding, the Court announced that depreciation is within the scope of section 263(a), and that sections 161 and 261 indicate that section 263 takes precedence over section 167(a).

I. BACKGROUND

A. The Internal Revenue Code

The two sections commonly used in determining the tax treatment of construction-related depreciation are section 167 in part VI and section 263 in part IX. Section 167 allows a depreciation deduction for exhaus-

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[1]FPC Reg., 18 C.F.R. 293-94 (1974).

The Idaho Public Utilities Commission has adopted these procedures and also requires the taxpayer to capitalize construction-related depreciation. *See* 10 IDAHO CODE ANN. §§ 61-523, 24 (1947).

[2]All references in the text to "section" or "sections," unless otherwise indicated, refer to the Internal Revenue Code of 1954 as amended.

[3]The Commissioner also asserted that section 167(a) does not apply to construction-related depreciation because the taxpayer was not in the "trade or business" of constructing its own assets. *See* note 11 *infra.*

[4]Idaho Power Co., 29 CCH Tax Ct. Mem. 383 (1970), *rev'd,* 477 F.2d 688 (9th Cir. 1973), *rev'd,* 94 S. Ct. 2757 (1974).

[5]Idaho Power Co. v. Commissioner, 477 F.2d 688 (9th Cir. 1973), *rev'd,* 94 S. Ct. 2757 (1974).

[6]Commissioner v. Idaho Power Co., 94 S. Ct. 2757 (1974).

tion, wear, and tear of property used in the trade or business.[7] In contrast, section 263 disallows deductions for any "amount paid out" for capital improvements.[8] The terms "trade or business" and "amount paid out" are not defined in the Code. Nevertheless, the commissioner has contended that most taxpayers who claim depreciation on equipment used to construct capital improvements do not qualify for section 167 treatment because they are not engaged in the "trade or business" of constructing capital improvements.[9] Furthermore, the Commissioner has contended that depreciation is an "amount paid out" within the meaning of section 263.[10]

Courts have usually accepted the Commissioner's argument that most taxpayers are not in the "trade or business" of constructing their own capital improvements.[11] In the instant case, however, the Ninth Circuit rejected this argument, implying that all activities that are appropriate to a taxpayer's principal business are part of its "trade or business" under section 167.[12] The Commissioner conceded this issue on

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[7]INT. REV. CODE OF 1954, § 167(a).

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —

(1) of property used in the trade or business . . . .

[8]INT. REV. CODE OF 1954, § 263(a).

No deduction shall be allowed for —

(1) Any amount *paid out* for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Id. (emphasis added).

[9]Rev. Rul. 59-380, 1959-2 CUM. BULL. 87, 88 (1959).

[T]he building equipment used in the construction cannot be considered as property used in the regular trade or business of the taxpayer... Depreciation sustained on construction equipment owned by a taxpayer and used on the erection of capital improvements for its own use is not an allowable deduction . . . .

[10]The Commissioner's position is based on Treas. Reg. § 1.263(a)-2(a) (1958) which states:

The following paragraphs of this section include examples of capital expenditures:

(a) The *cost* of acquisition, construction or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Id. (emphasis added).

[11]In *Great Northern Ry.*, 30 B.T.A. 691 (1934), a depreciation deduction on equipment used in self-construction of capital assets was allowed because the equipment was used in *a* trade or business of the taxpayer. This view apparently prevailed until 1959 when the IRS ruled that equipment used in self-construction must be used in the taxpayer's *regular* trade or business in order for related depreciation to be deductible. The Court of Claims followed this test in *Southern Natural Gas Co. v. United States*, 412 F.2d 1222, 1264-69 (Ct. Cl. 1969) in denying a depreciation deduction because the equipment used in self-construction was not used in *the* trade or business. The court of appeals in the instant case disagreed with the 1959 IRS ruling and allowed a deduction for depreciation taken on equipment used in self-construction of capital improvements. The court emphasized the continuity and regularity of the taxpayer's construction activities, thereby inferring a "trade or business" must consist of more than occasional self-construction activities. *See* cases cited at Commissioner v. Idaho Power Co., 94 S. Ct. 2757, 2762 n.5.

[12]477 F.2d at 696.

appeal to the Supreme Court.[13]

Most courts have also accepted the Commissioner's position that construction-related depreciation is an "amount paid out" within the meaning of section 263(a). In *L. W. Brooks, Jr.*,[14] for example, the Tax Court concluded that in the cost of producing income, depreciation is as much an "expenditure" as the cost of labor or other items of direct cost. Nevertheless, in construing other Code sections where similar language is employed, courts have indicated that depreciation is not "paid out." For example, section 170(a)(1) allows a charitable deduction for any charitable contribution "payment of which is made within the taxable year." In *Orr v. United States*, the Fifth Circuit held that depreciation is not a "payment" because no transfer of money or property occurs.[15] Section 213(a)(1) allows, under certain conditions, a deduction for "expenses paid" for medical care and insurance premiums. In *Maurice S. Gordon*,[16] the Tax Court reasoned that depreciation is not an "expense paid" within the plain meaning of that term, but a decrease in value.

The Court of Claims followed the Commissioner's interpretation of "trade or business" in *Southern Natural Gas Co. v. United States*.[17] In that case, the taxpayer used its automotive equipment in constructing additions to pipeline facilities. The Court of Claims held that the taxpayer was not in the "trade or business" of constructing pipelines and that the term "amount paid out" included depreciation sustained on construction-related equipment. The Tax Court in the instant case followed *Southern Natural Gas* in reasoning that the taxpayer was not in the "trade or business" of constructing its own capital improvements. The Tax Court also accepted the reasoning in *L. W. Brooks, Jr.*, that depreciation is an "expenditure" and, by equating "expenditure" with "amount paid out," required the taxpayer to capitalize its construction-related depreciation. However, the Ninth Circuit disagreed with the Tax Court and, based upon *Orr* and *Gordon*, concluded that depreciation is not "an amount paid out" within the plain meaning of the term, but is a "decrease in value."[18]

The pertinent sections of the Code are contained in parts VI and IX, subchapter B, chapter 1, subtitle A. Part VI commences with section 161,[19] which states that the items specified in part VI are subject to the

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[13] 94 S. Ct. at 2762 n.5.

[14] 50 T.C. 927 (1968), *rev'd on other grounds*, 424 F.2d 116 (5th Cir. 1970).

[15] Orr v. United States, 343 F.2d 533, 556 (5th Cir. 1965); *accord*, Clinton H. Mitchell, 42 T.C. 953, 973 (1964). *See also* Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960).

[16] 37 T.C. 986 (1962).

[17] 412 F.2d 1222, 1264-69 (Ct. Cl. 1969).

[18] 477 F.2d at 694-95.

[19] INT. REV. CODE OF 1954, § 161.

exceptions provided in part IX. Part IX commences with section 261, which provides that no deduction is allowed in respect to the items specified in part IX.[20] However, until the instant case, sections 161 and 261 have not been construed as establishing the priority of part IX over part VI. On the contrary, sections 161 and 261 were viewed as simple references between separate parts of the Code.

Mertens indicates that section 161:

> [H]as no independent substantive impact. Under it, statutory permission is granted for the deduction of the specific items indicated in Part VI of Subchapter B. As is evident, this provision is largely a mechanical drafting device making certain that there is legal authority for the allowable deductions indicated.[21]

According to *Mertens*, section 261 has a similar purpose:

> As a mechanical drafting matter having no independent substantive impact, Section 261 disallows a deduction from gross income for those items specified in Part IX of Subchapter B of the 1954 Code. This section corresponds to Section 24(a) of the 1939 Code.[22]

B. Code Treatment of Similar Items

Other construction-related expenses are treated in a variety of ways, either by express Code provision or by administrative and judicial interpretation. For example, the costs of labor, materials, and tools are required to be capitalized and depreciated over the life of the constructed asset. On the other hand, interest,[23] losses,[24] sales and use taxes,[25] and pension plan contributions[26] are all deductible in the year actually incurred. Certain taxes and other carrying charges may be capitalized or currently deducted at the taxpayer's option.[27] Research and experi-

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> In computing taxable income . . . there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).

[20] INT. REV. CODE OF 1954, § 261.

> In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

[21] J. MERTENS, FEDERAL INCOME TAXATION, CODE COMMENTARY § 161 (Malone ed. 1973).

[22] *Id.* § 261.

[23] INT. REV. CODE OF 1954, § 163; *see* INT. REV. CODE OF 1954, § 266 (interest as a carrying charge may be deducted or capitalized at the taxpayer's option); Rev. Rul. 70-88, 1970-1 CUM. BULL. 32 (interest during construction deductible even though capitalized on taxpayer's books as required by federal regulatory agency).

[24] INT. REV. CODE OF 1954, § 165; *see* All-Steel Equipment, Inc., 54 T.C. 1749, 1759 (1970), *rev'd in part*, 467 F.2d 1184 (7th Cir. 1972).

[25] INT. REV. CODE OF 1954, § 164; *see* INT. REV. CODE OF 1954, § 266 (sales and use taxes as carrying charges may be deducted or capitalized at the taxpayer's option).

[26] INT. REV. CODE OF 1954, § 404; *see* I. T. 3408, 1940-2 CUM. BULL. 178 (1940).

[27] INT. REV. CODE OF 1954, § 266.

mentation expenses[28] are among a group of items specifically exempted from capitalization by section 263.[29]

C. Accounting Theory

In an effort to determine the scope of the depreciation deduction, the Supreme Court has espoused two ostensibly differing theories of depreciation. The "replacement theory," which the Ninth Circuit stressed in the instant case,[30] originated in the early case of *Knoxville v. Knoxville Water Co.*[31] where the Supreme Court emphasized the role of depreciation in providing a sufficient sum out of earnings for replacement of a consumed or obsolete asset. In *Hertz Corp. v. United States*,[32] however, the Supreme Court formulated a "benefit theory" which emphasizes the allocation of the expense of using an asset to the various periods "benefited" by that asset.

The American Institute of Certified Public Accountants (AICPA) defined depreciation accounting in Accounting Terminology Bulletin No. 1 as a system of accounting which aims to distribute the cost of tangible capital assets over the estimated useful life of the unit in a systematic and rational manner.[33] The AICPA, however, has never dealt specifically with construction-related depreciation. Accountants agree that direct costs, such as materials and labor, incurred in construction of a capital asset should be capitalized, but they disagree on the propriety of capitalizing overhead costs, including depreciation, that relate to construction activities.[34]

The Federal Power Commission establishes utility rates based upon a utility's "net investment" in plant and facilities. To arrive at "net in-

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[28]INT. REV. CODE OF 1954, § 174.

[29]INT. REV. CODE OF 1954, §§ 174 (research and experimentation expenses), 175 (soil and conservation expenses), 180 (expenses for fertilizer etc.), 182 (expenditures by farmers for clearing land), 616 (expenditures for the development of mines or deposits).

[30]477 F.2d at 690-91.

[31]212 U.S. 1, 13 (1909).

> [A] 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.

See Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943); Idaho Power Co. v. Commissioner, 477 F.2d 688, 691 (9th Cir. 1973), *rev'd*, 94 S. Ct. 2757 (1974). *See also* Treas. Reg. § 1.167(a)-1(a) (1972).

[32]364 U.S. 122, 126 (1960).

[33]2 APB ACCOUNTING PRINCIPLES, ACCOUNTING TERMINOLOGY BULLETIN NO. 1 — REVIEW AND RESUME ¶ 56, at 9513 (1973).

[34]G. JOHNSON & J. GENTRY, FINNEY AND MILLER'S PRINCIPLES OF ACCOUNTING — INTERMEDIATE 381 (7th ed. 1974) [hereinafter cited as FINNEY AND MILLER]; W. MEIGS, A. MOSICH, C. JOHNSON, & T. KELLER, INTERMEDIATE ACCOUNTING 368 (3d ed. 1974) [hereinafter cited as MEIGS].

vestment," the FPC has developed a Uniform System of Accounts that specifies which items must be capitalized and included in the capital asset accounts.[35] This practice assures the utilities under the FPC's control a fair return on invested capital based upon uniformly applied standards.[36] The FPC's Uniform System of Accounts requires all utilities to capitalize construction-related depreciation.[37]

II. The Supreme Court's Decision

In beginning its analysis, the Supreme Court announced that its "primary concern" was to "treat construction-related depreciation in a manner which comports with accounting and taxation realities."[38] The Court reasoned that depreciation represents the cost of physical consumption[39] of a capital asset and that a depreciation deduction represents an attempt to allocate the expense of using an asset to the various periods benefited by that asset. Based upon these premises, the Court reasoned that construction-related depreciation benefits the entire period of the constructed asset's useful life and should be capitalized over that period. The Court contrasted its "benefit theory" of depreciation with the "replacement theory" adopted by the Ninth Circuit in the instant case. According to the Court, replacement was rejected as the "strict and sole purpose of depreciation"[40] in *United States v. Chicago, B. & Q. R. R.*[41] Additionally, the Court said that if replacement is the dominant purpose of depreciation, the asset to be replaced is the constructed improvement, not the equipment used to build it.

To bolster its reasoning, the Court pointed out that other construction-related expenses such as the costs of tools, materials, and labor are included in the cost of a constructed facility rather than deducted in the year of actual payment. The Court reasoned that construction-related depreciation, like these direct costs, is finally disposed of in the constructed capital asset. Further, the Court reasoned, requiring the taxpayer to depreciate the equipment over the longer life of the constructed improvements prevents the distortion of income and maintains tax parity between a taxpayer that constructs its own capital facilities and a taxpayer that does not.

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[35] 16 U.S.C. §§ 796(13), 797(b), 813, 825(a), (c) (1960).

[36] *See* Alabama Power Co. v. FPC, 134 F.2d 602, 609 (5th Cir. 1943).

[37] FPC Reg., 18 C.F.R. 293-94 (1974).

[38] 94 S. Ct. at 2763.

[39] *But see* 4 J. Mertens, Federal Income Taxation §§ 23.38-.42 (Malone ed. 1973). Physical consumption is but one cause of depreciation, others include economic changes, the normal progress of the art, invention and other current developments, local conditions peculiar to the taxpayer and trade or business, and taxpayer's policy as to repairs, renewals, and replacements.

[40] 94 S. Ct. at 2764.

[41] 412 U.S. 401, 415 (1973).

The Court also noted that federal and state regulatory agencies require the taxpayer to use accounting procedures that capitalize construction-related depreciation.[42] The Court conceded that in determining tax questions, little attention, if any, is ordinarily given to compulsory agency practices,[43] but the Court relied upon section 446 which states: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" unless the method "does not clearly reflect income."[44] The Court concluded that if the agency accounting practice clearly reflects income, it is "almost presumptively controlling of federal income tax consequences."[45]

After focusing on accounting theory and regulatory practices, the Court analyzed the pertinent sections of the Internal Revenue Code. The Court acknowledged that a literal application of section 167 would allow the depreciation deduction.[46] Hence, the critical issue was whether section 263, requiring capitalization, also applied, and if it did, how the conflict between the two sections should be resolved. The Court held that section 263(a) does apply to construction-related depreciation, thereby rejecting two of the taxpayer's contentions previously accepted by the court of appeals. In doing so, the Court asserted that depreciation is an "amount paid out" within the meaning of section 263(a), and noted that the regulations indicate "amounts paid out" include *costs* of acquisition.[47] The Court considered the regulation as an administrative understanding that "amount paid out" is equivalent in meaning to "cost incurred." By adopting this construction, the Court reasoned that depreciation is "paid out" in the same sense as are amounts expended for materials and labor. Moreover, the Court announced that certain decisions[48] construing sections 170 and 213, which indicate depreciation is not an "amount paid out," are irrelevant.[49]

The Court resolved the conflict between section 167(a) which requires deduction and section 263(a) which requires capitalization by holding that section 263(a) takes priority over section 167(a) when the literal requirements of each are fulfilled. The Court also stated that the wording of section 161, "subject to the exceptions provided in Part IX,"

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[42] *See* notes 35-37 *supra* and accompanying text.

[43] *See* Old Colony R.R. v. Commissioner, 284 U.S. 552, 562 (1932).

[44] INT. REV. CODE OF 1954, § 446.

[45] 94 S. Ct. at 2766.

[46] 94 S. Ct. at 2762 n.5.

[47] *See* note 10 *supra*.

[48] *See* notes 15-16 *supra* and accompanying text.

[49] 94 S. Ct. at 2766 n.11. The Court said that these cases concerned the timing of an expenditure and have no relevance to the issue of capitalization.

indicates that any section in part IX takes precedence over any section in part VI.[50]

Finally, the Court recognized the congressional intent involved in the 1954 Code to provide for liberalization of depreciation, but rejected the applicability of that intent to this case because, (1) the liberalization was intended to take place without departing from realistic standards of depreciation accounting, and (2) the changes relate primarily to computation of depreciation and, thereby, do not affect section 167(a) and section 263(a).[51]

III. Analysis

Throughout the opinion, the Court focused upon the purpose of depreciation. The Code, however, evidences no congressional intent to adopt a specific theory of depreciation. Hence, accounting theory should only determine the tax treatment of construction-related depreciation to the extent that a taxpayer adopts a particular theory in reporting his income.[52] Whereas the Ninth Circuit emphasized the "replacement theory" of depreciation which supports its interpretation of the applicable Code sections,[53] the Supreme Court adopted the "benefit theory" and announced that the purpose of depreciation is to "allocate the expense of using an asset to the various periods which are *benefited* by that asset"[54] (emphasis added).

The Court cited a passage in *United States v. Chicago, B. & Q. R. R.*[55] as rejecting the "replacement theory."[56] When taken in context, however, the quoted passage does not reject the "replacement theory." The

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[50] 94 S. Ct. at 2767.

[51] Justice Douglas believes the Supreme Court is particularly ill equipped to decide tax disputes because of the increasingly complex and technical nature of tax law and the inexperience of the Court in such matters due to its infrequent exposure to them. Nevertheless, Justice Douglas agrees with the Ninth Circuit and would affirm its determination.

[52] *See* INT. REV. CODE OF 1954, § 446.

> (a) General Rule. — Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

[53] The "replacement theory" emphasizes cost recovery over the life of a depreciable asset to allow for replacement of each asset when it is fully depreciated. Thus, even if the depreciation on the equipment used for construction benefits future periods cost recovery over the longer life of the constructed improvements would be insufficient to replace the equipment when it was depreciated. The Supreme Court's "benefit theory," on the other hand, requires cost recovery over the life of the constructed improvements because the construction-related depreciation "benefits" periods beyond its useful life.

[54] 94 S. Ct. at 2763.

[55] 412 U.S. 401, 415 (1973).

> Whatever may be the desirability of creating a depreciation reserve under these circumstances, as a matter of good business and accounting practice, the answer is . . . "Depreciation reflects the cost of an existing capital asset, not the cost of a potential replacement."

Id. (citations omitted).

[56] 94 S. Ct. at 2764.

taxpayer in that case sought to depreciate equipment paid for by a government subsidy, which required the taxpayer to replace the equipment as it became obsolete or worn out. The quoted passage merely points out that sound accounting principles allow only depreciation of the *cost* of an asset and not its potential replacement. Therefore, even though the taxpayer was required to replace the asset, in the absence of a cost, no depreciation was allowed.[57]

Neither the "replacement theory" nor the "benefit theory," when taken out of context, completely states the purpose of depreciation. Each theory has been derived from passages in Supreme Court cases dealing with specific depreciation problems, but none of these passages purported to be a complete explanation of depreciation. Both theories recognize that depreciation is based on cost recovery allocated rationally over the asset's useful life,[58] but the crucial question is, what is a rational allocation in a given situation? Inasmuch as every capital asset used in construction is "consumed" and also "benefits" future periods, neither theory furnishes a practitioner with the analytical tools necessary to decide whether and to what extent depreciation must be capitalized.

To bolster its application of the "benefit theory," the Court relied on the fact that other construction-related expenses, such as the cost of labor and materials, must be capitalized. The Court asserted that depreciation on construction equipment, like these direct costs, is assimilated into the cost of the capital asset constructed. In a strict sense, however, depreciation on automotive equipment is not "assimilated" into the cost of a constructed building as are the construction materials that actually become part of the building or the cost of labor incurred directly in construction. The concept that depreciation is like a direct cost apparently is based on the Court's assertion that depreciation will benefit future periods.[59] But the Court's reference to the treatment of other construction-related items is misplaced, for a strict application of the "benefit theory" would require capitalization of many items that are currently deductible because every cost, expenditure, or diminution in value incurred during construction "benefits" future periods to some degree. Thus, the "benefit test" for capitalization will be difficult to apply because the Court did not indicate how much a cost must benefit a future period to necessitate capitalization.

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[57] *See* Parsons v. United States, 227 F.2d 437 (3d Cir. 1955).

> Finally, it may be noted that this is one of the many situations in which the annual allowance for depreciation may not aggregate the replacement value of the business property. But if this is viewed as harsh or objectionable, the vice is inherent in the fact that the present statutory scheme of depreciation allowances is based upon cost rather than replacement value.

[58] *See* Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960); 2 APB ACCOUNTING PRINCIPLES, *supra* note 33.

[59] 94 S. Ct. at 2765.

A. Accounting Theory

Although accounting theory does not determine the tax treatment of construction-related depreciation, it furnishes a more sophisticated analysis then either the "benefit" or "replacement" theory. Accountants do not classify depreciation as a direct cost, but as an item of overhead.[60] Accountants agree that the cost of a self-constructed capital asset includes the cost of material and labor, but disagree on how much overhead, if any, should be capitalized.[61]

A small number of accountants believe that no overhead should be allocated to the cost of a self-constructed capital asset.[62] This approach results in no depreciation being capitalized. A few accountants favor a second method which would capitalize a portion of all expenses including administrative expenses such as officers' salaries.[63] The third theory, which has substantial support among accountants, requires capitalization of a portion of all overhead items related to self-construction, including fixed expenses, in the same ratio as they are normally charged to operations.[64] The proponents of this approach argue that no special cost exemptions should be granted and assert that this approach avoids undercosting self-constructed capital assets.[65] This approach capitalizes a portion of construction-related expenses such as taxes, interest, power, pension plan contributions, and depreciation. Finally, many accountants believe that only overhead that would not be incurred in the absence of the construction activity should be capitalized.[66] The supporters of this "incremental overhead approach" assert that some additional costs will necessarily be incurred during self-construction. Thus, although many fixed expenses would remain the same, other expenses would vary almost proportionately with the amount of construction.[67] The "incremental overhead approach" capitalizes "extra" depreciation. Depreciation on an asset that is acquired for use in normal operations and is used in construction when it would otherwise be idle

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[60] FINNEY AND MILLER 32; A. MATZ, O. CURRY, COST ACCOUNTING — PLANNING AND CONTROL 258 (5th ed. 1972).

[61] FINNEY AND MILLER 382; MEIGS 412; H. SIMMONS & W. KARENBROCK, INTERMEDIATE ACCOUNTING 413 (4th ed. 1964).

[62] MEIGS 412.

[63] FINNEY AND MILLER 382. The "benefit theory," if carried to its extreme, would require a portion of all costs to be capitalized.

[64] FINNEY AND MILLER 381; MEIGS 412; H. SIMONS & W. KARENBROCK, *supra* note 61, at 414. *See* C. HORNGREN: COST ACCOUNTING: A MANAGERIAL EMPHASIS 413-17 (3d ed. 1972). Overhead rates are ordinarily developed by dividing estimated total overhead by estimated total direct-labor hours or estimated total machine hours.

[65] *See* note 64 *supra*.

[66] FINNEY AND MILLER 381; MEIGS 412; A. HOLMES, G. MAYNARD, J. EDWARDS, & R. MEIER, INTERMEDIATE ACCOUNTING 365 (3d ed. 1958).

[67] FINNEY AND MILLER 381.

is not capitalized. On the other hand, depreciation on special tools or machinery used in self-construction becomes a part of the cost of the constructed asset.

B. *Agency-Imposed Compulsory Accounting Practices*

The Federal Power Commission and the Idaho Public Utilities Commission both require the taxpayer to capitalize construction-related depreciation. The Court announced, in an unprecedented move, that if the practices imposed by these agencies clearly reflect income, they are "almost presumptively controlling of federal income tax consequences."[68] This statement contradicts the Supreme Court's assertion in *Old Colony R.R. v. Commissioner* that administrative accounting procedures are made for purposes other than the determination of tax liability under the revenue acts, and hence should not be used to determine tax liability.[69]

The objectives of the FPC in promulgating accounting procedures are not the same as those of Congress in passing revenue acts. The FPC formulates regulations to aid in its rate-making function. To provide equitable rates to all utilities, a constant ascertainable standard is vital. The FPC, therefore, specifically lists all expenses which are to be capitalized by the utilities it controls. Under this rationale many items which are currently deductible under the Code are required to be capitalized, such as payroll taxes, property taxes, interest, law expenses, insurance, relief and pension expenses, and earnings and expenses during construction.[70]

C. *Section* 263(a)

The court of appeals held that section 263(a) does not apply in the instant case because depreciation is not an "amount paid out" within the meaning of that section. Section 263(a) itself does not define "amount paid out," but the regulations indicate that "amounts paid out" include the "cost of acquisition, construction or erection of buildings."[71] The Supreme Court interpreted this regulation as an "administrative understanding" that "amount paid out" equates with "cost incurred," and concluded that depreciation is a "cost incurred."[72]

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[68]94 S. Ct. at 2766 (dictum).

[69]Old Colony R.R. v. Commissioner, 284 U.S. 552, 562 (1932); *accord,* Kansas City S. Ry. v. Commissioner, 52 F.2d 372, 377-78 (8th Cir.), *cert. denied,* 284 U.S. 676 (1931); Barretville Bank & Trust Co., 17 CCH Tax Ct. Mem. 749 (1958); *cf.* Commissioner v. Lincoln Sav. & Loan Assn., 403 U.S. 345, 355-56 (1971).

[70]FPC Reg., 18 C.F.R. 240-42 (1974).

[71]*See* note 10 *supra.*

[72]94 S. Ct. at 2766.

This conclusion is unsettling for several reasons. First, there is no specific language in the applicable regulation which indicates the phrase "cost of acquisition, construction or erection" was intended to include construction-related depreciation. The "cost of acquisition, construction or erection" is listed as an "example" of section 263(a),[73] but the word "cost" is not defined. It is unreasonable to attribute a broad meaning to "cost," which is used only as an example of an "amount paid out." If depreciation is not "an amount paid out" within the meaning of section 263(a), it is *a fortiori* not a "cost" within the meaning of the regulation. A regulation cannot expand the scope of a Code section.[74]

Second, if section 263(a) now extends to all "costs" of construction, the future deductibility of other construction-related expenses is placed in doubt. In a broad sense, interest, taxes, contributions to pension plans, and losses are all "costs" of construction.

Third, the Court's apparent rejection of the plain meaning of the term "amount paid out" creates confusion in that the wording of the Code section cannot be relied upon. Furthermore, the decision creates an inconsistency in language between sections of the Code inasmuch as similarly worded sections indicate that depreciation is not a "payment" or "expense paid."[75] Finally, the Court has, in construing section 167 in other contexts, indicated depreciation is not "paid out."[76] Moreover, the Supreme Court has stated that Congress recognizes depreciation as a legitimate expense even though it is a "decrease in value."[77]

D. Sections 161 and 261

Section 161 has not been mentioned in past decisions dealing with construction-related depreciation.[78] Courts have viewed section 161 as primarily a mechanical drafting device.[79] The Commissioner char-

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[73]*See* note 10 *supra*.

[74]*See* Arkansas-Oklahoma Gas. Co. v. Commissioner, 201 F.2d 98, 102 (8th Cir. 1953).

[75]*See* Orr v. United States, 343 F.2d 553 (5th Cir. 1965); Maurice S. Gordon, 37 T.C. 986 (1962).

[76]Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960); *see* United States v. Ludey, 274 U.S. 295, 300 (1927). *See also* Manufacturers Hanover Trust Co. v. Commissioner, 431 F. 2d 664, 667 (2d Cir. 1970); 39 Stat. 756, 768 (1916).

[77]Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960). The Court was concerned with section 23(*l*) of the 1939 Code which is the predecessor of section 167(a) of the 1954 Code.

[78]Prior to the instant case, no court had determined that the requirements of both section 167(a) and section 263(a) were fulfilled.

[79]"Under section 161 of the Internal Revenue Code of 1954, *a generic section*, a taxpayer is entitled to take various itemized deductions in reducing gross income to taxable income." Boone v. United States, 482 F.2d 417, 418-19 (5th Cir. 1973); *see* Road Mat., Inc. v. Commissioner, 407 F.2d 1121, 1123 n.2 (4th Cir. 1969); Zeeman v. United States, 275 F. Supp. 235, 254 (S.D.N.Y. 1967), *modified*, 395 F.2d 861 (2d Cir. 1969).

acterizes the purpose of section 161 as "priority ordering";[80] the taxpayer, however, views it as a "housekeeping provision"[81] with no independent substantive impact. In the instant case, the Court, faced for the first time with the necessity of interpreting section 161, agreed with the Commissioner. The regulations do not support this conclusion. Treasury Regulation 1.161-1 indicates the purpose of section 161: "Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof."[82] No double deduction occurs if the taxpayer deducts its depreciation expense under section 167(a) and does not also capitalize under section 263(a).

The brief legislative history of section 161 also shows no "priority ordering" purpose. The House and Senate both indicate:

> This section states the general rule that in computing taxable income there shall be allowed the deductions specifically provided in the other sections of Part VI relating to itemized deductions for individuals and corporations.[83]

The Court stated that section 261 also acts to establish the priority of section 263 over 167, but the regulations do not support this conclusion either. Treasury Regulation 1.261-1 explains that: "[I]n computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in Chapter one of the Code . . . and the regulations thereunder."[84] The Commissioner conceded that depreciation is deductible under section 167(a) which is a "deduction expressly provided in Chapter one of the Code."[85]

The Court's technique of statutory construction is interesting but not helpful. In construing section 263(a) the Court rejected the plain meaning of "amount paid out" because of an "administrative understanding" derived from the regulations. On the other hand, in construing section 161, the Court relied upon the wording of the statute as establishing a priority between sections. There is no support for this conclusion in the judicial, administrative, or legislative history of section 161.

IV. Conclusion

State and federal regulations require Idaho Power to use a method of accounting which capitalizes construction-related depreciation, and

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[80] Brief for Appellant at 17-18; Reply Brief for Appellant at 5-6.

[81] Brief for Appellee at 21-22.

[82] Treas. Reg. § 1.161-1 (1958).

[83] H.R. Rep. No. 1337, 83d Cong., 2d Sess., A 43 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 195 (1954).

[84] Treas. Reg. § 1.261-1 (1958).

[85] 94 S. Ct. at 2762 n. 5.

the Court stated that this compulsory method may control a taxpayer's income tax consequences. The Court's decision in the instant case may allow a different result where taxpayers are free to choose an acceptable accounting method. For example, the Tax Court has recognized the "incremental overhead method"[86] as clearly reflecting income.[87] Under this method, if a taxpayer does not acquire special tools or machinery for use in self-construction activities, the taxpayer will not capitalize any depreciation on its books. Following the Court's interpretation of the role of section 446, a taxpayer's method of accounting which clearly reflects income would be "almost presumptively controlling of federal income tax consequences."[88] Under this rationale, a taxpayer would not capitalize any depreciation on its books or on its tax return.

Nevertheless, some taxpayers that use the "incremental overhead method" will capitalize construction-related depreciation. For instance, the Idaho Power Company will probably purchase some additional equipment to use in its ongoing large-scale construction activities. On the other hand, much of the automotive equipment involved in the instant case might have been purchased for use in normal operations and used in construction only when it would otherwise be temporarily idle. The incremental overhead analysis is theoretically sounder than the Court's "benefit theory" in determining what self-construction expenses to capitalize.

Federal Tax Liens — ASSIGNMENT OF ACCOUNTS — THE "NO PROPERTY" RULE UNDER THE 1966 FEDERAL TAX LIEN ACT AND ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE — *Nevada Rock & Sand Co. v. United States,* 376 F. Supp. 161 (D. Nev. 1974).

Coop Oil Products, Inc. (Coop) contracted with Nevada Rock & Sand Co. (NRSC) to perform certain construction work. In exchange for materials to complete its contract, Coop assigned to Witco Chemical Corporation (Witco) all monies due or to become due under the NRSC contract. Notice of the assignment was sent to NRSC which consented to make payment directly to Witco upon completion of Coop's performance. Witco failed to file notice of the Coop assignment as required by Nevada's Uniform Commercial Code. Subsequently, Coop completed performance of the NRSC contract, and approximately $10,000 became due and payable to Witco under the assignment. Prior to payment by NRSC of the amount due, the Internal Revenue Service (IRS) assessed delinquent taxes against Coop and, upon Coop's failure to pay the taxes,

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[86]*See* notes 66-67 *supra* and accompanying text.

[87]Fort Howard Paper Co., 49 T.C. 275, 285 (1967).

[88]94 S. Ct. at 2766.