Treasury Department : : Bureau of Internal Revenue

BULLETIN "F"

INCOME TAX

DEPRECIATION AND OBSOLESCENCE

REVENUE ACT OF 1918

This bulletin contains information from which taxpayers and their counsel may obtain the best available indication of the trend and tendency of official opinion in the administration of the income and profits tax provisions of the Revenue Act of 1918, with respect to depreciation and obsolescence. It does not have the force or effect of a Treasury Decision and does not commit the Department to any interpretation of law which has not been formally approved and promulgated by the Secretary of the Treasury.

Taxpayers and officers of the Bureau of Internal Revenue are cautioned against reaching a conclusion in any case merely on the basis of similarity to conditions stated herein and should base their judgment on the application of all pertinent provisions of the law, regulations, and other Treasury Decisions to all of the facts in each case.

OFFICE OF COMMISSIONER OF INTERNAL REVENUE

WASHINGTON
GOVERNMENT PRINTING OFFICE
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The Income Tax Bulletin Service for 1920, consisting of Weekly Bulletins of income tax rulings, Bimonthly Digests of rulings published in the Weekly Bulletins, and semiannual Cumulative Bulletins with the full rulings published in the previous six months' Weekly Bulletins assembled under the various section and article numbers, can be obtained by the public by subscription, price $2 a year. Subscriptions should be sent to the Superintendent of Documents, Government Printing Office, Washington, D. C.

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DEPRECIATION AND OBSOLESCENCE.

INTRODUCTION.

The contents of this bulletin indicate the trend and tendency of official opinion in the Bureau of Internal Revenue in administering the portions of the Revenue Act of 1918 which provide for the deduction from gross income of reasonable allowances for exhaustion, wear and tear, and obsolescence of property used in trade or business. The subject matter includes Treasury Decisions, Opinions of the Solicitor of Internal Revenue, the Advisory Tax Board and the Committee on Appeals and Review, portions of Regulations 45 and other information of a general nature.

Since obsolescence was not recognized for income-tax purposes prior to the passage of the Revenue Act of 1918, comparatively few rulings have been made on that subject. This bulletin, however, contains several opinions rendered by the Advisory Tax Board relating to intangible assets and other property rendered obsolete by prohibition legislation.

The Bureau does not prescribe rates to be used in computing depreciation and obsolescence, as it would be impracticable to determine rates which would be equally applicable to all property of a general class or character. For this reason no table of rates is published. The rate applicable and the adjustment of any case must depend upon the actual conditions existing in that particular case.

AUGUST 31, 1920.

EXCERPTS FROM REVENUE ACT OF 1918.

SEC. 214(a). That in computing net income there shall be allowed as deductions: * * *

(8) A reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

SEC. 234(a). That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

(7) A reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

SEC. 215. That in computing net income no deduction shall in any case be allowed in respect of— * * *

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

(c) Any amount expended in restoring property for which an allowance is or has been made; * * *

SEC. 1309. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

DEFINITIONS.

Depreciation means the gradual reduction in the value of property due to physical deterioration, exhaustion, wear, and tear through use in trade or business.

Obsolescence means the gradual reduction in the value of property due to the normal progress of the art in which the property is used, or to the property becoming inadequate to the growing needs of the trade or business. Obsolescence, a gradual lessening of value must be distinguished from "loss of useful value" (art. 143, Reg. 45), which contemplates an abrupt termination of usefulness.

SCOPE OF DEPRECIATION AND OBSOLESCENCE.

DEPRECIATION.

An allowance may be deducted by taxpayers for depreciation and obsolescence of certain property either tangible or intangible, which gradually approaches a point where its usefulness in the trade or business is exhausted. The allowance must be confined to property which is actually used in the trade or business. Consequently, it may not apply to a building used by a taxpayer solely as his personal residence, or to furniture or furnishings therein; neither may it apply to his personal effects or clothing, nor to automobiles and other vehicles used chiefly for pleasure.

The allowance does not apply to timber or to bodies of minerals, metals, or other natural deposits which through the process of removal are depleted. Allowance for such depletion is provided in other parts of the Act. See sections 214(a) 10 and 234(a) 9, Revenue Act of 1918. No allowance may be claimed for depreciation of inventories or stock in trade; nor for land apart from the improvements or developments added to it.

No amount may be included in a deduction for depreciation representing reduction in value of property due to change in environment—for example, loss in rental value of property due to deterioration of the neighborhood. Fluctuation in the value of depreciable property has no bearing on net income as shown in income tax returns except to the extent that it is realized upon sale, abandonment, or other disposition of the property.

The potential earning capacity of an individual, his inventive genius or his literary ability may not be made the basis of an allowance for depreciation.

The allowance for amortization of facilities acquired "after April 6, 1917, for the production of articles contributing to the prosecution of the present war," * * * (sec. 214(a) 9, Revenue Act of 1918), is inclusive of the allowance for depreciation which would ordinarily be allowable separately. Depreciation for any taxable period after December 31, 1917, should, therefore, not be claimed with respect to property as to which an allowance for amortization is claimed for the same taxable period.

Automobiles.—A deduction may be claimed for depreciation of automobiles and similar equipment used in the trade or business. The rate will depend principally on the purpose for which the equipment is used and must be estimated in each case by the taxpayer according to his experience and judgment. A professional man who uses an automobile in making professional calls is entitled to an allowance for depreciation, but if the automobile is used partly for pleasure or purposes apart from the business only a proportionate part of the depreciation sustained may be deducted; if used chiefly for pleasure, no depreciation deduction is allowable.

Bonds and securities.—Bonds and securities are not subject to wear and tear within the meaning of the statute, and therefore the allowance for depreciation does not apply to any shrinkage in their value.

The fact that bonds or similar securities are written down in value by direction of the Comptroller of the Currency or a State banking department is immaterial. A deduction for loss with respect to such shrinkage in value will not be allowed except upon maturity of the securities, disposition thereof by sale or otherwise or upon definite ascertainment of their worthlessness. This will not preclude a "dealer in securities" as defined in article 1585 of Regulations 45 from computing the inventory value of the securities which constitute his stock in trade on the basis of "cost or market, whichever is lower" if he has adopted that basis for computing inventories and follows it consistently.

Buildings.—Buildings are recognized as subject to depreciation and in some cases to obsolescence, regardless of their construction or purpose for which used. The deduction is allowable, however, only in the case of buildings owned by the taxpayer and used in trade or business. The rate of depreciation will necessarily depend upon the construction of the building, purpose for which used, climatic conditions, repairs made, etc. A frame building may remain serviceable for a period of 20 to 30 years, while a building of steel, concrete, and stone construction may have a life of 50 to 100 years. The ordinary useful life of factory buildings is further lessened by the vibration incident to the use of heavy high-speed machinery, or by the effect of acids or gases used in certain industries. Similarly constructed buildings will depreciate at varying rates, dependent upon local climatic conditions. The rate to be used in computing the allowance for depreciation will depend in each case upon the conditions affecting the particular property in question.

Depreciation of personal residence.—Depreciation of a building occupied by a taxpayer as his personal residence is not deductible for income tax purposes. If a portion of the residence is used for business purposes, as in the case of a physician or any other professional man who has his office in his home, a proportionate part of the depreciation sustained may be deducted, the amount to be based generally on the ratio of the number of rooms used for business purposes to the total number of rooms in the building. The same principle is applicable if a taxpayer rents a portion of his personal residence to other individuals. Under such conditions, however, the taxpayer must include in his gross income any amounts received as rentals. A taxpayer who is not allowed a deduction for depreciation of his personal residence may, in case he sells the property, disregard depreciation in computing any taxable profit derived from the transaction.

If a taxpayer owns residential property and rents it to other individuals, he is entitled to a deduction for depreciation of the rented property even though the property is not used in his principal trade or business but must include in gross income the entire amount received as rentals.

Alteration of building.—Expenditures by a taxpayer in altering a building to conform to a street widening, which alteration does not increase the value of the building, constitute a business expense for the year in which such expenditures are incurred, deductible only in the return of net income for that year, and any division of such deduction so as to spread the same over the returns for a period of years, whether called a depreciation charge or otherwise, is unauthorized.

Voluntary removal of buildings.—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements may be deducted from gross income in a sum representing the difference between the cost of such property demolished or scrapped and the amount of a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping; that is to say, the deductible loss is only so much of the original cost of the property, less salvage, as would have remained unextinguished had a reasonable allowance been charged off for depreciation during each year prior to its destruction.

Actors' costumes.—If costumes purchased by actors and actresses are used exclusively in the production of a play, and are not adapted for occasional personal use and are not so used, a deduction may be claimed on account of such depreciation in their value as occurs during the year on account of wear and tear arising from their use in the production of the play or on account of their becoming obsolete when the production of the play is discontinued.

Drawings, models, and experimental work.—A taxpayer who has incurred expenses in his business for designs, drawings, patterns, models, or work of an experimental nature intended to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles and experimental results as capital assets to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. Such information as will enable the Commissioner to determine whether the deduction is allowable must be furnished with the return or may be submitted prior to the time of filing the return. Except for such depreciation allowances, no deduction shall be made by the taxpayer against any sum so set up as an asset except on the sale or other disposition of such assets at a loss or on proof of a total loss thereof.

Farm property and equipment: live stock.—A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery and other physical property, including live stock purchased for draft, dairy, or breeding purposes, but no claim for depreciation on live stock raised or purchased for resale will be allowed. Live stock purchased for draft, breeding, or dairy purposes, or for any purpose other than resale, may be included in the inventory for each year at a figure which will reflect the reduction in value estimated to have occurred during the year through increase of age or other causes. Such a reduction in value should be based on the cost and estimated life of the live stock. If an inventory is not used, a reasonable allowance for depreciation may be claimed, based upon the cost of draft and work animals and animals kept solely for breeding purposes and not for resale.

Property acquired by gift, bequest, or devise.—If a taxpayer acquires depreciable property by gift, bequest, or devise, and uses it for purposes of trade or business, he is entitled to a deduction from gross income for depreciation of such property. See page 19.

Depreciation of intangible property.—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. The words "capital outlay" used in this paragraph mean cash, other property, or corporate stock given in exchange for the intangibles.

Depreciation of improvements in the case of mines.—It shall be optional with the taxpayer, subject to the approval of the Commissioner, whether (a) the cost or value of mining property, including ores and minerals, plant and equipment, and charges and additions to capital account not charged to expense and deducted as expense in the returns of the taxpayer, shall be recovered at a rate established by current exhaustion of mineral, or (b) the cost or value of the mineral and charges to capital account of expenditures other than for physical property shall be recovered by appropriate charges based on depletion, and the cost or value of plant and equipment shall be recovered by reasonable charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. This paragraph shall not be interpreted to mean that the value of a mining plant and equipment may be reduced by depreciation or depletion deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining, or that any part of the value of land for purposes other than mining may be recoverable through depletion or depreciation.

Depreciation of improvements in the case of oil and gas wells.—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for the depletion or return of capital, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223, Regulations 45, of capitalizing the cost of such items or charging it to expense. The amount deductible on this account shall be such an amount based upon its cost or fair market value as of March 1, 1913, equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit.

Depreciation of improvements in the case of timber.—The cost or value as of March 1, 1913, as the case may be, of development of a timber operation or plant not represented by physical property having an inventory value, and such cost or value of all physical property which has not been deducted and allowed as expense in the returns of the taxpayer, shall be recoverable through depreciation. It shall be optional with the taxpayer, subject to the approval of the Commissioner, whether (a) the cost or value, as the case may be, of the property subject to depreciation shall be recovered at a rate established by current exhaustion of stumpage, or (b) the cost or value shall be recovered by appropriate charges for depreciation computed by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. In no case may charges for depreciation be based on a rate which will extinguish the cost or value of the property prior to the termination of its useful life. This paragraph shall not be interpreted to mean that the value of a timber plant and equipment, so far as it is represented by physical property having an inventory value, may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation.

Leaseholds.—Where a leasehold is acquired for a specified sum, the purchaser may deduct from gross income as a business expense an aliquot part of such sum each year, based on the number of years the lease has to run.

Professional libraries.—A professional man is entitled to deduct a reasonable allowance covering depreciation actually sustained on that part of his library which is necessary and used wholly in the pursuit of his profession, taking as a basis for such allowance, the fair market value as of March 1, 1913, if acquired prior to that date, or the cost, if acquired on or subsequent to that date. The cost of professional periodicals and books purchased by a business or professional man and having a temporary value, should be deducted as an expense of doing business, but the cost of volumes which have a more permanent value to the business or profession, should be capitalized and made the subject of depreciation allowances.

Orchards.—The life of an orchard may be somewhat indefinite, but it can be determined as accurately as the probable life of a building or other tangible property upon which depreciation charges are allowed. In any event it is certain that there is a gradual and ultimate wearing out of an orchard within a number of years after the productive stage has been reached.

All expenditures necessary to bring orchard trees to a producing stage should be capitalized and thereafter a fair and reasonable annual allowance for depreciation may be deducted in order to return to the owner free of taxation the capital invested, just as in the case of an investment in other tangible property used in any other business or trade. The basis for computing the depreciation is the cost of the trees at the time the orchard has reached an income-producing stage, including initial cost and capitalized expenditures incurred in bringing them to maturity, and the rate of depreciation is to be determined by the average life of the trees from the income-producing stage under normal conditions.

In the case of orchards and vineyards acquired subsequent to March 1, 1913, and later destroyed by storms, floods, frost, or otherwise, any deduction for loss should be confined to the amount of capital originally invested in the growing trees and in the new nursery stock which was totally destroyed and the amount expended from date of acquirement to date of destruction in an endeavor to bring such trees and stock to an income-producing state, provided such amount has not been deducted as an expense of doing business. This total must be reduced by the amount of any depreciation sustained. Any expenditures on account of permanent improvements or on account of trees and vines the growth of which was merely retarded and not entirely destroyed may not be included in the deduction for loss.

Organization or promotion expenses.—Organization expenses such as attorneys' and accountants' fees, together with fees paid to State authorities prior to or coincident with the securing of a charter and the incorporation of a business, constitute investments of capital and are not allowable deductions from gross income. Such expenses are not proper items to be added to the cost of any physical property to be provided for through annual allowances for depreciation.

Patents or copyrights.—In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. The allowance should be computed by an apportionment of the cost of the patent or copyright or of its fair market value as of March 1, 1913, over the life of the patent or copyright since its grant, or since its acquistion by the taxpayer, or since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorneys' fees, etc., actually paid. If a corporation purchased a patent and paid for it in stock or securities, its cost is the fair market value of the stock or securities at the time of the purchase. Depreciation of a patent can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. If the patent becomes obsolete prior to its expiration such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the date when it was acquired and the date when it legally expires may be deducted if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if affirmative and satisfactory evidence that the obsolescence occurred in the year for which the return is made is submitted to the Commissioner. The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable.

Assigned patents or copyrights.—In case of patents and copyrights the rights to which have been assigned, the assignor (owner) is entitled to appropriate depreciation deductions as outlined in the preceding paragraph but must report the entire amount of royalties received as income. The assignee may deduct the amount of royalties paid each year, and if he has paid a bonus or lump sum for the patent rights in addition to contracting to pay royalties, he may deduct in addition to the royalties paid an aliquot part of such bonus or lump sum based on the number of years over which his contract or agreement extends.

In an appeal involving depreciation of patents, considered by the Committee on Appeals and Review, the facts and the decision were as follows:

A invented certain apparatus and secured United States patents thereon. The patents were assigned to a foreign corporation under an agreement by which A retained 40 per cent interest in profits therefrom. Legal title to the patents passed to the company subject to the agreement mentioned. A's interest was recognized by the company and by the United States licensees under the patents. It was held that the agreement should be recognized as giving A a depreciable interest in the patents, and that the value of each patent as at March 1, 1913, should be segregated and the depreciation allowable thereon determined on the basis of its own life instead of using as a basis the average life of all the patents and the value of all the patents in bulk. Of the total depreciation allowable for any year, 60 per cent is deductible in the return of the company and 40 per cent in A's return.—A. R. M. 35.

OBSOLESCENCE.

Prior to the passage of the Revenue Act of 1918, no deduction on account of obsolescence was permitted. It is true that articles 177, 178, and 179 of Regulations No. 33, revised, promulgated in connection with the Revenue Act of 1917, authorize deductions for obsolescence, but the term as there used refers not to the *gradual* reduction in value due to the normal progress of the art but rather to the amount of loss sustained when the property *has become obsolete.* It contemplates a completed rather than a continuing process. Its parallel is to be found in article 143 of Regulations 45—Loss of Useful Value.

Obsolescence of buildings.—No amount may be charged off in any year in anticipation of obsolescence of a building which *may* become obsolete a number of years later. A certain amount of obsolescence may, however, be claimed from the time it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence shall be approximately the difference between the fair market value of the building as at March 1, 1913, or its cost if acquired on or after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete, and should be claimed in the returns filed for those years. For instance the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was

$18,000, and its estimated salvage value in 1920 will be $5,000. At the end of the year 1918, it was definitely determined and certain that in 1920 the building would have to be torn down and replaced by a larger building, due to its inadequacy to meet the growing demands of the industry which it housed. The difference between the depreciated value December 31, 1918 ($18,000), and its estimated salvage value ($5,000) represents ordinary depreciation plus obsolescence. This amount of $13,000 should be spread over the years 1919 and 1920, and deduction claimed accordingly in returns filed for those years. In cases where obsolescence is claimed, it must be supported by a statement sufficient to establish the facts upon which it is based.

Obsolescence of intangibles.—Obsolescence is not ordinarily applicable in the case of intangibles but will be allowed in exceptional cases, as in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the good will, or its value as of March 1, 1913, if acquired prior to that date, can be definitely shown and the period of its obsolescence determined with reasonable accuracy.

To sustain a claim for deduction for obsolescence of good will, it must be shown that the good will will be of no value at the close of an approximately definite period, and that the taxpayer will be forced to discontinue the business and be unable to continue in another similar business.

An allowance for obsolescence of good will will be made only in connection with such good will as is assignable, as distinguished from good will attaching to individuals owning or conducting a business or to the premises at which it is or was conducted; and no allowance for obsolescence will be granted in any case where, in connection with the operation of the business, the good will will be valuable in another business after the termination of the business in which the taxpayer is engaged.

Ore-sampling business.—A taxpayer engaged in the business of sampling ores is entitled to a deduction for obsolescence not only of his plant and equipment but for value of good will existing and having a definitely established value as of March 1, 1913, or acquired thereafter by capital outlay, if it can be shown that the plant and equipment will be useless and the good will of no value at the close of an approximately definite period by reason of exhaustion of the ores on which the business depends.

Bottle manufacturing plants.—Property consisting of a plant, including equipment, for the manufacture of beer bottles, which because of prohibition legislation has lost its usefulness and can not be sold has, to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purposes without reconstruction, become obsolete, and the taxpayer to that extent is entitled to a deduction for obsolescence. That part of the shrinkage in value of the plant, if any, which is not thus due to obsolescence may not be claimed as a deduction for loss until the property is sold or becomes worthless and the loss is definitely ascertained.

Property of brewers and distillers.—The same principle stated in the case of bottle manufacturing plants is applicable in the case of other property or equipment of distillers, brewers, and liquor dealers which has been impaired in value through prohibition legislation. The loss in value may be established by evidence other than the actual sale of the obsolete property.

Intangible assets of brewers, distillers, and dealers in liquor.—In Advisory Tax Board Memorandum 44 (Cumulative Bulletin, December, 1919, p. 133) it was held that distillers and dealers in liquor are entitled to make a deduction (based upon actual cost or fair market value as at March 1, 1913) from gross income, on account of depreciation or obsolescence of their intangibles, such as good will, trademarks, trade brands, etc., such deduction being limited to assignable assets, the value of which has been destroyed by prohibition legislation, and that in arriving at the taxable income for the first taxable year ending on or after January 31, 1918, the obsolescence fully accrued on that date is to be allowed as a deduction in computing the income subject to taxation under the Revenue Act of 1918, plus a further deduction of such proportion of the remaining value of the intangible assets as the interval between January 31, 1918, and the end of the taxable year bears to the total interval between January 31, 1918, and January 16, 1920 (unless at an earlier date the taxpayer discontinues his business, in which case such earlier date shall mark the close of the period), and that for any taxable year following the taxable year just referred to a deduction in respect of the value of such intangible assets on January 31, 1918, based upon a ratable distribution, will be permissible. This paragraph applies also to brewers.

Vineyards.—The question as to whether a deduction is allowable under the Revenue Act of 1918 for obsolescence in the case of vineyards the usefulness of which is impaired or destroyed in whole or in part by prohibition legislation was considered by the Solicitor of Internal Revenue and an opinion rendered as follows:

It is represented that certain vineyards are seriously affected by prohibition legislation; that by reason of the character of the grapes which they produce the owners have been unable up to the present time to find a market to replace that which prohibition laws are about to destroy; that while in some instances there may still be an opportunity to use, for wine-making purposes, the crop of the year 1919, in many cases the opportunity for making wine is already passed; that experiments are now being conducted in the hope of finding a way to utilize the particular variety of grapes here considered so that it will not be necessary to abandon the vineyards; and that in view of such experiments the vineyards in question have, in many instances, not been junked, but are being cultivated in the hope of finding a profitable use for the crop. It is further represented that in some cases these vineyards will be or already have been abandoned, the vines pulled up, and the land planted to other crops and that in a few instances owing to the character of the land or its location, the total abandonment of the vineyards for any purpose may result.

While the Act of October 3, 1913, and the Revenue Act of 1917 were construed to allow a deduction for obsoleteness, demonstrated by the actual junking or abandonment of property, as a deduction in determining the net income of an individual or a corporation, obsolescence, or the gradual becoming out of use, was not recognized as an allowable deduction prior to the Revenue Act of 1918.

Obsolescence—that is, the process of gradually becoming out of use—has long been recognized in the manufacturing world as a material factor in determining the useful life of machinery. It has been a matter of general experience that whereas the physical life of a machine when wear and tear only were considered might be 20 years, yet its useful life in a given employment might be materially shortened by the introduction of improved processes and new inventions, and that where the new processes and inventions were revolutionary its useful life might be reduced to a brief period, the minimum being the time necessary for the manufacture and installation of the new machinery.

The effect of prohibition legislation upon wine vineyards is so closely analogous to that produced by the introduction of revolutionary inventions in manufacturing as to bring it clearly within both the reason and the language of the statute. A reasonable deduction for the obsolescence thus resulting is, therefore, allowable.

Where a vineyard planted to wine grapes continues to be cultivated after the enactment of prohibition legislation in the hope that some new and profitable use for the crop may be found, it now appears that a material loss will be incurred by the owner. The situation, however, is so novel as to render the determination of the amount of the loss impossible at this time, and there is no data available from which to determine the length of time that will be required to ascertain whether such use for the grapes may be found. These elements of uncertainty must be recognized in making any ruling as to the deductions allowable in the case cited and necessitate a departure from the rule heretofore followed that what constitutes a proper deduction is to be determined by the facts existing at the time the loss is incurred and that neither the taxpayer nor the Government can be allowed to amend the return to accord with subsequently ascertained facts. A "reasonable allowance" in advance of actual obsoleteness can only be made by allowing a tentative deduction for obsolescence for the tax year in which the legislation is passed, leaving the definite determination of the loss involved to await the result of the experiment. The deduction allowed by the statute is a "reasonable allowance" which involves a recognition that it must be made on a basis less certain than is required where an actual loss based on previous abandonment is claimed. From a memorandum of the Advisory Tax Board it is learned that the Board considers that where abandonment has not occurred and the vineyards are being experimentally cultivated one-half the loss which would result in case of failure to find a profitable use for the grapes produced by the vineyard will be a reasonable tentative deduction upon an obsolescence basis for the tax year in which the prohibition act is passed, it being assumed that two years will be a sufficient period within which to determine the success or failure of the experiment, and this conclusion is regarded as reasonable. Should obsoleteness not ensue within the second year, this allowance will prove to have been too liberal.

Where a vineyard is abandoned for the growing of wine grapes and the vines and improvements incidental solely to such use are junked and the land applied to other uses, there is a definite basis for the determination of the loss. Such loss is represented by the difference between the value of such vines and improvements on March 1, 1913, if previously acquired, or their cost if subsequently acquired, and their salvage or junk value plus any depreciation previously charged off. This loss by obsolescence will be distributed over the period elapsing between the time when the prohibition measure causing it was passed and the year in which abandonment occurs. Any improvements, such as the installation of drainage or irrigation, fencing, breaking up of the ground, or similar improvements, which, although incidental to the planting of the vineyard, tend to permanently improve the land for other uses, are not to be included in determining the value or cost of the property abandoned.

Generally speaking, no allowance for obsolescence or obsoleteness is allowable in the case of land, because deductions for these causes depend upon substantial loss of use, and the presumption is that land which has been useful for one purpose will still be of use for some other purpose. In rare instances, however, this presumption may be overcome by the production of evidence tending to show that after the prohibitory law becomes effective the land will not be commercially profitable for any purpose. Mere decrease in the value of land, of even 40 or 50 per cent, will not be sufficient basis for an allowance for obsolescence or for obsoleteness. Such decrease in value can be deducted only when realized by sale or in some other manner. The exception here made is in the case of land which not only decreases in value but decreases to so marked a degree that it becomes practically worthless. This decrease must be due to a substantial loss of usefulness of the land through the prohibition legislation, due to the fact that the vineyard land is not susceptible of profitable cultivation in other crops because of the character of the soil or its location. Where the taxpayer has successfully shown that his case is one of the unusual cases in which the land is rendered substantially useless by prohibition legislation, a deduction for obsolescence of the land as well as the vines and improvements is allowable, and in such case it will be proper to include in the cost or value used as the basis of obsolescence the value of any improvements which were regarded as increasing the permanent value of the property and which have not heretofore been treated as an expense.

It is therefore held that:

(1) Where vineyards planted to wine grapes appear to be rendered useless for profitable operation as vineyards through the enactment of prohibition legislation, but the owners continue to cultivate them in the hope that some new and profitable use for the crop may be found, a reasonable deduction for obsolescence may be claimed. There being at this time no data available upon which a determination of what constitutes a reasonable deduction may be made, a tentative deduction of one-half the loss which would result from the total abandonment of the property for vineyard purposes may be made in the return for the year in which the legislation was enacted, subject to adjustment when the success or failure of the experiment shall have been satisfactorily established.

(2) Where vineyards devoted to the growing of wine grapes are, as a result of prohibition legislation, abandoned as vineyards and the vines and improvements incidental solely to grape growing are junked and the land employed in other uses, the loss directly resulting may be deducted in determining the net income of the owner, care being taken to exclude from the deduction the value of any improvements, such as installation of drainage or irrigation, fencing, breaking up of the soil, and similar improvements, which while incidental to the planting of the vineyard, tend to permanently improve the ground for other uses. The allowance for obsolescence will be distributed over the period elapsing between the passage of the prohibition measure and the date when abandonment occurs.

(3) In general, no deduction for obsolescence or obsoleteness is allowable in the case of land, but in exceptional cases, where the loss of usefulness through prohibition legislation is so great that the land practically becomes worthless, the taxpayer may, upon the proper showing, be allowed a reasonable deduction on that account for the land as well as for the vines and improvements. In this case the cost or value used as the basis of such deduction for obsolescence or obsoleteness may properly include the value of any improvements which when made were regarded as permanently improving the land and which have not heretofore been charged off as expenses. In the case where the entire deduction is claimed in a single year by reason of actual abandonment on account of obsoleteness of land, vines, and improvements, the amount of such deduction will be the difference between the value on March 1, 1913, if acquired prior to that date, or the cost, if acquired on or after that date, and the salvage or junk value, taking into account any deductions or obsolescence previously allowed. Where a reasonable allowance for obsolescence is claimed before actual abandonment, to be spread over a period of two or more years, care must be taken to eliminate from the sum used as the basis of the allowance any general decrease in the value of real estate due to other causes, such decrease being deductible only when definitely determined through sale.

(4) Any return of income from vineyard property in which a deduction is claimed as a result of obsolescence must be accompanied with an affidavit setting forth fully the facts necessary to a determination of the loss properly chargeable to obsolescence under the rules aobve stated.

(5) Law Opinion 524 and Solicitor's Memoranda 735, 797, and 872 are modified so far as not in accord herewith.—O. 862.

BASIS FOR COMPUTATION OF DEDUCTION.

The basis for computing the amount deductible on account of depreciation and obsolescence is the cost of the property, or its fair market value as of March 1, 1913, if acquired by the taxpayer prior to that date, and the probable useful life of the property in the trade or business. The fair market price or value of property as of March 1, 1913, is considered to be the cost of the property less depreciation sustained to that date unless the taxpayer can establish a greater value by evidence satisfactory to the Commissioner. To the cost or the fair market value as of March 1, 1913, should be added from time to time the cost of improvements, additions, or betterments not deducted as expenses in the taxpayer's returns, and from it should be deducted the amount of any damage to the property or loss of property through casualty.

In case of property acquired by gift, bequest, or devise, the deduction is based on the fair market price or value of the property at the date when acquired, or if acquired prior to March 1, 1913, its fair market price or value as of that date, and its remaining useful life in the trade or business, proper adjustment being made from time to time by reason of improvements, additions, betterments, or losses since acquirement or since March 1, 1913.

Prior to the approval of Treasury Decision 2754 (August 23, 1918) depreciation allowances were required to be based on the cost of the property. This Treasury decision authorized depreciation deductions based on the value of property as of March 1, 1913, if acquired prior thereto. The basis in the case of property acquired on or after that date remained unchanged.

In an opinion rendered by the Solicitor of Internal Revenue it was held that Treasury Decision 2754 is applicable to returns for 1913 and all subsequent years. This Treasury decision was based on a prior opinion of the Solicitor of Internal Revenue in which it was held that the depreciation charges allowable for any year represent the portion of the gross income of the year necessary to make good a capital shrinkage, that the charges should therefore be such as to amount in the aggregate during the life of the depreciating property to the value of that property as a capital asset; and that under the United States Supreme Court decisions in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, and *Lynch* v. *Turrish*, 247 U. S. 221, this capital value should be determined as of March 1, 1913.

In no case, however, may the total amount to be returned to the taxpayer through depreciation deductions exceed the cost of the property in question or its value as of March 1, 1913, if acquired prior to that date. When the fair market price or value of property as of March 1, 1913, is used as the basis for computing depreciation deductions, such price or value should be spread ratably over the remaining useful life of the property and deductions made accordingly. Such deductions are allowable until the total equals the fair market price or value of the property as at March 1, 1913, irrespective of amounts deducted prior to that date. For example, A erects an office building in 1908 at a cost of $540,000, its estimated useful life being 50 years. The annual charge for depreciation would be $10,800. The fair market value of the building March 1, 1913, substantiated by proper evidence is $540,000. This amount may be spread ratably over the remaining useful life of the property, 45 years, and $12,000 charged off each year until the full amount of $540,000 has been charged off irrespective of the fact that over $50,000 will have been charged off prior to 1913.

The appreciation in the value of the building as of March 1, 1913, over the cost less depreciation sustained to that date should be evidenced by proper book entries in order that the aggregate of the depreciation charged off will not exceed the debits to the building account. The amount of appreciation thus set up on the books is not required to be returned as income since appreciation in the value of property is not considered income prior to its realization through conversion of the property.

Allowances for depreciation may under no circumstances be based on a fictitious cost price or value of property, or on its replacement value. If property was acquired prior to March 1, 1913, and its fair market value as of that date forms the basis for computing the allowance for depreciation and obsolescence, such value must be substantiated by evidence satisfactory to the Commissioner. No appraised value as of any date other than March 1, 1913, may be used as the basis for computing the allowance.

What the fair market price or value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably or adequately make it appear.

The meaning of the term "fair market value" for income tax purposes is outlined in the following paragraphs from Advisory Tax Board Recommendation 57:

Section 202 (b) of the Revenue Act of 1918, provides: "When property is exchanged for other property the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its *fair market value, if any;* * * *."

By the use of the language quoted Congress recognized that for the purpose of determining gain or loss derived from the exchange of property for property, property received in exchange may not have any "fair market value," the object of the present inquiry is to secure a statement in general terms of the circumstances under which, for this purpose, property received in exchange may be said to have no "fair market value."

In the absence of reason to the contrary the words, "fair market value" must be given their ordinary meaning. The expression "market value" either with or without the adjective "fair," is a familiar one and has frequently been defined and explained. Without attempting in this recommendation to collate these definitions, it may be said that they amount in substance to this, that the "market value" of property is the fair value of the property in money as between one who wishes to purchase and one who wishes to sell. It is not, however, what can be obtained for the property when the owner is under peculiar compulsion to sell or the purchaser to buy; nor is it a purely speculative value which an owner could not reasonably expect to obtain for the property although he might possibly be fortunate enough to do so. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective "fair" emphasizes the idea of fairness inherent in this conception of market value, and excludes any possibility of a construction of the words "market value" with reference to a market in which, or to circumstances of sale under which, for any reason a fair price could not be obtained. Under this interpretation property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell, and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion; that is, property has no "fair market value" when market conditions are such that there would be no trading in the property in question at a fair price. It does not follow, however, that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The fact that there is no "market price" or "current price" so established does not indicate that the property may not readily be sold at a fair price, and the meaning of "market value" is not ordinarily so restricted. The courts have recognized not only that there are cases in which property has no "market value," or more properly "market price," in this restricted sense, but also that there are cases in which property has no "market value" in the broader sense in which the words are used in the statute as herein construed. See *Wall* v. *Platt*, 169 Mass. 398; *Montgomery County* v. *Schuylkill Bridge Co.*, 110 Pa. St. 54.

A construction of the statute in which the words "fair market value" are defined as above indicated is in accord with its theory and purpose. A fundamental consideration in income taxation is to determine when income, or elements essential to the computation of income, such as gain and loss, are realized. Clearly, gain or loss is realized upon the sale of property for cash. It seems, moreover, that even apart from express statutory provision gain or loss is realized from the exchange of property for other property which may fairly be said to be the equivalent of cash. See *California Copper Syndicate* v. *Harris*, 41 Scot. L. R. 691; 5 Tax Cas. 159. Such was the ruling of the Bureau under the Act of October 3, 1913, and the Revenue Act of 1916. (O. 434.) The Revenue Act of 1918 expressly recognizes this principle in the language now under consideration in providing that "the property received in exchange shall * * * be treated as the equivalent of cash." It is reasonable to regard property which has a "fair market value," as the words are herein defined, as "the equivalent of cash." A taxpayer receiving such property can determine the amount of his gain or loss in terms of cash with a reasonable degree of certainty and can, if necessary, without undue sacrifice obtain by the sale of such property cash with which to pay his taxes. It is, however, unreasonable to regard property which has no "fair market value," in this sense, as "the equivalent of cash." A taxpayer receiving such property can neither determine the amount of his gain or loss with certainty nor obtain cash by sale of the property without sacrifice.

It may be argued against the construction here given to the words "fair market value" that these words are used in other parts of the statute in such a way as to imply that property always has a "fair market value" and that the same meaning should be given to the words throughout the statute. Thus, in ascertaining gain or loss upon the sale or other disposition of property acquired before March 1, 1913, the basis is "the fair market price or value of such property as of that date" (sec. 202(a) 1), or, where stock or securities acquired before March 1, 1913, are exchanged for other stock or securities in connection with a reorganization, merger, or consolidation, "the fair market value as of that date" (sec. 202(b)). So in ascertaining the amount of depletion in the case of property acquired before March 1, 1913, the basis is the "fair market value * * * on that date," and in the case of property having a discovery value the basis is the "fair market value of the property at the date of the discovery, or within 30 days thereafter." (Secs. 214(a) 10; 234(a) 9.)

The provisions above quoted raise no necessary implication that property always has a "fair market value." The resort to "fair market value" in the case of discovery can be made only where the "fair market value of property is materially disproportionate to the cost"; that is, it must appear that the property has a "fair market value" and that such value is materially disproportionate to cost. There is no presumption that either fact exists. In the case of depletion of property acquired before March 1, 1913, "fair market value" is to "be taken in lieu of cost up to that date." The natural construction of this language is that "fair market value" is to be taken wherever possible, otherwise "cost up to that date." In ascertaining the gain or loss resulting from the sale or other disposition of property the purpose of valuing such property on March 1, 1913, is to determine the amount which must be withdrawn from the sale price in order to keep the capital intact. In the case of a sale or other disposition of property, not, however, including depletion (see *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103), it would be necessary to so withdraw the value of the property on March 1, 1913, even if there was no statutory provision therefor. See *Doyle* v. *Mitchell Bros.*, 247 U. S. 179; *Lynch* v. *Turrish*, 247 U. S. 221; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330. The present statute must be construed as authorizing the withdrawal of such value. This result can be reached either by holding that all property had a "fair market price or value" on March 1, 1913, or by holding that "fair market price or value" is the statutory measure of the value to be withdrawn in any case in which the property has a "fair market price or value," but that where it has no such "fair market price or value" other means of measuring value must be resorted to. The latter interpretation gives to the words "fair market * * * value" their ordinary meaning, and, while recognizing that they have the same meaning throughout the statute, gives effect to the words "if any" in the paragraph under consideration. It seems, therefore, the more reasonable.

Since "fair market price," if not synonymous with "fair market value" is narrower in its scope, it seems unnecessary to distinguish between the expression "fair market price or value" and "fair market value." While it is possible to construe the words "fair market" as modifying only the word "price" and not the word "value" in section 202(a), the use of the phrase "fair market value" in other parts of the statute seems to indicate that this is not the proper construction. It may be noted, however, that if this construction were adopted the same result would be reached as is reached on the lines developed in this recommendation.

Some practical bearings of the construction herein given to the statute should be noted. Statements herein made are, however, far from exhaustive of a subject of special difficulty in the application of a general principle to specific cases. In determining whether property has a "fair market value" all available evidence must be considered. A case in which property has no "fair market value" should be regarded as unusual, and a determination that property has no "fair market value" should not be made lightly. Property is not without "fair market value" merely because there is a considerable divergence of opinion as to its value. "Fair market value" is to a large extent a matter of opinion and men of equally wise judgment will differ widely in their opinions. Frequently excellent evidence as to the "fair market value" of property, especially that which, though not ordinarily traded in, has a value in use, is found in its cost, or in the cost of reproducing it, with adjustments for depreciation and the like. (It should be noted, however, that while cost is frequently excellent evidence of "fair market value," "fair market value" may be either greater or less than cost and must, wherever made the statutory test, be taken regardless of its relation to cost.) As already pointed out, property can not be said to have no "fair market value" merely because no price therefor is established by public sales or sales in the way of ordinary business. Of course it is not essential that property be listed or traded in on any exchange in order that it may have a "fair market value." For example, stock in a small closely held corporation does not *ipso facto* lack "fair market value," nor does article 1563 of Regulations 45 so hold. Evidence as to the assets and liabilities of such a corporation and as to its earnings may furnish very definite indications as to its "fair market value." Even if a corporation is newly organized and has never done business as such, but has succeeded to the business of an individual or partnership, its stock will ordinarily have a "fair market value" ascertainable by reference to its assets and liabilities, the history of the specific business, and the history and conditions of the industry in general. Similar considerations apply to other kinds of property.

In any case in which it is found that property received in exchange has no "fair market value" and that, consequently, no gain or loss results from the exchange, the property received in exchange is to be treated as taking the place of the property exchanged therefor and takes as its value for the purpose of computing depreciation, depletion and gain or loss resulting from sale or other disposition, the cost, or the market value on March 1, 1913, or on the date of discovery, as the case may be, of the property exchanged for it. Property which has no "fair market value" for the purpose of determining gain or loss under section 202(b) has no "fair market value" for any of the purposes of the Revenue Act of 1918.

It is held, therefore, that section 202(b) of the Revenue Act of 1918 must be construed as recognizing that there are exchanges of property for other property which do not result in taxable gain or deductible loss for the reason that the property received in exchange has no "fair market value." A general statement as to the circumstances under which this is true is made in the body of this recommendation.—T. B. R. 57.

The Committee on Appeals and Review considered the subject of valuation of intangible assets as of March 1, 1913, and reported as follows:

The Committee has considered the question of providing some practical formula for determining value as of March 1, 1913, or of any other date, which might be considered as applying to intangible assets, but finds itself unable to lay down any specific rule of guidance for determining the value of intangibles which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-marks, trade brands, etc. However, there are several methods of reaching a conclusion as to the value of intangibles which the Committee suggests may be utilized broadly in passing upon questions of valuation, not to be regarded as controlling, however, if better evidence is presented in any specific case.

Where deduction is claimed for obsolescence or loss of good will or trade-marks, the burden of proof is primarily upon the taxpayer to show the value of such good will or trade-marks on March 1, 1913. Of course, if good will or trade-marks have been acquired for cash or other valuable considerations subsequent to March 1, 1913, the measure of loss will be determined by the amount of cash or value of other considerations paid therefor, and no deduction will be allowed for the value of good will or trade-marks built up by the taxpayer since March 1, 1913. The following suggestions are made, therefore, merely as suggestions for checks upon the soundness and validity of the taxpayers' claims. No obsolescence or loss with respect to good will should be allowed except in case of actual disposition of the asset or abandonment of the business.

In the first place, it is recognized that in numerous instances it has been the practice of distillers and wholesale liquor dealers to put out under well-known and popular brands only so much goods as could be marketed without affecting the established market price therefor and to sell other goods of the same identical manufacture, age, and character under other brands, or under no brand at all, at figures very much below those which the well-known brands commanded. In such cases the difference between the price at which liquor was sold under a given brand name and also under another brand name, or under no brand, multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand during that year, and where this practice is continued for a long enough period to show that this amount was fairly constant and regular and might be expected to yield annually that average profit, by capitalizing this earning at the rate, say, of 20 per cent, the value of the brand is fairly well established.

Another method is to compare the volume of business done under the trade-mark or brand under consideration and profits made, or by the business whose good will is under consideration, with the similar volume of business and profit made in other cases where good will or trade-marks have been actually sold for cash, recognizing as the value of the first the same proportion of the selling price of the second, as the profits of the first attributable to brands or good will, is of the similar profits of the second.

The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the Committee that this return should be capitalized upon the basis of not more than five years's purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles.

In view of the hazards of the business the changes in popular tastes and the difficulties in preventing imitation or counterfeiting of popular brands affecting the sales of the genuine goods, the Committee is of the opinion that the figure given of 20 per cent return on intangibles is not unreasonable, and it recommends that no higher figure than that be attached in any case to intangibles without a very clear and adequate showing that the value of the intangibles was in fact greater than would be reached by applying this formula.

The foregoing is intended to apply particularly to businesses put out of existence by the prohibition law, but will be equally applicable so far as the third formula is concerned, to other businesses of a more or less hazardous nature. In the case, however, of valuation of good will of a business which consists of the manufacture or sale of standard articles of every-day necessity not subject to violent fluctuations and where the hazard is not so great, the Committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10 to 8 or 9 per cent, and that the percentage for capitalization of the return upon intangibles might be reduced from 20 to 15 per cent.

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings, eliminating any year in which there were extraordinary factors affecting earnings either way. Also, in the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.—A. R. M. 34.

The Advisory Tax Board in Memorandum 39 considered the application of a taxpayer for authority to compute depreciation and obsolescence of an intangible asset (a patented invention) for 1918 on the basis of value as of the beginning and the end of that year, instead of basing the deduction on cost. The facts and the decision follow:

The claim of the taxpayer is that depreciation and obsolescence should be allowed to the full amount of the 1918 income; that in arriving at the amount of depreciation and obsolescence the value of the intangible property as of January 1, 1918, and the value as of December 31, 1918, should be taken as the two determining factors.

This claim must be denied. The purpose of all deductions, whether by way of depreciation, obsolescence, depletion, or loss, is to allow a return to the taxpayer of his capital investment without subjecting such capital to income tax. In determining the amount of capital to be recovered without taxation, considerations of practicability must govern. It must, for instance, be capable of measurement by such instruments as are available in the administration of a tax law. This does not mean that other forms of capital do not exist, but merely that a point is reached at which it becomes administratively impracticable to distinguish between capital and income. In such cases the major portion of the annual realization is normally income; therefore the presumption must be adopted that the whole amount is income. Applying this principle to the present case, it will be seen that A through a series of years had by study, training, experimentation, and other means developed a capacity for producing technical devices of a high order. To a considerable extent, however, the expenditures necessary to reach this attainment are of a kind common to all men and are necessary to fit any man to earn a living. Nor is it possible to differentiate between the man of genius and the ordinary man in such a way as to impute a capital investment to the one when it must as a practical matter be denied to the other, for, of course, genius is attributable to gifts of nature more than it is to outlays upon educational or other development.

Even though it were practicable by finer instruments of measurement to reach a capital value of the individual's developed capacity, it would not meet the claim now under consideration, which is, as stated above, that the capital value subject to depreciation and obsolescence as from January 1, 1918, is the market value of the particular device. Such market value on that date would be equal to the discounted value of the anticipated earnings, or, in other words, the capital sum would consist of the income which it is the design of the income tax law to tax. This principle, if applied to property generally, as it would have to be if allowable in the case now under consideration, would not only cripple the present tax law, but in large measure would make all income immune from taxation. The rule that cost in the case of property acquired since March 1, 1913 (except as to gifts and inheritances which are specifically otherwise provided for in the law) [is the only element of value which can be recognized as capital], rests securely on the ground that capital created by human effort must pass through the door of taxable income before it can for the purpose of that tax establish its position as capital. The law does not tax value appreciation, nor does it recognize value appreciation as capital until such appreciation has been realized and taxed. Neither does the law lay a tax upon the creation of ideas or devices, nor can it without devitalizing itself recognize as capital the value of such mental or material conceptions until after such value has been realized by sale or in such other manner as will first give it the status of taxable income. This step having been taken, the value to the new owner upon which he may claim a capital allowance in computing net income is the cost to him. This is a fundamental in the basis of income taxation, and no exception thereto can be allowed except such as are specifically provided for by the statute.

Stress was laid by the taxpayer upon the provisions of section 214(a) 10 and of section 234(a) 9, which provide that in the case of mines, oil and gas wells, discovered by the taxpayer, the value under certain conditions may be taken as the fair market value of the property at the date of discovery or within 30 days thereafter. This, however, is not a normal rule for the computation of net income, but is an exception specifically granted by the statute and carefully restricted to mines and oil and gas wells. That other kinds of property or other taxpayers may be equally meritorious is immaterial; they are omitted by the statute and can not be brought within it by any proper method of construction.

For the reasons above indicated the Advisory Tax Board recommends that the claim of the taxpayer for a deduction from gross income by way of depreciation and obsolescence based upon the value of his intangible property at January 1, 1918, be denied, and that the amount of each deduction be limited to a reasonable amount based upon the specific cost to him of such property exclusive of all items of such cost which have been deducted as expenses in income tax returns for previous years.—T. B. M. 39.

RATE OF DEPRECIATION—PROBABLE USEFUL LIFE OF PROPERTY.

Consideration of the elements entering into depreciation and of the many problems arising therefrom, involves questions of great difficulty, the solution of which does not yield to exact determination in such a manner that precise rules of treatment can be established or theoretical formulae deduced which can be applied to all cases, or even to many. It is considered impracticable to prescribe fixed, definite rates of depreciation which would be allowable for all property of a given class or character. The rate at which property depreciates necessarily depends upon its character, locality, purpose for which used, and the conditions under which it is used. Manufacturing plants in the same locality, doing identically the same kind of business, depreciate at widely different rates, to a large extent dependent upon the management and the fidelity with which repairs are made and the property maintained; but so many other elements enter into the question that even the relative importance of the different factors can be determined only with difficulty and as approximations. The taxpayer should in all cases determine as accurately as possible according to his judgment and experience the rate at which his property depreciates. The rate used will, however, be subject to the approval of the Commissioner.

In recognition of these facts, if understatements of taxable net income in returns are due to charging off depreciation in excess of an amount deemed reasonable by the Commissioner, negligence or intent to defraud will not be imputed to the taxpayer unless the position taken is so unreasonable as to indicate gross carelessness or bad faith.

It is recognized also that property, for example, manufacturing machinery, may be subject to extraordinary depreciation due to being operated overtime, at an overload, or being used for some purpose for which it is not adapted. Under such conditions, a taxpayer may deduct in addition to the amount measuring the depreciation under normal conditions, a further sum to provide for the extraordinary depreciation. It does not necessarily follow that if a machine operated normally for 8 hours a day, is operated for 16 hours a day, it will depreciate twice as rapidly as when operated under normal conditions. The estimate of the extraordinary depreciation should be made by the taxpayer according to his judgment and experience and will be subject to the approval of the Commissioner.

On account of the difficulty of estimating accurately the probable useful life of property, in many cases when the property is discarded and salvaged, the sum of the depreciation deductions and the salvage value may be greater or less than the original cost of the property. If such sum is less than the cost, the difference may be deducted as a loss; if such sum exceeds the cost, the excess must be reported as income; the adjustments to be made in the return for the year in which the property is discarded or salvaged. This refers only to differences within reasonable amounts and will not apply when the difference or excess is large or when, through negligence, carelessness, or fraud, the depreciation deductions have been insufficient or excessive. In such cases the Commissioner may require corrections to be made for prior years by means of amended returns and is authorized to assert penalties in cases of negligence, carelessness, or fraud.

If it develops at any time before property is discarded that the useful life of the property has been inaccurately estimated, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread ratably over the estimated remaining useful life of the property. Inasmuch as under the provisions of the income-tax Acts in effect prior to the Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, the taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art.

The rate of depreciation of a building is not based upon the number of years it would stand before being condemned and torn down, but is based on the number of years it would remain habitable and serviceable for the general purposes for which constructed or acquired. If A purchases for $10,000 a building having an estimated life at date of acquisition of 40 years, and at the expiration of 10 years sells the building to B for $6,000, in such case B should base his depreciation deduction on the purchase price and the estimated remaining useful life of the building at the date when he acquired it. Such estimated remaining life does not necessarily bear any relation to the estimate made by A, the former owner, and may be greater or less than 30 years.

Freight steamships on Great Lakes.—Three per cent is held to be a reasonable allowance for depreciation of bulk freight steamships on the Great Lakes; however, when due to peculiar conditions, it can be definitely determined that the established rate of depreciation will not be sufficient to return all of the capital invested, as at the date of acquisition, or March 1, 1913, whichever is later, by the time the vessel will be rendered useless, an addition to the regular rate to cover obsolescence may be allowed. The amount of this addition must be determined upon the basis of the facts in each particular case; that is, the type of vessel in question, the fitness for possible use in other lines of transportation, and the date when it can be definitely foreseen that the vessel will be no longer commercially useful in this particular line of traffic.

This rule does not necessarily apply to steamers engaged in other lines of traffic, for the reason that there are distinct differences in the method of construction and the manner of operation of package freighters and passenger steamers and the bulk freighters under consideration. (From Recommendation 27 of the Committee on Appeals and Review, published in full in Bulletin 9–20, p. 14.)

Repairs, replacements and improvements as affecting rate of depreciation.—The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as a business expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be added to the property account or be charged against the depreciation reserve. The allowance for depreciation is intended to cover the estimated lessening in value of the original property, due to wear and tear, decay or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property in spite of ordinary current repairs.

Accordingly, amounts paid for repairs are not allowable deductions if they are duplications of allowances for depreciation. It does not follow, however, that there may not be in the same case allowable deductions both for depreciation and payment for repairs. As a rule, property that has been subject to use even though maintained in serviceable condition by repair has a shortened expectancy of usefulness. In such case there may be a deduction for payments for repairs and also a deduction for loss due to depreciation of the property which occurred despite the maintenance of such property in repair.

The allowance for depreciation to which a taxpayer is entitled is the net depreciation for the taxable year. Losses by reason of exhaustion, wear and tear suffered during the taxable year, but made good by repairs during the year, are not included in such net depreciation. Nor can the taxpayer speculate as to the extent of the loss which he would have suffered if he had not arrested deterioration by repairs. The taxpayer is entitled to an allowance for the actual net depreciation suffered during the taxable year, and in addition thereto to an allowance for expenditures for ordinary repairs. He is not, of course, entitled to a deduction for amounts expended during one taxable year to make good depreciation suffered and allowed as a deduction in a previous year.

The amount expended by a taxpayer during any taxable year or period for improvements, replacements, or renewals of a permanent nature is a capital investment and is not deductible from his gross income for such taxable year or period. The amount so expended should be charged directly to the property account or to the depreciation reserve account, dependent upon how depreciation charges are treated in the books of account, and a pro rata portion thereof deducted as depreciation each year of the life of such improvements, replacements, or renewals.

METHOD OF COMPUTING DEPRECIATION ALLOWANCE: ACCOUNTING PRACTICE.

The proper allowance which may be deducted from gross income for depreciation and obsolescence of property used in the trade or business is an amount which should be set aside by a taxpayer during each year of the useful life of the property according to a consistent plan by which the total of such amounts for the useful life of the property, together with its salvage value at the end of its useful life in the business, will provide in place of the property its cost or its fair market value as of March 1, 1913, if acquired by the taxpayer prior to that date.

A simple illustration follows: The X Manufacturing Company purchased a piece of machinery in 1914 for $4,275. Its estimated useful life in the business is 15 years, at the expiration of which time it will have a salvage value of $75. The annual deduction on account of depreciation would be $280.

Capital sum recoverable through depreciation allowances.—The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date, and in the case of property acquired by gift, bequest, or devise, the sum recoverable is the fair market price or value of the property at the time acquired, or its fair market price or value March 1, 1913, if acquired prior to that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility, which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, buildings and land, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition.

The capital sum to be replaced by allowances for depreciation should be charged off over the useful life of the property, either in equal annual installments, this plan being generally known as the "fixed percentage" method, or, in accordance with any other recognized trade practice, such as apportionment over units of production.

Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return. The "fixed percentage" method as applied by the Commissioner contemplates that the annual depreciation deductions with respect to any property should be equal; that the rate of depreciation should be assumed to be uniform during the useful life of the property, as compared with the so-called "fractional method—weighted years," "declining balance method—scientific or unscientific," "revaluation method," and "sinking fund method," the use of which is advocated by accountants, but none of which have been approved in their entirety by the Commissioner for income tax purposes.

The only other method which has been approved by the Commissioner is an apportionment of the depreciation charges over the total amount of work to be performed or over units of production. For example, a contractor may purchase machinery for use only in performing a certain contract, which machinery will be worthless or have little or no salvage value upon completion of the contract on which he will be engaged for the whole of one taxable year and half of the succeeding taxable year. But the number of units of work, or percentage of completion accomplished during the first period of 12 months and during the second period of six months, may be equal. The contract may call for the making of an excavation, and the same number of yards may be excavated during each of the above periods. Under such circumstances, if the contractor returns his gross income each year on the basis of percentage of completion of the contract, he will be permitted to spread the total amount of the depreciation allowance equally over the two periods, deducting half of the total amount in his return for the first 12 months, and the other half in his return for the succeeding taxable period.

If the contractor had returned his income on some basis other than that of percentage of completion of the contract, it would have been necessary for him to modify his basis for computing the depreciation allowances. Thus, if the gross income was returned on the basis of time required for completion of the above contract, two-thirds of the gross income being reported in the return for the first 12 months, and the other third reported in the return for the succeeding period; in that case two-thirds of the total depreciation allowance would be deducted in the return for the first period and the remainder in the next return.

A lumber company contracts to cut and saw the timber on a certain tract of land, the estimated time required being two years. It erects buildings and installs equipment which by reason of prohibitive cost of removal will be worth only the salvage value upon completion of the contract. The cost of the property and equipment may be charged off and deducted as depreciation allowances on the basis of the time required to complete the contract, or in the proportion that the amount of timber cut and sawed each year bears to the total amount of timber available.

WHO MAY CLAIM DEDUCTIONS FOR DEPRECIATION AND OBSOLESCENCE.

An allowance for depreciation and obsolescence may be claimed by individuals, citizen or alien, resident or nonresident; fiduciaries of estates and trusts, partnerships; corporations, domestic or foreign, including personal service corporations; associations, joint stock companies, and insurance companies, with respect to property actually used in trade or business and recognized by the Bureau of Internal Revenue as subject to depreciation or obsolescence or both.

Lessor and lessee.—Ordinarily an allowance for depreciation may be taken only on account of property owned by the taxpayer and used in trade or business and may not be taken on account of property of which he is merely the lessee. This will not preclude the deduction each year by the lessee of an aliquot part of the cost or the bonus paid for the lease. In the case of additions, improvements, or betterments to the property made at the expense of the lessee, which, according to the terms of the lease, revert to the lessor at the termination of the lease, the lessee may apportion the cost of such additions, etc., over the life of the lease and deduct an aliquot part thereof each year. If, however, the life of improvements for business purposes made at the expense of a lessee is less than the life of the lease, depreciation may be taken by the lessee instead of treating the cost as additional rent. Stockholders of a corporation are not entitled to deduct in their individual returns any amount on account of depreciation of the property of the corporation from which they receive dividends.

Fiduciaries or beneficiaries of estates and trusts.—An individual who receives income from a trust estate may not deduct from gross income in his individual income tax return any amount representing depreciation of property belonging to the estate. However, under the Revenue Act of 1918 it is permissible for the fiduciary in ascertaining the net income of the estate or trust for which he acts to deduct a reasonable allowance to cover the depreciation sustained during the taxable year, whether or not the terms of the will or agreement creating the estate or trust or a decree of court provide for taking care of the depreciation which may be sustained on the property held in trust.

Estates and trusts are under certain circumstances treated as a unit, and in other cases may represent an aggregate of distinct interests to all of which the fiduciary is responsible. Irrespective of whether the estate or trust is or is not treated as a unit, the fiduciary in computing the net income upon which he is required to pay the tax may claim a deduction for depreciation in accordance with section 214(a) 8 Revenue Act of 1918 and articles 161–171 Reg. 45. See also T. D. 2987.

Joint owners of property.—A joint owner of inherited property, collecting rents and profits from such property and managing the property on behalf of all the owners, pursuant to an oral agreement, is an agent and not a fiduciary. It is, therefore, necessary for each of the joint owners to file an income tax return and account for his share of the income from the property in addition to income received by him from other sources. In preparing such returns each joint owner may claim as a deduction for each year his proportionate share of the depreciation allowance for such year with respect to the property held in joint ownership.

Nonresident alien individuals and foreign corporations.—Nonresident alien individuals and foreign corporations may deduct an allowance for depreciation and obsolescence from gross income arising from sources within the United States only to the extent that such deduction is connected with such gross income.

CONDITIONS OF ALLOWANCE.

Reduction in the value of property due to exhaustion, wear, and tear through use in trade or business is an actual fact, whether or not evidenced by book entries.

An allowance for depreciation and obsolescence must, however, be charged off by the taxpayer in his books and records in order to constitute an allowable deduction from gross income. The manner in which it is charged off is not material, except that the amount measuring a reasonable allowance for depreciation must either be deducted directly from the book value of the property or preferably credited to a depreciation reserve account, which should be reflected in the taxpayer's annual balance sheet. The allowance should be computed and charged off with express reference to specific items, units, or groups of property, and taxpayers should keep such records as may be readily verified.

The statement in the preceding paragraph to the effect that the depreciation allowance must be charged off before it can be deducted does not mean that depreciation sustained during one year may be charged out of the income of another year for income tax purposes; neither does it mean that failure to deduct depreciation before closing accounts for the year will prevent its ultimate deduction by the taxpayer. It means that if the taxpayer inadvertently neglected to make the proper entries on his books before closing them for the year during which the depreciation was sustained and failed to make the proper deduction from gross income in his return for that year, he may reopen his books, make the proper adjustment entries on them, and file an amended return showing the proper deduction for depreciation, provided bad faith or gross negligence was not shown in the preparation of his original return and in the manner in which he kept his accounts.

When the amount of depreciation charged off is credited directly to the property account, the value of the property appearing in a statement of affairs or a balance sheet will be its depreciated value, but subsequent deductions should nevertheless be computed on the basis of original cost or value as of March 1, 1913, as the case may be.

When the amount of depreciation charged off is credited to a depreciation reserve account the records of the taxpayer will show the original cost of the property when acquired while the depreciation reserve will be in the nature of a suspended credit to the property account.

Depreciation reserves.—Amounts deductible on account of depreciation should be credited to appropriate reserve accounts and carried as a liability against the assets to the end that when the total of these credits equals the capital investment account no further deductions on these accounts will be allowed.

While the presumption is that amounts credited to these accounts will be used to make good the loss sustained, either through a renewal or replacement of the property or a return of capital, there is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed or in restoring the capital invested in the depreciated assets.

The conversion of the depreciation reserve into tangible assets will not constitute such a diversion as would deny the taxpayer the right of deduction, provided in all cases that the deduction claimed in the return is reasonable.

A distribution made from a reserve for depreciation will be considered a liquidating dividend and will constitute taxable income to a stockholder only to the extent that the amount so received is in excess of the cost or fair market value as of March 1, 1913, of his shares of stock. No distribution, however, will be deemed to have been made from such a reserve except to the extent that the amount paid exceeds the surplus and undivided profits of the corporation.

Corporate taxpayers in some cases compute their net income for the taxable period without having made allowance for depreciation and then distribute the entire net income so computed to their stockholders so that the books show no surplus or undivided profits. In such cases if a corporation subsequently desires to avail itself of the privilege of deducting an allowance for depreciation in its return for such taxable period it must first reopen its books and make the appropriate charges as outlined on page 34. It will then be placed in the position of having paid a dividend from a depreciation reserve or from capital to the extent that the amount of dividend paid exceeds the true net income, meaning the net income *after* making proper charges for depreciation. The amount of the excess will be deemed a distribution in partial liquidation and taxed accordingly to the stockholders, and the invested capital of the corporation for excess profits purposes will be deemed to have been reduced to the same extent in accordance with article 860 of Regulations 45.

WHEN ALLOWANCE IS DEDUCTIBLE.

The deduction for depreciation and obsolescence allowable in the return for any taxable year or period is an amount sufficient to cover the reduction in value of property through exhaustion, wear and tear through use in the trade or business during such taxable year or period. The fact that depreciation and obsolescence have been sustained in prior years but were not claimed as a deduction in returns of net income will not warrant the deduction of an increased amount during the current year. The taxpayer's remedy lies in filing amended returns for prior years in which such deductions may be claimed and claims for refund of excess taxes paid.

On the other hand, excessive depreciation deductions are subject to disallowance by the Bureau upon audit of a taxpayer's returns. In such cases additional assessments of tax are made on the basis of the excessive deductions disallowed.

Delayed profit and loss adjustments.—Where common carriers during the year 1918 took up through their profit or loss account (pursuant to instructions of the Interstate Commerce Commission) "delayed" debit and credit items, such as allowances for depreciation sustained during the years 1912 to 1916, inclusive (the necessary data not having been available prior to the year 1918), it was held by this office that such credit and debit items should not be treated as part of the gross income and deductions therefrom in the return for 1918, but amended returns in which proper adjustments were to be made were required for the years affected.

EFFECT ON NET INCOME AND TAX.

In all cases the amount of the depreciation allowance reduces the net income, and consequently the amount of tax due. The gain derived or loss sustained from the sale of depreciable property also is affected by the amount of depreciation sustained, since in determining such gain or loss proper adjustment must be made for any depreciation sustained, it being immaterial for the purpose of the computation whether or not such depreciation has been deducted in returns of net income, except in the case of the sale of assets on account of which no depreciation deduction is allowable.

Furthermore, the invested capital of a corporation, association, joint-stock company, or insurance company is affected by depreciation, since in determining such invested capital under the Revenue Act of 1918 proper adjustment must be made in surplus account for any depreciation sustained, regardless of whether or not any deduction for depreciation was made in returns for prior years. This was equally true under the Revenue Act of 1917 as to individuals, partnerships, and corporations.

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