

## DEPRECIATION POLICY UNDER THE INTERNAL REVENUE CODE—A CAPITAL LEVY?

A generally accepted principle of accounting for profits is that depreciation<sup>1</sup> of fixed assets as an element of cost must be based on historical cost without correction for change in the price level.<sup>2</sup> In periods of inflation or deflation, this system of accounting results in a distorted income figure.<sup>3</sup> Income is illusory to the extent that depreciation based on current dollar values exceeds depreciation based on historical cost. The imposition of tax on this fictitious portion of "income" results in a capital levy.<sup>4</sup> Areas of government and business which heavily rely on accountants' representations of profits may suffer dire economic consequences by failure to recognize in income determination changes in the price level.<sup>5</sup>

---

1. Depreciation is the exhaustion of an asset due to the forces of wear and tear from operation and from the unavoidable action of time and the elements. For accounting purposes, depreciation represents the periodic distribution of portions of the asset cost to the expense account. The problem is to allocate costs in such a way that each period will bear a portion of the cost reflecting the exhaustion of equipment in that period. For tax purposes, under the Internal Revenue Code, depreciation must be a reasonable allowance for the exhaustion of property used in trade or business. It is recognized as a deduction from gross income. For both accounting and tax purposes, the recognized basis for computing depreciation is the original cost of the asset.

2. PATON, ACCOUNTANTS' HANDBOOK 713 (3d ed. 1947); FINNEY AND MILLER, PRINCIPLES OF ACCOUNTING, INTERMEDIATE 487-488 (4th ed. 1951); NEWLOVE, SMITH, AND WHITE, INTERMEDIATE ACCOUNTING 124 (Rev. ed. 1948); A.I.A., RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS 67-71 (Bull. No. 43, 1953).

3. The following cases have held that, for income tax purposes, depreciation is limited to the recovery of original cost: *Symington-Anderson Co. v. Commissioner*, 33 F.2d 372 (D.C. Cir. 1929), *cert. denied*, 280 U.S. 590 (1929); *Cameron v. Commissioner*, 56 F.2d 1021 (3d Cir. 1932); *Becker v. Anheuser-Busch, Inc.*, 120 F.2d 403 (8th Cir. 1941), *cert. denied*, 314 U.S. 625 (1941); *Detroit Edison Co. v. Commissioner*, 131 F.2d 619 (6th Cir. 1942), *aff'd*, 319 U.S. 98 (1943).

4. For an informative discussion of actual case studies made by the American Accounting Association of the misleading nature of the financial statements of four industrial firms using original cost basis of depreciation accounting, see Mason, *The Price-Level Study of The American Accounting Association*, 30 ACCT'G REV. 37 (1955).

In addition to federal taxation, the impact of inflation is also felt in the field of security regulation where full disclosure to prospective investors is a prime objective. State regulation of corporate dividends, public utility rate regulation, and wage negotiations between labor and management are other areas where the recognition of the changing dollar values in income determination will promote better understanding of the actual economic position of the enterprise being examined.

For a discussion of the effect of rising prices as related to dividend distribution under various state corporation statutes, see Kiley, *Some Legal Problems Arising from Profit Determination in Periods of Rising Prices*, 24 U. OF CINN. L. R. 519 (1956).

5. E.g., the scheme of federal income tax, state corporation laws on dividend distribution, credit extensions, public utility rate making, and investments must necessarily rely on representations of income.

With the inflationary price rise of World War II and its aftermath and because corporate profits are at an unprecedented high, the "write-up" movement which began in the early 1940's is gaining impetus.<sup>6</sup> The purpose is to show less taxable earnings by writing up the book values of capital assets to current values, thus increasing depreciation charges against revenues.<sup>7</sup>

Theoretically, cost is "a measure of actual economic sacrifice incurred" and "true net income cannot emerge until all actual costs in this sense have been deducted."<sup>8</sup> Therefore, if a piece of equipment is purchased for \$10,000 in 1935 and the identical equipment today costs \$20,000 to replace, depreciation charges in 1956 based on the 1935 value do not represent "actual cost" in 1956. When the accountant proceeds on an assumption that the dollar is a fixed and unvarying economic quantum and thereby ignores the change in the price level, net income as determined by conventional accounting for depreciation is partly or wholly fictitious.<sup>9</sup>

---

6. For some of the leading books and articles written on the subject, see SWEENEY, *STABILIZED ACCOUNTING* (1936); GOODE, *CORPORATION INCOME TAX* 172-178 (1951); Dean, *Provision for Capital Exhaustion Under Changing Price Levels*, 65 *HARV. L.R.* 1339 (1952); Landman, *The Old and New Depreciation Problem*, 27 *TAXES* 911 (1949); A Symposium, *Depreciation and the Price Level*, 23 *ACTING REV.* 115 (1948); Dean, *The Relation of Law and Economics to the Measurement of Income*, 28 *ACTING REV.* 328 (1953); Brown, *Tax Allowances for Depreciation Based on Changes in the Price Level*, 1 *NAT'L TAX J.* 311 (1948).

7. A somewhat analogous situation existed during the Great Depression. The "write-down" movement was in vogue for the purpose of freeing future income for dividends. As a result of the drop in corporate net income and the consequent curtailment of dividends, those vested with managerial powers often found their retention of control threatened. To create an impression of success and to abate the growing possibility of a corporate *coup*, management resorted to the practice of writing down book values of capital assets with a corresponding reduction in stated capital. The theoretical justifications for this practice were sound, but as a practical matter, the write-down movement did not follow the justifications offered to creditors. Many of the write-downs were arbitrary to the point at which depreciation charges reflected a relatively insignificant part of future costs, making greater dividend distributions possible. It was feared that this arbitrary method of writing-down assets would lead to a situation where working capital would be insufficient to maintain the necessary fixed assets at full working efficiency and to purchase necessary amounts of raw materials and labor. The probable result was inadequate provisions for repayment to creditors and more borrowing in order to maintain working capital at an operating level. For an excellent discussion of the write-down movement of the thirties, see Comment, 44 *YALE L.J.* 1025 (1935).

8. Paton, *Depreciation and the Price Level—Second Affirmative*, 23 *ACTING REV.* 118, 121 (1948).

9. It must be emphasized that the monetary unit (the dollar in the U.S.) serves as the unit in terms of which the "value" of all goods and services is measured and expressed. The adoption of a monetary unit by a society enables the "value" of each good or service to be expressed as a "price"—the exchange value in a market. It is an accepted economic principle that the monetary unit itself, if a satisfactory measure of value, must maintain a relatively stable purchasing power. Where the value of the monetary unit changes, an expression of the value of a given good or service by a larger quantum of units than was formerly necessary is required. For example, if a chair was expressed as commanding the value of \$10 at a given moment of time, when the value

The historical cost concept has long been a limiting factor to the various methods of depreciation accounting permitted under the Internal Revenue Code.<sup>10</sup> In periods of rising prices, the application of this concept results in a capital levy and perhaps violates the Constitutional provision permitting Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment."<sup>11</sup> Although the Constitution leaves it to the courts to determine what is "income", it should be clear that "income" cannot be construed to include a return of capital.<sup>12</sup>

The validity of such a constitutional argument against the current practice of depreciation accounting under the Code depends upon the concept of income as embodied in the sixteenth amendment. A precise definition of income has never been universally recognized.<sup>13</sup> The purpose for which the income is measured governs its definition. The purpose of the sixteenth amendment is to empower Congress to lay and collect taxes on income without apportionment but it is left to the courts to decide the theory of income upon which Congress can levy a tax.<sup>14</sup>

In the case of *Doyle v. Mitchell Bros. Co.*<sup>15</sup> "income" was defined

---

of the monetary unit decreases by 50%, assuming all other factors remain constant, the value of that same chair must be expressed as \$15. Although one might say that the "value" has increased by \$5, there is no economic gain since the owner of that chair still has one chair. The purchasing power of the dollar over goods and services in the market, the quantity of goods and services that each dollar will buy, has decreased by 50%, thus necessitating an increase in the price of the chair by a proportionate amount; but the purchasing power of the owner of the chair has remained the same. For analysis, two factors must be distinguished: (1) a change in the value of the monetary unit; and (2) a change in the value of the commodity itself. In both cases, the result on a given commodity is a change in its price. However, in the first instance, there is no economic gain or loss. In the second, there is economic gain or loss incurred by the owner of the commodity. The case for a higher depreciation allowance under the Internal Revenue Code must therefore be restricted to the situation where a change in the monetary unit occurs.

10. INT. REV. CODE OF 1954, § 167(f). For a discussion of the choice of methods of recovering cost through depreciation under the Revenue Act of 1954 and the related regulations promulgated by the Commissioner, see Graves, *Depreciation for Tax Purposes*, 34 TAXES 59 (1956).

11. U.S. CONST. AMEND. XVI.

12. The decisions show great confusion on the question whether depreciation and depletion deductions are required by the Constitution or whether they are a matter of congressional grace. See cases cited in notes 19 and 22, *infra*.

13. For a discussion of the different concepts of income, see 2 BONBRIGHT, VALUATION OF PROPERTY 894-911 (1937).

14. For an excellent review of some of the developments in the concept of taxable income during the past several years, both statutory and judicial, see Rapp, *Some Recent Developments in the Concept of Taxable Income*, 11 TAX L.R. 329 (1956).

15. 247 U.S. 179 (1917). Although this case arose under the Federal Corporation Excise Tax Act of Aug. 5, 1909, c.6, § 38, 36 STAT. 11, the concept of income expounded therein has been cited by the Supreme Court in cases arising under the sixteenth amendment. To justify this practice, Mr. Justice Butler stated in the case of *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1925), that the purpose or effect of the sixteenth amendment was not to bring any new subject within the taxing power. "Congress already had power to tax all incomes." The amendment abolished the distinction between

as "gain derived from capital, from labor, or from both combined, including profit gained through the sale or conversion of capital" and as importing "something entirely distinct from principal or capital" or that portion of gross receipts necessary to be withdrawn in order to preserve intact the capital used in producing those receipts.<sup>16</sup> Although the generally accepted definition of depreciation accounting by the accounting profession is that it is a system of allocating cost over the estimated useful life of the asset rather than a method of valuation,<sup>17</sup> it is beyond argument that the effect of depreciation accounting is to retain a portion of gross revenue necessary to be withdrawn in order to preserve intact the capital used in producing those revenues. The accountants' definition requires a crucial assumption in arriving at the conclusion that historical cost must be used as a basis of depreciation write-off.<sup>18</sup> It presupposes that "cost" means historical cost. This is the same supposition made in the interpretation of the Internal Revenue Code. The Code, however, nowhere explicitly defines "cost" as "historical cost."<sup>19</sup>

A difficulty and a possible inconsistency arose from the Supreme Court's holding that depletion deductions are a matter of congressional grace.<sup>20</sup> Under the present structure of depletion allowances on the percentage basis,<sup>21</sup> no one can argue that it is not by *grace* of Congress that such an allowance can be made. However, it cannot be maintained

taxes on income that are direct taxes requiring apportionment and those that are not and thus put on the same basis all incomes "from whatever source derived." "Income" has been taken to mean the same thing as used in the Federal Corporation Excise Tax Act of 1909, the sixteenth amendment, and various revenue acts subsequently passed. See *Merchants' Loan and Trust Co. v. Smietanka*, 255 U.S. 509, 519 (1921); *Eisner v. Macomber*, 252 U.S. 189, 207 (1919); *Southern P. Co. v. Lowe*, 247 U.S. 330, 335 (1918); *Stratton's Independence v. Howbert*, 231 U.S. 399, 415 (1913). Mr. Justice Pitney stated in *Eisner v. Macomber*, *supra*, that: "The 16th Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the Amendment was adopted." 252 U.S. at 205.

16. *Id.* at 185.

17. See A.I.A., REVIEW AND RESUME NO. 1—ACCOUNTING TERMINOLOGY BULLETINS 25 (1953).

18. The definition adopted by the American Institute of Accountants states that "Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner." *Ibid.*

19. Section 167(f) of the Internal Revenue Code of 1954 read in conjunction with section 1012 provides in substance that the basis of property shall be the cost of such property. The interpretation that "cost" is "historical or original cost" is a matter of judicial creation. See note 3 *supra*.

20. *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916); see also, *Sunray Oil Co. v. Commissioner*, 147 F.2d 962 (10th Cir. 1945), *cert. denied*, 325 U.S. 861 (1944); *Lucky Tiger-Combination Gold Mining Co. v. Crooks*, 95 F.2d 885 (8th Cir. 1938). *But see*, *Untermeyer v. Commissioner*, 59 F.2d 1004 (2d Cir. 1932), *cert. denied*, 287 U.S. 647 (1932); *Jefferson Lake Sulphur Co. v. Lambert*, 133 F. Supp. 197 (E.D. La. 1955); *Huntington Beach Co. v. U.S.*, 132 Ct. Cl. 427, 132 F. Supp. 718 (1955), *aff'd*, *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956).

21. INT. REV. CODE OF 1954, § 613.

from the holding that, *a fortiori*, a deduction for capital exhaustion is also a matter of congressional grace.<sup>22</sup> Insofar as such deductions identify the portion of current revenues representing a return of capital, they are required by the Constitution.<sup>23</sup> It seems clear then that failure to adjust original cost to reflect reduction in the value of the dollar does, in reality, overstate income and render the tax in part a capital levy.

Robert Haig's definition that "income is the money value of the net accretion to one's economic power between two points in time" may be stated as the ideal.<sup>24</sup> This definition cannot be consistently followed under the federal tax scheme due to practical and constitutional limitations, but can be adopted as a general guide to a pragmatic approach to taxation.<sup>25</sup> Under this concept of income, an increase in the monetary

22. Landman, *The Old and New Depreciation Problem*, 28 TAXES 911, 912 (1949). "Accounting tradition dating from the sixteenth century sanctions depreciation deductions on deteriorating fixed assets in computing net income. However, only Congressional grace is responsible for depreciation deductions for tax purposes. Taxpayers have no inherent right to such deductions, though they have their origin in accounting science." *Ibid.*

23. *Davis v. U.S.*, 87 F.2d 323 (2d Cir. 1937), *cert. denied*, 301 U.S. 704 (1937). Note the words of Judge Chase: "(O)ur scheme of income taxation provides for a method of computation whereby all receipts during the taxable period which are defined as gross income are gathered together and from the total are taken certain necessary items like cost of property sold; ordinary and necessary expenses incurred in getting the so-called gross income; depreciation, depletion, and the like in order to reduce the amount computed as gross income to what is in fact income under the rule of *Eisner v. Macomber*, 252 U.S. 189 and so lawfully taxable as such. In this way true income is ascertained by taking from gross income as defined that which is necessary as a matter of actual fact in order to determine what as a matter of law may be taxed as income. While such subtractions are called deductions, as indeed they are, they are not to be confused with deductions of another sort like personal exemptions; deductions for taxes paid; losses sustained in unrelated transactions and other like privileges which Congress has seen fit to accord to income taxpayers under classifications it has established. While the first kind of deductions are inherently necessary as a matter of computation to arrive at income, the second may be allowed or not in the sound discretion of Congress; the only restriction being that it does not act arbitrarily so as to set up in effect a classification for taxation so unreasonable as to be a violation of the Fifth Amendment. Such deductions as distinguished from the first kind are allowed by Congress wholly as a matter of grace." *Id.* at 324-325. It is also implied in the decision that if a tax is levied on the first type of deduction; i.e., cost of property sold, depreciation, depletion, etc., it is in substance a levy of a direct tax without apportionment. See *Brushaber v. Union Pacific R. Co.*, 240 U.S. 1 (1916). *But see* *Detroit Edison Co. v. Commissioner*, 131 F.2d 619 (6th Cir. 1942), *aff'd*, 319 U.S. 98 (1943); *Kansas City Southern Ry. Co. v. Commissioner*, 52 F.2d 372 (8th Cir. 1931), *cert. denied* 284 U.S. 676 (1931).

24. HAIG, *THE FEDERAL INCOME TAX* 1-28, as quoted in GOODE, *CORPORATION INCOME TAX* 168 (1951).

25. The pragmatic approach to taxation takes into consideration convenience, equity, and economic and fiscal expediency in determining an acceptable tax base. "Convenience, for the taxpayer and the government, implies use where possible of ordinary accounting records and avoidance of new and unusual record-keeping. Equity is broadly interpreted as equal treatment for equals on the basis of a reasonable classification. Expediency suggests the goal of minimum adverse economic effects consistent with revenue demands and the standards of convenience and equity." GOODE, *op. cit. supra* note 24, at 168.

value of an asset caused solely by price level changes is not income because it is not an increase in economic power. Cost must be measured with regard to changes in the value of the monetary unit employed because the economic power concept is a "net" concept of income which excludes elements of cost. To determine one's net accretion in economic power between two points in time, cost must be deducted with regard to changes in the price level.

It has been argued that the economic power concept is not consistently followed in the federal income tax scheme.<sup>26</sup> As a matter of constitutional requirement, the "realization" principle is followed and gains and losses are not ordinarily recognized for tax purposes until "realized" as the result of bona fide transactions. Therefore, it is argued, recognition of an increase in costs not yet objectively realized in a transaction can hardly be justified unless unrealized gains on capital assets are also recognized for tax purposes.<sup>27</sup> But this argument fails to distinguish between income and cost and between the different types of income.<sup>28</sup>

---

26. The Internal Revenue Code does not expressly adopt Haig's economic-power concept of income but defines taxable income mainly by enumeration of items to be included, excluded, or deducted. In general, however, in determining what items are to be included, excluded, or deducted, the economic-power concept may have been recognized as placing broad limits on the process of categorizing the specific items. *Ibid.*

27. The realization principle of income determination, which is not supported by sound economic theory but only by arguments of convenience in the measurement process, recognizes income to be derived or cost to be incurred only when certain events happen; i.e., the sale or purchase of a given item. This is said to provide an objective standard of measurement. However, when it is applied to the internal changes of a corporate enterprise, it becomes wholly untenable and any income figure derived from the accounting process misleading. It is a useful concept when applied to determine when a sale or purchase should be recorded but when it is extended to affect the costing process in the purely internal cost management of a firm, it becomes useless and reason clearly outweighs its merits of convenience. If such a concept of cost is used in determining selling price where a firm is fortunate enough to be in such a market position, in a continuing period of inflation such as we have been experiencing in the past 15 or more years, it would not be long before such a firm would find itself with working capital insufficient to replace its worn-out equipment. Some may argue that this is a matter of financial management and that management should have enough foresight to retain sufficient profits to make replacements. This argument ignores the profit motive and incentive in a capitalistic society. If taxes are to be paid out of profits that are in part illusory, then the shareholders must sacrifice profits that otherwise would have been distributed as dividends or plowed back not for replacements but for increasing the capacity of production.

28. "Cost" and "income" are interrelated terms. If an item is regarded as an element of cost, then it is not income. If it is income, then it is not an element of cost. These propositions hold true only when considering an item or transaction as of a moment of time. An item regarded as income to a firm today may be an element of cost tomorrow. For example, if services are rendered and a piece of equipment is received in payment therefor, the fair market value of that equipment can fairly be held as income to the firm. But, when that piece of equipment is put into productive use, it becomes an item of cost of production. Therefore, it is not incongruous to state that the appreciation in the value of capital assets caused solely by an increase in the price level, while it may be non-taxable income to its owner since it is not yet realized, may be an element of cost when used in production.

In holding that stock dividends are not "income" under the sixteenth amendment and that income will be derived when the stockholder sells his dividend shares, the case of *Eisner v. Macomber*<sup>29</sup> established the principle that a mere increase in the value of assets held by a person is not income in the constitutional sense because it is not "realized" or "derived" until some conversion takes place.<sup>30</sup> Under this decision, the "realization principle" adhered to in the Code is a constitutional requirement rather than one arising from congressional initiative. However, this decision cannot be construed to impose the realization principle in the determination of costs. The realization principle merely defers the taxability of certain income to the future. Cost goes hand in hand with the goods in the production of which the cost was incurred. Realization of cost comes at a time when the related goods are sold or exchanged. In this regard, some distinction must be made between capital assets held for sale and those held for production.<sup>31</sup> In the latter case, there is a gradual realization by use in production. Such assets are not purchased with the intention of later selling them at a profit as is usually the case for assets in the nature of stocks and bonds. Future sale except for scrap is not intended and a "realization" will never occur in the usual sense of the term. It only occurs when the goods produced or services performed by the use of such assets are sold. If depreciation is not taken at current values, the effect would be to tax the appreciation in value due to rise in the price level at ordinary rates rather than capital gains rates; thus putting such assets on an appreciably disadvantageous position in comparison with most other types of assets classified as capital assets under the Code.<sup>32</sup>

---

29. 252 U.S. 189 (1919).

30. *Id.* at 213.

31. Furthermore, depreciation of capital goods used in production cannot be likened to the LIFO (last-in, first-out) method of inventory accounting for they are entirely different types of assets to a particular business firm. Capital goods are held until their economic use is exhausted. Inventories, on the other hand, are items held for sale or for the production of goods that are to be sold in a relatively short period of time. Because purchases are made frequently and some inventory is always kept on hand, LIFO method of inventory accounting quite adequately matches current costs with current revenues. But this is not so in case of capital goods. Purchases of a particular item are infrequent and they are not used in production in whole, nor are they definitely measurable pieces as are inventories. For these reasons, the fact that inventory accounting under any method is restricted to original cost does not make it a necessity that depreciation of capital goods be limited to original cost.

32. A gain in the market price of capital goods used in production may be realized in one of two ways: (1) by selling the assets themselves, or (2) by using such assets in the production of goods. Partial relief is provided for under given conditions where the assets themselves are sold by operation of section 1231 of the 1954 Code. But as to the assets used in production, no relief is provided except where the corporation goes into a costly reorganization and commences the new corporation with assets restated at current values. If the prices continue to rise, the expense of reorganization merely

Although it may be contended that market price in most industries is not determined by tacking on a certain markup on cost of producing the item, it can be reasonably stated that market price does tend to follow cost of production. If cost of production rises because of higher labor, material, and overhead costs, market price tends to rise, although disproportionately. Market price tends to reflect the higher cost of replacing capital equipment used in production. If such equipment is depreciated at historical cost, that portion of market price which is intended as recovery of costs of machinery used in production would be taxed at ordinary rates rather than at capital gains rates permitted for other types of capital assets sold outright.

Another argument advanced by those opposed to any deviation from the present method of accounting for depreciation is that owners of physical assets benefit from an inflation as compared with holders of fixed money claims.<sup>33</sup> Therefore, it is contended, the giving of special relief to the owners of physical assets would be inequitable. It cannot be doubted that holders of fixed money claims do incur a loss through inflation but this fact does not imply that non-recognition of illusory gains resulting from the rise in the price level is unjustifiable or inequitable. The holders of fixed money claims incur an economic loss whereas the owners of physical assets do not obtain an economic gain. The non-recognition of an economic loss should not bar the recognition of a deduction arising from non-economic gains.

It is also argued that since as between those who purchased assets when prices were low and those whose assets were acquired when prices were high only the former group benefits from an increased depreciation allowance, the effect thereof would add to the favorable economic posi-

---

to take advantage of the tax provisions may not be justified by its advantages in subsequent tax savings.

The argument for the imposition of lower capital gains' rates is just as applicable to capital goods used in production as it is for other capital goods. The argument that section 1231 of the 1954 Code compensates for this difference is untenable. As far as fixed assets are concerned, any relief is illusory since any gain derived from the sale of such goods is usually insignificant in amount.

For a discussion of a treatment of capital gains and losses which stem from changes in the general price level, see Cloe, *Capital Gains and the Changing Price Level*, 5 NAT'L TAX J. 207 (1952). The author suggests that a price correction technique whereby some price index, such as the Bureau of Labor Statistics consumer price index or its index of wholesale prices, be used to determine the rise or decline in the price level between the date of purchase of a capital asset and the date of sale. By this method, the author contends, taxation of capital gains would be based upon *real* changes in capital valuation and therefore, *real* ability to pay. A significant economic effect of this method may be the freeing of "locked-in" investments leading to considerable selling and shifting of investments and the resulting re-allocation of resources which would likely lead toward more efficient use of investment capital. *Id.* at 216-217.

33. See GOODE, *op. cit. supra* note 24, at 174.

tion already enjoyed by this group.<sup>34</sup> The benefit accruing to those who purchased assets when prices were low may, however, be more apparent than real. Although it is strongly contended that accounting for depreciation is not for the purpose of providing for future replacements, in terms of long-term planning sufficient working capital must be maintained and accumulated for future replacements if a firm expects to stay in business.<sup>35</sup> It is the responsibility of management to retain a sufficient amount of income to make future replacements. However, when this amount is taken out of income *after* taxes, the net amount remaining for distribution to stockholders or for future expansion will be less than the net profit of a firm with high cost assets. If taxes are to be paid out of profits that are in part illusory, then the shareholders must sacrifice profits that otherwise would have been distributed as dividends or plowed back for increasing productive capacity.<sup>36</sup> Economic stability

34. *Id.* at 175. Goode argues as an equity consideration of the proposal to increase depreciation allowances that only taxpayers who have bought assets when prices were low as compared with those whose assets were acquired when prices were high would benefit from the additional allowances. He states: "The inflation gives the owners of the low-cost assets a speculative gain which can be realized by selling the assets at once or by selling goods produced with their help over their remaining useful life. The speculative gain will be reduced by the income tax, but it will not be eliminated unless tax rates reach 100 per cent. An additional allowance for depreciation would further improve the relative standing of the group that is already in the better position."

35. See TERBORGH, DEPRECIATION POLICY AND THE POSTWAR PRICE LEVEL, (1947).

36. The following simplified example serves to illustrate this point. It is assumed that both firms are in identical positions in all respects except that Firm One purchased its assets when prices were low and Firm Two purchased during an inflationary period when the cost of the identical equipment had doubled. It is also assumed that the level of prices remained constant after Firm Two purchased its assets.

	FIRM ONE	FIRM TWO
Income before deduction for depreciation.....	\$100,000	\$100,000
Less: depreciation charges on historical cost ....	10,000	20,000
	<hr/>	<hr/>
Net Income Before Taxes .....	\$ 90,000	\$ 80,000
Corporate Income Tax (at 1956 rates) .....	41,300	36,100
	<hr/>	<hr/>
Net Income after Taxes .....	\$ 48,700	\$ 43,900
Reservation of income necessary to maintain working capital for replacements.....	10,000	none
	<hr/>	<hr/>
Available to Stockholders .....	\$ 38,700	\$ 43,900

The difference of \$5200 in the amount available to stockholders between the two firms is explained by the taxation of that portion of income which represents a recovery of the higher cost of capital assets. Firm Two would be able to accumulate depreciation reserves and indirectly build-up its working capital without having some working capital taken away by taxes. Firm One, on the other hand, must pay taxes out of that portion of income representing the cost of capital assets used in production on the current basis. The net effect to Firm One is that in order to build-up its working capital to compensate for higher costs of replacements, it must retain a portion of net income after taxes. The result is that the amount available to stockholders is less in Firm One than in Firm Two. Although the stockholders of Firm Two invested more

depends to a large extent on maintaining existent productive capacity. Economic progress, on the other hand, depends on the ability to increase productive capacity.

The practical importance of this problem of income determination varies with the circumstances of the particular corporation. If the investment for plant and equipment is relatively small and depreciation cost is accordingly a minor contribution to cost of production or of sales, the problem does not present enough significance to justify an adjustment of this cost to current values. Similarly, where the plant and equipment have been acquired in recent years at costs in substantial agreement with current values, or where a reorganization has been effected with book values restated at current values, the problem would not exist, for revenues stated at current prices match costs stated substantially at current prices. On the other hand, numerous firms of varying size are significantly affected by this problem, because of the materiality of depreciation cost in relation to net income. Obviously, this problem is not merely theoretical.

Since the present provisions for depreciation deduction are so imbedded in the federal scheme of taxation, it is highly improbable that the Supreme Court will hold them unconstitutional on grounds that the taxpayer is not allowed to recover sufficiently to preserve its capital intact. Any relief must come from Congress. The search for a perfect solution has led to much controversy concerning the form this relief should take.<sup>37</sup> However, it is questionable whether such a perfect solution is necessary before *any* relief can be granted to owners of fixed assets. There is already much speculation and estimation involved in many areas of accounting for gross income and deductions under the Code. A partial relief such as the price-index approach, as suggested by many scholars in law, accounting, and economics may suffice for the present.<sup>38</sup>

---

dollars than the stockholders of Firm One initially, in terms of purchasing power or economic sacrifice stockholders of both firms invested equal amounts. In the light of this analysis, it cannot be said, as far as federal income taxation is concerned, that stockholders of Firm One with low-cost assets are enjoying a more favorable economic position than stockholders of Firm Two with high-cost assets.

37. The fact that a method of accounting for depreciation during inflation is not feasible for general use to the accountant should not bar its use for federal income tax purposes. The emphasis is, however, on the accounting profession because the problem seems to be more of a practical one of determining the amount of deduction rather than a theoretical one of whether such a deduction should be allowed.

38. The replacement cost approach may theoretically provide an adequate relief, but due to its practical limitations most accountants would reject it as a solution. Such an approach requires a periodic appraisal of existing facilities and an estimation of the cost of replacement. The cost of appraisal will be prohibitive for most firms and the estimation of the cost of replacement would be practically impossible due to constant technological changes. The reluctance in accepting this method of writing-up assets and determining periodic depreciation charges for general accounting or for federal

There are many who maintain that government should not enter into the field of economic regulation through its policies of taxation.<sup>39</sup> Since the case for higher depreciation allowances for taxpayers with high cost assets is based largely on economic grounds,<sup>40</sup> it is contended that Congress should not afford any relief in this regard. Historically, governments seem to have been concerned more with the fiscal adequacy of taxes. In his explanation of which expenses of government ought to be defrayed by general contributions of the entire society and which by certain members only, Adam Smith set forth the famous canons of taxation<sup>41</sup>—maxims of equity, certainty, convenience, and economy of administration, under the economic principles which to him seemed sound in a laissez-faire economy. Smith's ideas on taxation for revenue only may be regarded as a "tradition" which is contradicted by history. Any

---

income tax purposes seems justified. For a discussion of the mechanics of the replacement cost technique, see SWEENEY, *STABILIZED ACCOUNTING* (1936).

The price-index approach suggested by many scholars is gaining favor especially for federal income tax purposes. This is probably due to the availability of reliable price indices prepared by the U.S. Department of Labor. Its advantage lies mainly in its simplicity and the fact that its adoption in the Code will not entail a major revision. For an explanation of the mechanics of the price-index approach, see SWEENEY, *STABILIZED ACCOUNTING* (1936); and Cloe, *Capital Gains and the Changing Price Level*, 5 *NAT'L TAX J.* 207 (1948).

It is interesting to note that a modified price-index approach has been used in the French income tax scheme. France has been experiencing a decline in the purchasing power of its monetary unit much more pronounced than that in the United States. In 1945, legislation was enacted permitting business enterprises subject to tax on industrial and commercial profits to revalue their capital assets and depreciation reserves. This revaluation is accomplished by applying to the original cost specified coefficients varying according to the year in which the assets were purchased. For example, under the 1948 law the original cost of assets acquired in 1945 were adjusted by multiplying such cost figures by 3.6. This legislation recognized that depreciation allowances based on original cost were completely inadequate for the preservation of the productive capacity of the French economy as a result of the decline in the value of the franc. As the franc continued to decline in value after 1945, further revaluations were permitted in 1947 and 1948 by the use of revised coefficients. See Dean, *Provision for Capital Exhaustion Under Changing Price Levels*, 65 *HARV. L.R.* 1339, n.21 (1952).

39. See generally, PAUL, *TAXATION FOR PROSPERITY* (1947); and PAUL, *TAXATION IN THE UNITED STATES*, 685-694 (1954).

40. It is felt that a liberalization of federal depreciation policy under the Internal Revenue Code would provide a powerful impetus to capital investment; encourage industry to maintain the nation's productive mechanism at a peak of efficiency, dampen the swings of the business cycle, increase our national income, and thereby broaden the tax base substantially. Beck, *Capital Replacement, Depreciation and Taxes*, 26 *TAXES* 658 at 649 (1948).

41. The first is that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities"; secondly, that "the tax which each individual is bound to pay ought to be certain, and not arbitrary"; thirdly, that "every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it"; and finally, that "every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state." SMITH, *THE WEALTH OF NATIONS*, II, 310-311 (Cannan ed. 1904).

tax that produces revenue will in some way alter the social and economic order. Furthermore, from the birth of the United States to the present, tax programs have been envisioned and employed as tools to sculpture the social and economic order.<sup>42</sup>

The contention that our tradition is one of taxation for revenue only seems inconsistent with this nation's history of tax policy.<sup>43</sup> Today, we are far from the laissez-faire economy envisioned by Adam Smith. Statistics alone should convince the skeptic that federal income taxes on individuals and corporations consume so substantial an amount of national income that significant social and economic consequences are bound to follow.<sup>44</sup> To formulate taxation policies without regard to these factors and to adhere to the past practice of taxation by political expediency rather than sound principles, would lead this country into another social and economic chaos.

## COMMON LAW MARRIAGE—A LEGAL ANACHRONISM

Marriage is a status in which the public has the utmost interest.<sup>1</sup> To protect this interest the state regulates the formation of marriage by establishing a statutory procedure to be followed in creating the marriage

---

42. "In this country at least, the purpose of taxes is not limited to raising the money the government needs to spend. American statesmen have employed taxation with incidental, or even dominant, nonfiscal motives ever since the day of Hamilton's *Report on Manufactures*. Jefferson urged inheritance taxes to promote small proprietorships. Thomas Paine saw in death taxes a way to finance old-age pensions and grants to youth. In the twentieth century taxation began to assume a mounting share in the process of social adjustment." PAUL, *TAXATION FOR PROSPERITY* 214 (1947).

43. The following are some examples of taxes with no revenue raising purpose whatsoever and taxes with multiple functions: (1) the federal and state taxes on oleomargarine, which have no revenue-raising purpose whatsoever; 53 STAT. 248 (1939), (later repealed by 64 STAT. 20 (1950)); Wis. Stat. § 97.42 (1951); (2) the excise tax on liquor which is intended as a measure of social discipline as well as a source of revenue; 44 STAT. 104 (1926), as amended 26 U.S.C. § 2800 (1952); (3) the federal estate tax which has the dual purpose of raising revenue and of limiting inheritances; INT. REV. CODE OF 1954, § 2001-2207; (4) the gift tax which is intended more as a "policeman" than a revenue raiser; INT. REV. CODE OF 1954, § 2501-2524; (5) the corporation income tax with its special provisions designed to encourage the distribution of dividends and to refrain from accumulating surplus beyond "reasonable needs"; INT. REV. CODE OF 1954, § 531-537.

44. U.S. Department of Commerce estimates indicate that the national income for 1955 approached \$324,000,000,000 and federal income taxes paid for the same period amounted to \$21,500,000,000 by corporations, or 6.6% of national income, and \$31,300,000,000 by individuals or 9.7% of national income. 42 FED. RES. BULL. No. 9 at 972, 992 (1956).

1. *Maynard v. Hill*, 125 U.S. 190, 205 (1888); *Sweigart v. State*, 213 Ind. 157, 165, 12 N.E.2d 134, 138 (1938).