RECENT DEVELOPMENT

IDAHO POWER CO. v. COMMISSIONER: DEPRECIATION DEDUCTION ALLOWED ON EQUIPMENT USED TO CONSTRUCT CAPITAL FACILITIES

In *Idaho Power Co. v. Commissioner*,[1] the Court of Appeals for the Ninth Circuit allowed a current deduction for depreciation of equipment used in the construction of capital improvements, reversing a decision of the Tax Court which held that depreciation of such equipment is a cost of construction which must be capitalized and depreciated over the useful life of the property constructed.[2] Idaho Power Company is a public utility in the business of providing electricity to its customers. It regularly makes capital improvements and builds new facilities using its own employees and equipment.[3] In its books of account, the company had capitalized the depreciation of equipment attributable to these construction projects as required by the Federal Power Commission[4] and the Idaho Public Utilities Commission.[5] However, on its tax returns the company deducted the depreciation on its equipment, including depreciation allocable to capital construction,[6] based upon a composite useful life of ten years for the equipment so depreciated.[7] The Commissioner of Internal Revenue disallowed this deduction and capitalized the equipment depreciation attributable to construction of the capital assets, allowing instead a depreciation deduction for the amounts so capitalized spread over the thirty-year life of the property constructed.[8] The Commissioner's action was upheld

1. 477 F.2d 688 (9th Cir.), *cert. granted*, 42 U.S.L.W. 3261 (U.S. Nov. 5, 1973) (No. 263).

2. *Id.* at 689.

3. In 1962, Idaho Power constructed $7,139,940 worth of facilities and in 1963 $5,642,342 worth. The amount of the disallowed deductions for equipment depreciation was $140,430 in 1962 and $96,812 in 1963. *Id.* at 690.

4. 18 C.F.R. pt. 101, at 220-21 (1973).

5. 477 F.2d at 690.

6. Tax accounting does not have to follow accounting for reporting purposes, particularly where the tax treatment is clearly provided by law. *See* 477 F.2d at 690 n.3. However, depreciation for income tax purposes has generally followed the accounting concept of depreciation. *See* A. MURRAY, DEPRECIATION 5 (1971); Egger, *Depreciation Updated*, 12 TUL. TAX INST. 207, 208 (1963).

7. 477 F.2d at 690.

8. *Id.*

by the Tax Court[9] on the grounds that depreciation of construction equipment is a cost of construction of new facilities which must be capitalized under section 263[10] of the Internal Revenue Code as part of the basis of the property constructed. The Ninth Circuit reversed, holding that section 167[11] of the Code allowed the deduction of depreciation on the equipment.[12]

Since the imposition of the first modern income tax in 1913,[13] the federal policy in income taxation has been to tax *net* income, *i.e.*, gross income minus the costs of earning that income.[14] This is accomplished by allowing the deduction of substantially all expenses incurred in conducting the taxpayer's trade or business or his profit-seeking transactions.[15] For example, section 162 of the 1954 Code continues the practice of allowing a deduction for all ordinary and necessary business expenses incurred during the taxable year.[16] Part VI of the Code also allows for the deduction of interest,[17] taxes,[18] losses,[19] bad debts,[20] and other items,[21] as well as providing in section 167 for the current deduction of a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the taxpayer's trade or business or of property held for the production of income.[22] The rationale for

9. Idaho Power Co., 39 P-H Tax Ct. Mem. ¶ 70,083 (1970), *rev'd*, 477 F.2d 688 (9th Cir.), *cert. granted*, 42 U.S.L.W. 3261 (U.S. Nov. 5, 1973) (No. 263).

10. Section 263 of the Internal Revenue Code of 1954 provides in relevant part: "No deductions shall be allowed for . . . [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

11. Section 167 of the Internal Revenue Code of 1954 provides: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."

12. 477 F.2d at 689.

13. Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 167.

14. *See* B. BITTKER & L. STONE, FEDERAL INCOME, ESTATE, AND GIFT TAXATION 231 (4th ed. 1972); C. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 1 (1960); A. MURRAY, DEPRECIATION 13 (1971); TAX FOUNDATION, INC., DEPRECIATION ALLOWANCES: FEDERAL TAX POLICY AND SOME ECONOMIC ASPECTS 8 (1970).

15. *See* B. BITTKER & L. STONE, *supra* note 14, at 231; Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1, 8 (1957).

16. INT. REV. CODE OF 1954, § 162.

17. *Id.* § 163.

18. *Id.* § 164.

19. *Id.* § 165.

20. *Id.* § 166.

21. *See id.* §§ 161-88.

22. See note 11 *supra*. *See also* Cedarburg Fox Farms, Inc. v. United States, 283 F.2d 711 (7th Cir. 1960). The computation of the depreciation allowance is based upon the cost, salvage value, and useful life of the property being depreciated. INT. REV. CODE OF 1954, §§ 167(d), (f), (g). *See also* Tanforan Co. v. United States,

the depreciation deduction is to permit the "tax free recovery" of the total cost of the asset by allowing the ratable deduction of the cost of the asset over the years in which it is productive.[23]

All of the deductions under Part VI of the Code are subject to the exceptions provided in Part IX.[24] These exceptions include section 263 which forbids current deductions for capital expenditures,[25] requiring instead that expenses incurred in the creation or acquisition of a capital asset be capitalized and amortized over the useful life of the equipment.

Thus, sections 263 and 167 are like two sides of the same coin. The first forbids current deductions of the costs of acquiring or constructing capital assets, while the second allows deductions for the depreciation in value of the asset once acquired. A problem arises, however, as to the proper tax treatment of the depreciation of construction equipment owned by the taxpayer for whom a capital asset is being constructed. This is because the depreciation of the construction equipment can be viewed either as a current business expense attributable

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313 F. Supp. 796 (N.D. Cal. 1970), *aff'd*, 462 F.2d 605 (9th Cir. 1972).

The courts have sometimes spoken of the depreciation deduction as having the purpose of providing a tax-free fund to replace the asset. *See, e.g.*, Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943); City of Knoxville v. Knoxville Water Co., 212 U.S. 1, 13-14 (1909). The initial cost and not the replacement cost has always been used to compute the allowance, however. *See* INT. REV. CODE OF 1954, § 167(g); Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 167.

23. *See* Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960); Reisinger v. Commissioner, 144 F.2d 475 (2d Cir. 1944); H.R. REP. No. 1337, 83d Cong., 2d Sess. 22-25 (1954); 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.04 (1973 rev.). This rationale for the depreciation deduction roughly corresponds to the rationale for depreciation in accounting, which is to allocate the expense of an asset to the accounting periods which are benefited by the asset. *See* Hertz Corp. v. United States, 364 U.S. 122, 126 (1960); *accord*, H.R. REP. No. 1337, *supra* at 22-25; TAX FOUNDATION, INC., DEPRECIATION ALLOWANCES: FEDERAL TAX POLICY AND SOME ECONOMIC ASPECTS 9 (1970).

The Code of 1954 seems to have departed from this traditional accounting theory somewhat, and has introduced measures "liberalizing" depreciation allowances to encourage investment, industrial expansion, and full employment. *See* INT. REV. CODE OF 1954, § 167(b); H.R. REP. No. 1337, *supra* at 22-25. However, the "liberalized" estimates of useful life and methods of allocating the cost over the years of service allowed by the 1954 Code were also justified as being more in accord with the actual pattern of loss of economic usefulness. *Id.*

24. INT. REV. CODE OF 1954, section 161 provides: "In computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part [VI], *subject to the exceptions provided in part IX* (sec. 261 and following, relating to items not deductible)." (Emphasis added.)

25. See note 10 *supra*. Capital expenditures are expenditures that will contribute to income-producing activities for periods longer than the current taxable year. B. BITTKER & L. STONE, *supra* note 14, at 315.

to the consumption of one asset—the construction equipment—or as part of the cost of constructing another capital asset—the power plant. This problem can be broken up into three questions of statutory interpretation. First, is the construction equipment "property used in the trade or business" under section 167? Second, is the depreciation of equipment used in the construction of a capital asset a capital expenditure within the meaning of section 263? Third, if the requirements of both sections 167 and 263 are complied with, how are the two sections to be reconciled?

Prior to the instant case, it was generally, although not universally, held that the depreciation of construction equipment which is owned by a taxpayer and used in the construction of capital assets for the taxpayer's own use had to be capitalized and depreciated over the life of the asset constructed.[26] However, there were few cases on point and even fewer which gave the question more than cursory treatment.[27] In *Great Northern Railway Co.*,[28] the first case to treat the issue, the Board of Tax Appeals held that where a railroad transported men and equipment to a construction site on its regularly scheduled commercial trains, the depreciation of the train equipment attributable to the construction work was to be capitalized. The Board adopted the straightforward approach that if the depreciation was attributable to the construction of capital facilities, it would be a cost of the capital asset and should therefore be capitalized.[29] The Board did not discuss, as did later cases, whether the train equipment, to the extent that it was involved in transporting men and materials to the job site, was also property used in the trade or business, and whether such a finding would further entail the conclusion that, even though the property was concurrently being used in the construction of a capital asset, the depreciation should

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26. *E.g.*, Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1264-69 (Ct. Cl. 1969); Churchill Farms, Inc., 38 P-H Tax Ct. Mem. ¶ 69,192 (1969), *aff'd sub nom.* Bayou Verret Land Co. v. Commissioner, 450 F.2d 850 (5th Cir. 1971); Producers Chem. Co., 50 T.C. 940 (1968); Great N. Ry., 8 B.T.A. 225, 260-63 (1927), *aff'd*, 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930); Rev. Rul. 380, 1959-2 CUM. BULL. 87; Treas. Reg. §§ 1.46-3(c)(1), 1.48-1(b)(4) (1964); 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.11a (1973 rev.). *But see* Great N. Ry., 30 B.T.A. 691 (1934).

27. *But see* Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969).

28. 8 B.T.A. 225, 260-63 (1927), *aff'd*, 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930).

29. The Board stated: "In our opinion, a part of the wear and tear of the train equipment of the rails, ties, etc., may be properly capitalized when men and materials for construction work are transported in transportation service trains." *Id.* at 263.

be currently deductible.[30] These considerations, however, constituted the basis for a change in the Board's position several years later in the second *Great Northern Railway Co.*[31] case. *Great Northern II* was factually indistinguishable from *Great Northern I.* In *Great Northern II,* however, the Board held that the train equipment, even though used in part for construction purposes, was property used in the railroad's trade or business.[32] Therefore, depreciation on this equipment was held to be currently deductible.[33] While the Board failed to provide any guidelines for determining when equipment used in construction could also be considered to be used in the taxpayer's trade or business, under *Great Northern II,* if equipment is used in the taxpayer's trade or business, the depreciation of it is currently deductible regardless whether it can be attributed to capital account.

The Board's position in the *Great Northern II* was subsequently challenged by the Internal Revenue Service in Revenue Ruling 59-380.[34] In this ruling, the Service held that "depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to and made a part of the cost of the capital improvements."[35] Further, it stated categorically that such construction

30. Plainly, it would not have been difficult for the Board to find that the depreciation of the train equipment attributable to the transportation of men and materials to the job site was incurred in the railroad's trade or business. The trains involved were regularly scheduled commercial service trains on which the men and materials for the construction activities were but a minor portion of the total passengers and freight transported. The workmen trausported constituted only .48% of the total passengers carried by the trains, and the construction materials constituted only .67% of the freight tonnage. The additional expense incurred in carrying the men and materials were negligible. 8 B.T.A. at 233. The Board's failure to discuss the question of whether the depreciation was incurred in the railroad's trade or business is susceptible to at least two interpretations. First, the Board may have thought that, to the extent the train equipment was used for construction purposes, it was not used in the railroad's trade or business. Second, it may have thought that, even if the equipment was used in the taxpayer's trade or business, since at the same time it was being used for construction activities, the depreciation was still allocable *pro tanto* to the capital account and therefore not currently deductible. Indeed, the revenue laws have forbidden current deductions for capital expenditures since 1913. Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 167.

31. Great N. Ry., 30 B.T.A. 691 (1934).

32. *Id.* at 708. Perhaps one reason for the Board's reversal of its previous position was the Commissioner's failure either to cite or to rely on *Great Northern I* in its brief. *Id.* It has subsequently been suggested that "the Board was influenced by what it construed to be a reversal of the Commissioner's position." Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1267 (Ct. Cl. 1969).

33. 30 B.T.A. at 708.

34. 1959-2 CUM. BULL. 87.

35. *Id.* at 88. *See also* Rev. Rul. 252, 1955-1 CUM. BULL. 319, which held that

equipment cannot be treated as property used in the regular trade or business of the taxpayer.[36] Under this approach, there is no conflict between sections 167 and 263 of the Code, because, if the equipment is used in construction activity, *ipso facto*, it cannot be property used in the trade or business and subject to the current deduction for depreciation provided for in section 167.[37]

Revenue Ruling 59-380 was the basis for the holding by the Court of Claims in *Southern Natural Gas Co. v. United States*[38] that equipment depreciation which is incurred in the creation of capital assets for the use of the owner of the equipment must be capitalized.[39] In *Southern Natural Gas*, the taxpayer only engaged in construction activities "from time to time," and the equipment in question was used largely for non-construction activities.[40] The court, in finding that these construction activities were not part of the trade or business of the taxpayer,[41] stated: "[E]quipment used in constructing additional facilities of the permanent improvement type is used in "a" trade or business . . . . However, it is not used in "the" trade or business of the taxpayer . . . . "[42] Since the equipment was held not to be used in Southern's trade or business insofar as it was being used for construction purposes, no current deduction for depreciation attributable to the construction activities was allowed.[43]

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timber planting costs, including depreciation of equipment, such as trucks used in planting, should be capitalized and recovered through depletion when the timber is sold.

36. Rev. Rul. 380, 1959-2 CUM. BULL. 87, 88.

37. The Service relied upon New Quincy Mining Co., 36 B.T.A. 376 (1937), in arriving at its holding in Revenue Ruling 59-380. In *New Quincy*, the taxpayer wanted to deduct currently the depreciation of construction equipment owned by it and used in the excavation of a mine. The Board held, however, that this depreciation must be capitalized and recovered through the depletion allowance. The Board found that the equipment was not used in the taxpayer's trade or business because, *inter alia*, such excavation was not a regular activity of the taxpayer, but was engaged in only once. 36 B.T.A. at 383. The Service's reliance on *New Quincy* might therefore indicate that it would take a contrary position where the construction activity was regularly engaged in by the taxpayer, finding that, in such a circumstance the construction equipment could be cousidered to be used in a taxpayer's trade or business. Such an inference cannot be drawn from the face of Revenue Ruling 59-380, however. Nevertheless, it is questionable whether the Service would concede that the depreciation of the construction equipment would be currently deductible even if the equipment could be considered to be used in the trade or business of the taxpayer.

38. 412 F.2d 1222 (Ct. Cl. 1969).

39. *Id.* at 1265-68.

40. *Id.* at 1264.

41. Plaintiff's business was the operation of a natural gas pipeline system, and not the construction of capital assets. *Id.*

42. *Id.* at 1267.

43. A possible inference from *Southern Natural Gas* is that if one *could* consider equipment owned by a taxpayer and used by him to create a capital asset for his own

In light of these prior decisions, when the *Idaho Power* case was presented to the Tax Court,[44] it was to be anticipated that the court would base its decision on whether the construction equipment was used in the taxpayer's trade or business. The Tax Court, however, adopted a different approach and stated that regardless whether the construction equipment, when used to create capital assets, is property used in the taxpayer's trade or business, the depreciation of that equipment is not currently deductible in either case, but must be capitalized under section 263.[45] Therefore, the Tax Court held that if the depreciation could be viewed as a cost of the construction of a capital asset, it must be capitalized.

In reversing the Tax Court, the Ninth Circuit Court of Appeals, in *Idaho Power Co. v. Commissioner*,[46] adopted the more traditional "trade or business" approach of the cases prior to the Tax Court's decision. The Ninth Circuit found that the construction equipment was property used in Idaho Power's trade or business within the meaning of section 167. The court said that the frequency and regularity with which Idaho Power constructs new capital facilities "point[s] to the conclusion that construction of facilities is a major aspect of the taxpayer's trade or business."[47] It held, therefore, that the depreciation

use as property used in his trade or business, then the depreciation of that equipment would be currently deductible under section 167, regardless whether it is allocable to the capital account. It is doubtful, however, that the *Southern Natural Gas* court would take this step. Instead, it has adopted a narrower interpretation of "property used in the trade or business" which excludes such construction equipment altogether. Although the court recognized that, broadly speaking, the expansion of a commercial enterprise through the acquisition or construction of capital assets may be considered to be within the scope of that enterprise's "business," it found that this interpretation of "business" is too broad for the purposes of section 167. The court instead interpreted "business" to include only the operation and use of capital assets, and not their construction. Accordingly, such construction equipment cannot be considered to be used in the trade or business under section 167. 412 F.2d at 1266.

44. 39 P-H Tax Ct. Mem. ¶ 70,083 (1970), *rev'd*, 477 F.2d 688 (9th Cir. 1973).

45. *Id.* at 429-30.

46. 477 F.2d 688 (9th Cir. 1973).

47. *Id.* at 696. The conclusion that the frequency and regularity with which Idaho Power Company constructs new facilities indicates that construction projects are an integral part of its trade or business collides directly with Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969). Although it might be argued that the negative implication of the Court of Claims' holding in *Southern Natural Gas* that construction activities conducted on a sporadic basis are not part of the taxpayer's trade or business might be that activities engaged in regularly *are* a part of his trade or business, it is unlikely that the Court of Claims would subscribe to this view. See note 43 *supra*.

Nevertheless, the *Idaho Power* court's conclusion is not unreasonable; and it may plausibly be argued that the construction activity of Idaho Power is so integrally related to its power generating operations, and done on such a regular basis, as to consti-

of the equipment allocable to construction was to be deducted currently rather than capitalized. Nevertheless, in light of the Tax Court's position, this argument was not sufficient, in itself, to justify the Ninth Circuit's holding. Accordingly, the court propounded three further arguments to support its position.

First, the court said that since the depreciation of construction equipment represents a "decrease in value," and not an "amount paid out" for the construction of a capital asset as required by the language of section 263, the depreciation cannot be treated as a capital expenditure.[48] Although the court's interpretation of "paid out" as being equivalent to cash expenditures is perhaps in accord with common usage, this is a narrower construction of the term than that propounded in the income tax regulations.[49] The regulations provide that capital expenditures include the *cost* of acquiring or constructing capital assets.[50] Traditional accounting practice considers equipment depreciation as well as cash expenditures to be includable in the cost of acquiring a capital asset.[51] In the absence of any legislative provisions to the contrary, it would seem best to follow the long-standing regulation supported by traditional accounting practice and treat equipment depreciation incurred in creating a capital asset as a *cost* of that asset.[52] Indeed, when a taxpayer hires a contractor to construct capital facilities for him, the wear and tear on that contractor's equipment, when charged to the taxpayer by the contractor, is a part of the *cost* of the capital asset. This cost becomes a part of that asset's basis in the hands of the taxpayer to be depreciated over the useful life of the asset. By

tute part of its trade or business. See text accompanying note 58 *infra*. However, even if the court in *Idaho Power* is correct that, under the circumstances of the case, the construction equipment *is* used in the taxpayer's trade or business, this does not necessarily entail the further conclusion that the depreciation of such equipment should be currently deducted and should not be capitalized. See notes 45 *supra* and 56-58 *infra* and accompanying text.

48. 477 F.2d at 694-95. The "paid out" language was a part of the 1913 income tax. Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 167. It has persisted until the present. INT. REV. CODE OF 1954, § 263.

49. There is no explanation of the capital expenditure or depreciation provisions in the committee reports. *See* H.R. REP. No. 5, 63d Cong., 1st Sess. (1913); S. REP. No. 80, 63d Cong., 1st Sess. (1913).

50. Treas. Reg. § 1.263(a)-2(a) (1958) provides that capital expenditures include: "The *cost* of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year." (Emphasis added.)

51. Where an asset is constructed by the taxpayer, the cost basis includes applicable overhead. A. MURRAY, DEPRECIATION 20 (1971). Depreciation is a part of overhead. *See* M. GORDON & G. SHILLINGLAW, ACCOUNTING: A MANAGEMENT APPROACH 568 (4th ed. 1969).

52. *See* W. PATTON, ACCOUNTANTS' HANDBOOK 652 (3d ed. 1952).

parity of reasoning, equipment depreciation should be considered a cost of the capital asset when the equipment is owned by the taxpayer for whom the asset is being constructed. The Ninth Circuit's holding to the contrary leads to disparate treatment among taxpayers, since large firms with the resources to construct their own capital facilities will benefit from more rapid tax write-offs, while firms that must "pay out" for new capital assets will be required to capitalize the entire cost of the asset, including wear and tear on the construction machinery.

A second but perhaps more significant argument by the court states, in effect, that where sections 167 and 263 conflict so that depreciation of property used in the taxpayer's trade or business can be conceptualized as a cost of a capital asset, the depreciation provision should be preferred to the capitalization provision. The court contended that deductions "specifically allowed" by the Code, such as for the depreciation of property used in the trade or business, should not be capitalized even though incurred in the construction of a capital asset.[53] These "specifically allowed" deductions, according to the court, differ from the general deduction for business expenses under section 162, which, the court agreed, is not available when the expense is incurred in acquiring a capital asset.[54] The court concluded by saying that, since the construction equipment is used in the taxpayer's trade or business, the depreciation of that property is deductible under section 167 regardless of whether it might be allocable to the capital account.[55]

The conclusion that expenses whose deductibility is specifically allowed by the Code should not be capitalized, even when incurred by the taxpayer in the construction of capital facilities, but that expenses whose deductibility is generally provided for in section 162 should be so capitalized, is supported neither by the organization nor by the language of the Code. Section 161,[56] by its language, provides that all deductions specified by Part VI, which includes section 167, as well as

53. 477 F.2d at 693. The court relied on All-Steel Equipment, Inc., 54 T.C. 1749 (1970), *rev'd on other grounds*, 467 F.2d 1184 (7th Cir. 1972). While *All-Steel* involved the cost of inventory and expenditures for taxes, losses, and research and experiment rather than capital expenditures and depreciation, it purported to explain the Code's overall scheme. The Ninth Circuit in *Idaho Power* also is supported by Pacific Coast Redwood Co., 5 B.T.A. 423 (1926); Spring Valley Water Co., 5 B.T.A. 660 (1920). *But see* Herbert Shainberg, 33 T.C. 241 (1959).

54. 477 F.2d at 693. *See also* General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963); Midland Empire Packing Co., 14 T.C. 635 (1950).

55. 477 F.2d at 696.

56. INT. REV. CODE OF 1954, § 161. See note 24 *supra*.

section 162, shall be subject to the exceptions provided in Part IX, which includes section 263. Thus, according to the plain language of the Code, the fact that equipment used to create a capital asset might be considered to be property used in the taxpayer's trade or business does not necessitate the conclusion that the depreciation of that equipment is currently deductible under section 167.[57] The Tax Court was therefore correct when it stated:

> Obviously, the acquiring of capital improvements . . . is appropriate if not vital to [Idaho Power's] continued operation of its business of producing and selling electric energy but this fact does not cause the cost of these capital improvements to be deductible in the year acquired. The real issue here is whether the portion of the depreciation deduction for transportation equipment allocable to the construction of capital improvements should be viewed as a part of the "cost" of such capital improvements.[58]

Accordingly, if the depreciation of the equipment is allocable to the creation of a capital asset, even though the equipment is used in the taxpayer's trade or business, that depreciation must be capitalized due to the conjunctive operation of sections 161 and 263.

The third basis for the court's position is the legislative history of the Code. In its opinion, the Ninth Circuit said that the congressional desire to allow faster tax write-offs through the use of various new depreciation methods, such as the declining balance method and the sum-of-the-years-digits method, supports the conclusion that the depreciation of the construction equipment should not be capitalized, but should be currently deductible under section 167.[59] The court contended that such treatment of equipment depreciation would result in a more rapid recovery of the cost of the equipment in conformity with congressional policy.[60] Nevertheless, it is evident that provisions in the Code providing for the accelerated deduction of depreciation are irrelevant in answering the threshold question of whether, in the first instance, such depreciation can properly be deducted. Congress certainly could not have intended that the provisions for accelerated depreciation should be interpreted to broaden the class of depreciable

57. The conclusion that there is no magic in the language "used in the trade or business" which makes the expense currently deductible is supported by the fact that the court agreed that costs of operating and maintaining the construction equipment, clearly "ordinary and necessary expenses paid or incurred . . . in carrying on [a] trade or business" under section 162, were to be capitalized. 477 F.2d at 690, 695.

58. Idaho Power Co., 39 P-H Tax Ct. Mem. ¶ 70,083, 430 (1970), *rev'd*, 477 F.2d 688 (9th Cir.), *cert. granted*, 42 U.S.L.W. 3261 (U.S. Nov. 5, 1973) (No. 263).

59. 477 F.2d at 692-93.

60. *Id.* at 692.

assets covered by section 167.[61] Indeed, the questions whether the depreciation of property is deductible, and what method should be used to take the deduction are logically unrelated. If the depreciation of the construction equipment is not otherwise properly deductible under section 167, congressional policy to encourage the accelerated depreciation of property used in the taxpayer's trade or business cannot make it so.

The Ninth Circuit's holding in *Idaho Power* is based on the erroneous notion, which has received support in prior cases,[62] that Code sections 167 and 263 are mutually exclusive in their coverage. This conclusion has been shown to be contrary to both the language and the structure of the Code. It is entirely proper, based upon the Code, the regulations, and traditional accounting theory, to consider the depreciation of equipment used in the construction of a capital asset as a part of the cost of that asset. Moreover, section 161 of the Code provides the basis for reconciliation of sections 167 and 263. Through the operation of section 161, such equipment depreciation may be capitalized under section 263, even if it is incurred in the taxpayer's trade or business. Failure to recognize the harmonizing influence of section 161 will result in the unequal treatment of taxpayers who own their own construction equipment and who build their own capital facilities *vis-a-vis* taxpayers who must hire outside contractors to perform this work. Only through a recognition of the proper role of section 161 can the courts properly treat the question of how to resolve the conflict between sections 167 and 263.

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61. Congressional concern over revenue losses resulting from the use of accelerated methods of depreciation by public utilities led, in 1969, to the enactment of section 167(2) of the Code which freezes the current situation regarding methods of depreciation for many utilities. *See* S. REP. No. 552, 91st Cong., 1st Sess. 171-76 (1969).

62. See notes 37 & 43 *supra* and accompanying text.