



1951

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Recommended Citation

Mackay, Richard Lewis (1951) "Depreciation of Thoroughbred Animals," *Kentucky Law Journal*: Vol. 40: Iss. 2, Article 2.

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DEPRECIATION OF THOROUGHBRED ANIMALS

BY RICHARD LEWIS MACKAY*

Depreciation is one of the few boons still allowed in the ever-tightening noose of the tax statutes and regulations. At a time when capital is being more and more eaten into by taxes, it is important to re-examine the means whereby what capital still exists may be conserved or salvaged.

This article is restricted, however, to capital conservation for owners of Thoroughbred animals since space limitations restrict adequate coverage of the general field. The statutes and regulations which follow apply generally to Thoroughbred animals, whether cattle, goats, sheep, swine, mules or horses. It is interesting to note that rabbits, dogs, cats, beaver and foxes, as well as numerous other animals, may be depreciated if held for the production of income or used in the trade or business.

The purpose of depreciation is to create a fund to restore the property, to the extent of the investment of the taxpayer, at the end of its useful life.¹

When animals used for draft, breeding or dairy purposes, regardless of species, are purchased, the money so expended is regarded as a capital investment.² The three requirements for depreciation of such animals are: first, that the property be "used in the trade or business" or "held for the production of income" second, that the property must have a definitely limited useful life; third, that the property must be subject to "exhaustion, wear and tear"³

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¹ Detroit Edison Co. v. Commissioner, 131 F 2d 619 (CCA 6th, 1942), aff'd 319 U.S. 98 (1943).

Reg. 111, Sec. 29.23 (1) and former section in Reg. 103, Sec. 19.23 (1).

Reg. 111, Sec. 29.23 (a)-11, also Reg. 103, Sec. 29.23 (a)-11.

³ Reg. 111, Sec. 29.23 (a)-15.

Reg. 111, Sec. 29.23 (1)-2. "Depreciable Property.—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance

If draft, breeding or dairy animals are included in an inventory the depreciation deduction will be lost.⁴ When the taxpayer elects to use the unit-livestock-price method for all of his other raised animals, apparently he is required to inventory raised draft, breeding or dairy animals.⁵ Depreciation may be taken on the animals he has purchased even though he inventories his raised animals,⁶ provided he does not include the purchased animals in the inventory. Should the herd, flock, etc., be regularly maintained, depreciation is not properly allowable.⁷ However if improper depreciation is once taken and allowed, there is no irrevocable election nor estoppel which requires taking depreciation in subsequent years.⁸ It is immaterial whether the owner is on the cash or accrual basis insofar as taking of depreciation on proper items is concerned.⁹

The prime authority for depreciation is the Internal Revenue Code, Section 23. "In computing gross income, there shall be allowed as deductions:

(1) DEPRECIATION.— a reasonable allowance for the exhaustion, wear and tear of property (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."

Court decisions and the Commissioner's Regulations serve to strengthen and interpret the statute.¹⁰

Livestock used for work, breeding or dairy purposes, whether purchased or raised, is property used in the trade or business and

should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. "

⁴ Reg. 111, Sec. 29.22 (a)-7.

Reg. 111, Sec. 29.23 (1)-10: "A reasonable allowance for depreciation may also be claimed on livestock acquired for work, breeding or dairy purposes, unless they are included in an inventory used to determine profits in accordance with section 29.22 (a)-7. If such livestock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory." (See also Section 29.23 (a)-11 and 29.23 (e)-5).

⁵ Charley W Peterson, TC Memo, Docket 3411.

⁶ Reg. 111, Sec. 29.22 (c)-6.

⁷ Belknap v. U.S., 55 F Supp. 90 (D.C.W.D. Ky., March 8, 1944).

⁸ *Ibid.*

⁹ IT 3666, CB 1944, p. 270 (Albright v. U.S., 173 F 2d 339 [CCA 8th, March 10, 1949] did not overrule this section of the Bulletin.)

¹⁰ See footnotes 1. and 3.

is of a character subject to an allowance for depreciation.¹¹ Cattle purchased for breeding purposes were held to be depreciable assets.¹²

The operation of a farm where animals are raised for breeding, dairy or work, must be a business and not for pleasure, otherwise no deduction for depreciation will be allowed. Farming may be a business even though the person engaged in operating the farm does gain pleasure from the operation, and though the farm does not show a profit.¹³ It is the expectation of gain, not the gain itself, which generally is determinative of whether the farm is operated as a business or merely for pleasure.¹⁴ There are many cases which have held the operation of a farm to be a business,¹⁵ and several holding that the farm was run for pleasure.¹⁶ Where the evidence shows that the purpose and activities of the taxpayer change from pleasure to business, deductions for losses have been permitted,¹⁷ even though the taxpayer was handling dogs. The operator of a dog kennel likewise was permitted to deduct losses.¹⁸

The Board of Tax Appeals has decided many cases involving the question of whether horse breeding and racing activities constitute a trade or business. Sometimes the courts have held that the activities were not businesses,¹⁹ but most cases have been in favor of the taxpayer's running a business or trade. A horse breeder and stock raiser, who raced, exhibited and sold his horses,²⁰ was held to

¹¹ IT 3666, CB 1944, p. 270.

¹² Daniel G. Fenney, 42 BTA 1049.

¹³ Fish v. Irwin, (D.C., N.Y., 1921), 3 AFTR 3428, and Chapin v. Irwin, D.C., N.Y., 1921), AFTR 3429.

¹⁴ Samuel Riker, Jr., Exr, Estate of J. Amory Haskell, 6 BTA 890.

¹⁵ Moses Taylor, 7 BTA 59; August Merckens, 7 BTA 32; Thomas F. Sheridan, 4 BTA 1299; James Otis, 7 BTA 882; Ryburn G. Clay, par. 41, 377 P-H Memo BTA, H. T. Cochran, 3 BTA 215; George B. Lester, 19 BTA 549; Norton L. Smith, 9 TC 1150; Rose P. Crane, 9 BTA 437; E. S. Hass, 13 BTA 1352; Hamilton F. Kean, 10 BTA 97; Walter P. Temple, 10 BTA 1238; Tatt v. Commissioner, (CCA 6th, 1948) 166 F. 2d 697.

¹⁶ Frank C. Munson, 2 BTA 174; James H. Persons, 5 BTA 716; Union Trust Co., Trustee v. Comm'r, (CCA 6th, 1931), 54 F. 2d 199, affirming 18 BTA 1234; W. Brown Morton, (CCA 2nd, 1949), 174 F. 2d 302; Louis Cheney et al., 22 BTA 672; Coffey v. Comm'r. (CCA 5th, 1944) 141 F. 2d 204, aff'g. 1 TC 579.

¹⁷ James L. Byrne, Par. 45, 371 P-H Memo TC.

¹⁸ Irving C. Ackerman, 24 BTA 512, aff'd 71 F. 2d 586 (CCA 9th, 1934).

¹⁹ Vanderbilt v. Comm'r, 5 BTA 1055, aff'd Deering v. Blair, 23 F. 2d 975, (T.D. 4151, CB June 1928, p. 231); Thacher v. Lowe, 288 F. 994 (T.D. 3444, CB June, 1923, p. 83); Harry C. Fisher v. Comm'r, 29 BTA 1041, aff'd 74 F. 2d (1014); Louise Cheney v. Comm'r., 22 BTA 672.

²⁰ Wilson v. Eisner, 282 F. 38 (CCA 2d, 1922); Von Baumbach v. Sargent Land Co., 242 U.S. 503, 37 S.C. 201 (1917); Flint v. Stone Tracy Co., 220 U.S. 107, 31 S.C. 342 (1911).

have a "business" for tax purposes. "Though a financially hazardous undertaking, breeding and racing stables may be classified as a business."²¹ Where racing and polo ponies were cross-bred to develop a better type of polo pony, it was first held that the farm operation was for pleasure²² but was subsequently reversed.²³ Where a taxpayer entered high grade saddle horses in shows, fairs, etc., and boarded other persons horses, he was determined to have a business.²⁴ Even though the taxpayer converted almost overnight from a hobby of raising saddle and show horses, he still had a business.²⁵

When the Whitney Farm continued to suffer losses from operation of its stables for several years, the Commissioner sought to have the farm declared a hobby farm, and therefore strike out the deductions for depreciation and other expenses.²⁶ This he was unable to do since there was an intent shown to make a profit, plus certain activities which tended to show an actual plan to produce a profit. All reasonable and necessary farm expenses may be deducted from income derived either from the farm or from other sources.²⁷ Even the breeding, training and sale of trotting horses came in for its day in court, being adjudged as business as had all the other cases preceding it.²⁸ Merely because the farm is well taken care of, with the grounds well-landscaped, the fences painted and in good repair, and neighbors near-by enviously gape at the farm, is no reason that the farm is operated merely for pleasure; the losses suffered thereon are deductible.²⁹

The entire question of whether depreciation may be taken when Thoroughbred animals are raised on a "farm" is dependent upon whether or not the farm is operated for business or pleasure. The determination is made upon whether the activities are for the purpose of seeking gain, whether a gain is reasonably to be expected, the particular acts or facts presented which indicate the

²¹ *Margaret E. Amory v. Comm.*, 22 BTA 1398 (1931), acq. CB X-2, 3; *Laura M. Curtis v. Comm.* 28 BTA 631 (1933), acq. CB XII-2, 4.

²² *Farish v. Comm.*, 36 BTA 1114.

²³ *Farish v. Comm.*, 103 F 2d 63 (1939).

²⁴ *Tyng and Buchsbaum v. Comm.*, 36 BTA 21 (1937).

²⁵ *Lillies S. Wegeforth et al., v. Comm. r.*, 42 BTA 633 (1940).

²⁶ *Whitney v. Comm.*, 73 F 2d 589 (CCA 3rd, 1934), aff'g BTA Docket 50,004.

²⁷ *Widener v. Comm.*, 8 BTA 651 (1927), and *Comm. r. v. Widener*, 33 F 2d 833, (CCA 3rd, 1929).

²⁸ *Blake v. Comm.*, 38 BTA 1457 (1938).

²⁹ *James Clark et al., Extrs. v. Comm.*, 24 BTA 1235 (1932), acq. CB X-1, 2.

intent of the taxpayer. Attention devoted to the farm in order to make it pay is evidential of an intent to make a profit. Each case is generally decided on the similarity to other cases, and dependent upon any peculiar circumstances surrounding the operation of the particular farm in question.³⁰ Other examples of farms adjudged to be businesses will be found in the footnotes.³¹

The basis for depreciation is the same basis as that which is used for determining gain or loss.³² The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of property determined in accordance with Sec. 113.³³

The useful life of property is determined by the operation of the property, that is, the purpose for which used, and climatic and other local conditions. Past experience, which is a matter of fact and not of opinion, coupled with informed opinion as to the present condition of the property, and current developments within the industry and particular business, furnish a reliable guide for determination of the useful life of the property³⁴ Where circumstances influencing the lives of depreciable assets in succeeding years are the same as in previous years, the rate of depreciation applicable for those succeeding years should also be the same.³⁵

Depreciation is allowed on the basis of an assumed average useful life of a particular type of depreciable asset.³⁶ It has been held, though not specifically on the subject of thoroughbred animals, that "the useful life of an asset is the period of time over

³⁰ GCM 21103, CB 1939-1, p. 164.

³¹ *Smith v. Comm.*, 78 F 2d 408; *Plant v. Walsh*, 280 F 722; *Kansas Savings and Trust Co.*, 2 BTA 1253; *Du Pont v. U.S.* (DC, Del., 1939), 38 F Supp. 122; *Paul Butler*, Par. 42,376 P-H Memo BTA; *W. H. Osmundson*, Par. 46,008 P-H Memo TC, *Cooke v. Glenn*, (DC, Ky.), 78 F Supp. 519, *aff'd* 177 F 2d 201, (CCA 6th, 1949); *D. F. Tenney*, *supra*; *Marshall v. Comm.*, 128 F 2d 741, (CCA 6th, 1942).

³² IRC, Secs. 114 and 113 (b).

³³ Reg. 111, Sec. 29.23 (1)-1.

³⁴ *T.D. 21,52* and *Southern California Freight Lines, Ltd.*, 36 BTA 328, *aff'd* 99 F 2d 104 (CCA 9th, 1938).

³⁵ *Leonard Refineries, Inc.*, 11 TC 1000.

³⁶ *Chicago & Northwestern Ry. Co. et al., Trustees, v. Comm.* 114 F 2d 882, (CCA 7th, 1940).

which it may be used for the purpose for which it was acquired.³⁷ In some cases where the taxpayer possesses accurate and technical knowledge of the business, industry and particular assets, the Commissioner has been required to accept the useful life as determined by the taxpayer.³⁸

The useful life schedules for Thoroughbred animals set out in Bulletin "F" are based on a reasonable expense policy as to the cost of repairs and maintenance, and for "new" property.³⁹

When the Commissioner questions the rate of depreciation, he is merely refusing to agree with the taxpayer as to the length of useful life of the property over which the cost or other basis is to be recovered. The burden falls on the taxpayer to submit evidence to overcome the presumption of correctness of the Commissioner's determination of the useful life.⁴⁰ The evidence necessary depends upon the grounds of the Commissioner's disallowance. The taxpayer may have to show the cost or other basis of the property, the useful life as determined by reasonable business experience, and the probable salvage value, if any at the end of the useful life.⁴¹ However, the Commissioner cannot arbitrarily determine the method of depreciation, and thereby automatically determine the rate.⁴²

A change in use of the property may require a re-determination of the useful life and rate of depreciation. Current developments within an industry and the probable effects on the useful life of depreciable assets employed in the industry⁴³ are factors considered. "Industry" is not confined to commercial or manufacturing concerns; it also applies to racing and breeding stables⁴⁴ as well as to many other types of animal raising and training.

Rate of depreciation, like useful life, is based on a reasonable expense policy as to maintenance and repair costs. In applying rates, consideration should be given to salvage values, to that portion of the service life already expired, and to that portion of the

³⁷ O.D. 845, CB June 1921, O. 178.

³⁸ *Cumberland Glass Mfg. Co. v. U.S.*, 71 Ct. Cl. 44, 44 F. 2d 455 (1930). Also, *Otis Steel Co.*, 6 BTA 358.

³⁹ Treasury Department, Bulletin "F" (Revised January, 1942).

⁴⁰ *Pittsburgh Hotels Co. v. Comm.*, (CCA 3rd, 1930) 43 F. 2d 345, reversing 15 BTA 587.

⁴¹ *Ibid.*

⁴² *Northeastern Gas & Oil Co.*, 5 BTA 332.

⁴³ *Cohen v. Lowe*, 234 F. 474 (1916).

⁴⁴ *Wilson v. Eisner*, *supra*.

cost previously recovered or recoverable through prior depreciation deductions or other allowances.⁴⁵

The taxpayer may sometimes set his own rates on depreciation⁴⁶ due to his greater knowledge of the particular depreciable assets involved. The Commissioner reduced the rate claimed by a taxpayer on his sheep and goats⁴⁷ but failed to obtain a ruling that the rate used in previous years was erroneous. When circumstances remain unchanged, the rate continues the same.⁴⁸

The intent of the revenue acts is satisfied by any accounting method which allows a "reasonable" depreciation. The amount or rate of depreciation need not be an absolute certainty, but should be determined by reasonable business practices.⁴⁹

Rates have been set up by the Treasury Department for depreciation of Agricultural Animals.⁵⁰ Note, however, that this schedule of depreciation is only a guide, it has no force and effect as a ruling or regulation since it has never been officially adopted. There are many cases setting forth varying rates and useful life rules. Among these cases, relating to animals, are horses,⁵¹ dairy cattle,⁵² composite rates on horses and wagons,⁵³ horses, wagons and harness,⁵⁴ horses and auto trucks,⁵⁵ livestock and logging equipment,⁵⁶ livestock and vehicles,⁵⁷ work horses used in mining operations,⁵⁸ work horses on farm and in factory operations,⁵⁹ horses used in lumbering operations,⁶⁰ and horses, mules and vehicles.⁶¹

It is interesting to note that rulings and cases are extremely

⁴⁵ Bulletin "F" (Revised January, 1942).

⁴⁶ Cumberland Glass Mfg. Co., *supra*. and Otis Steel Co., *supra*.

⁴⁷ Rio Bonita Ranch, Inc., TC Memo Op., Dkt. 110322 (July, 1943).

⁴⁸ Leonard Refineries, Inc., 11 TC 1000.

⁴⁹ Chicago & Northwestern Ry. Co., *supra*.

⁵⁰ Bulletin "F"—Cattle, breeding or work or dairy 8 yrs.

Goats, breeding or work or dairy 5 yrs.

Hogs, breeding 5 yrs.

Horses, breeding or work 10 yrs.

Mules, breeding or work 10 yrs.

Sheep, breeding 5 yrs.

⁵¹ F. E. Heath, 7 BTA 114.

⁵² *Ibid*.

⁵³ Kieser & Son Co., Inc., 15 BTA 359.

⁵⁴ Columbus Bread Co., 4 BTA 1126.

⁵⁵ Magdalen Doerfler, Beneficiary, 13 BTA 921.

⁵⁶ Lassen Lumber & Box Co., 6 BTA 241, acq. CB VI-2, p. 4.

⁵⁷ Palmetto Coal Co., 11 BTA 154.

⁵⁸ Trace Fork Mining Co., 15 BTA 872; Miller Brothers Coal Co., 6 BTA 1112.

⁵⁹ St. Paul Table Co., 2 BTA 698; Lord & Bushnell Co., 7 BTA 86; F. E. Heath, *supra*.

⁶⁰ Caffish Lumber Co., 20 BTA 1223.

⁶¹ Lewis Dill, 3 BTA 65.

rare that pertain to depreciation rates on and useful life of race horses; trotters; steeplechasers; jumpers; show horses; registered dogs, cats and rabbits; silver foxes, mink or beaver, Golden Hamsters, and other animals used in a trade or business. Experts in the field fear that the Bureau is merely awaiting a suitable test case wherein it will have an opportunity to knock out all depreciation for the specialized property mentioned above. To put out a bulletin or advisory letter might be considered to be a commitment which might be unfavorable should such a case arise.

The person who can take the depreciation must be the one who suffers an economic loss as a result of the decrease in value of the property.⁶² Generally this person is the one who has expended money in the purchase of the property or whose equitable interest decreases by exhaustion, wear and tear.⁶³ The purchaser of cattle or other property under an executory contract of sale may claim depreciation from the time possession and its legal consequences are transferred to him.⁶⁴ It is not necessary that a transfer of title be concurrent or prior to possession to enable the purchaser to claim depreciation. The life tenant of a horse, cattle, fox or other farm is entitled to claim the depreciation deduction on such property as though he were the fee simple owner.⁶⁵ However, the remaindermen are entitled to the deduction at the death of the life tenant.

In cases where the farm, and therefore, the livestock and other animals, are trust property the allowable deduction must be apportioned between the income beneficiaries and the trustees according to the trust terms. If the terms do not provide for an allocation, the local law will determine the apportionment on the basis of the trust income allocable to each.⁶⁶

In regard to animals or other property acquired by gift after December 31 1920, Bulletin "F" (Revised January, 1942) states: "If depreciable property was acquired by gift after December 31, 1920, the basis for computing depreciation in respect to such property shall be the same as it would be in the hands of the donor or

⁶² Barbour, 44 BTA 117, Rev. on other grounds, 136 F 2d 486 (1943).

⁶³ Frank Holton & Co., 10 BTA 1317; Military Equipment Co., 2 BTA 36; Fleming Railey, 26 BTA 543; Illinois Central R.R. Co., 30 BTA 1107.

⁶⁴ IT 2275, CB V p. 62.

⁶⁵ Sec. 23 (1) 2; Reg. 111, Sec. 29.23 (1)-1.

⁶⁶ *Ibid.*

the last preceding owner by whom it was not acquired by gift. The word "gift" as used herein applies to all gifts of whatever description, whether by a transfer in trust or otherwise, whenever and however made, perfected or taking effect; whether in contemplation of or intended to take effect in possession or enjoyment at or after the donor's death; whether subject at any time to any change through the exercise of any power of appointment, revocation or otherwise; or whether made by means of the exercise (other than by will) of a power of appointment or revocation, or any other power."

When the donor has not used this property in business, such as a show horse or a race horse which he has kept for his own personal admiration, it is not depreciable. However, if this property is put to use with the intention of making a profit, the donee's basis for depreciation will be the value of the property at the date of such conversion and not the donor's undepreciated cost.⁶⁷

The basis of the property is the same in the hands of the donee as it was in the hands of the last preceding owner by whom the property was not acquired by gift.⁶⁸

Generally the basis for computing depreciation in respect of depreciable property acquired, after February 28, 1913, upon a taxable exchange, is its fair market value at the date of the exchange; such value being considered its cost.

In the case of depreciable property acquired, after February 28, 1913, upon a wholly or partially tax-free exchange, the basis for computing depreciation in respect thereof is generally the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property which was acquired upon such an exchange consisted in part of the type of property permitted to be received without the recognition of gain or loss and in part of other property the basis of the property exchanged as so adjusted is to be allocated between the properties (other than money) received. For the purpose of such allocation there is to be assigned to such other property an amount equiva-

⁶⁷ Perkins v. Comm., 125 F. 2d 150 (CCA 6th, 1942), aff'g 41 BTA 1225.

⁶⁸ Wilson Bros. & Co. v. Comm. 124 F. 2d 606 (CCA 9th, 1942).

lent to its fair market value at the date of the exchange. For the purposes of this paragraph, the amount of any liabilities of the taxpayer assumed by the other party, or parties, to the exchange, including any liability assumed in the acquisition from the taxpayer of property subject thereto, is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption of such liabilities resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. This paragraph does not apply in ascertaining the basis for computing depreciation in respect of depreciable property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.⁶⁹

It must be noted that replacement cost of depreciable assets is not a proper basis for determining depreciation.⁷⁰

If the taxpayer cannot establish a basis for depreciation, i.e., cannot prove the cost or other basis, he cannot take any depreciation.⁷¹

The Commissioner's reduction of the depreciation base was held to be erroneous when a taxpayer showed that the depreciation allowance was not exceeding the physical exhaustion.⁷²

As was mentioned previously under basis, the basis for depreciation is not the cost but the adjusted basis as determined in accordance with Sec. 113 (b). Where livestock or other property is inherited, the basis for depreciation is the value of the property when acquired. Should the property be subject to a mortgage which is not to be assumed by the legatee or devisee, the basis will be the value of the property without reduction by the amount of the mortgage.⁷³ This would then have to be reduced by the amount of the depreciation allowed or allowable since received by the legatee or devisee. The basis for the depreciation of the property would have to be reduced according to any settlement of the mortgage for less than face value. This reduction would not be retroactive to depreciation taken previously.⁷⁴

⁶⁹ Bulletin "F" (Revised 1942).

⁷⁰ Greenabaum Bros., 6 BTA 86 Advocate Publishing Co., 6 BTA 780. Frost Mfg. Co., 13 BTA 802. National Packing Corp., 24 BTA 952.

⁷¹ Pittsburgh & W Va. Ry. Co., 30 BTA 843, 32 BTA 66.

⁷² Lincoln Cotton Mills, 15 BTA 680.

⁷³ Crane v. Comm., 331 U.S. 1, 67 S. Ct. 1047 (1946).

⁷⁴ Blackstone Theatre, 12 TC 801.

If a taxpayer fails to take an allowance for depreciation, he may not in subsequent taxable years take advantage of his prior failure nor can he take an inadequate allowance and make it up later, except that an adjustment of the depreciation rate may be made so that capital may be depreciated over the remaining useful life.⁷⁵

The Treasury Department has taken the stand that the adjusted basis of property must be reduced by depreciation claimed and not disallowed in prior years. The Department asserts that such reduction must occur even though the deductions did not reduce taxable income in those years. The Supreme Court has upheld this position⁷⁶ and has gone further in stating that the term "allowed" does not mean that the taxpayer must receive a tax benefit. Any deductions not "disallowed" by the Commissioner are "allowed"

When depreciation is allowable, the taxpayer's basis is adjusted downward even though he failed to take the depreciation.⁷⁷ If the taxpayer uses an excessive rate of depreciation and for one or more of the years in which he uses that rate, he fails to take his deduction he must, nevertheless, reduce his basis by the "allowable" depreciation for those years computed at this excessive rate.⁷⁸

The four methods of depreciation most generally used are the straight-line, or "flat basis" the unit-of-production, the composite rate, and the declining-balance. The Bureau prefers to use the straight-line method because of its simplicity and the fact that it can be quickly and easily checked. This method is to take the cost or other basis, determine the useful life of the asset and the probable salvage value at the end of the useful life. The salvage value is deducted from the cost or other basis and the remainder is divided by the number of years of useful life. The result is the amount of depreciation allowed or allowable each year during the period of useful life. As a practical matter, the Bureau permits the depreciation of the cost or other basis, without reduction by the salvage value. If some value is realized when the property is later sold, the amount must be declared as income.

The unit-of-production method permits the taking of deprecia-

⁷⁵ Reg. 111, Sec. 29.23 (1)-5.

⁷⁶ *Virgiman Hotel Corp. v. Helvering*, 319 U.S. 523, 63 S.C. 1260 (1943).

⁷⁷ *Carter Lumber Co. v. Comm.*, 143 F. 2d 296 (1944).

⁷⁸ *Comm. v. The Mutual Fertilizer Co.*, 159 F. 2d 470 (1947).

tion per each unit of work done. This depreciation per unit must be spread out over the useful life of the property regardless of the passage of time and under assumed normal usage. This method might be a valuable means of planning depreciation deductions for certain types of animals. Stallions, under normal conditions, would stand at stud thirty times a year. The useful life varies from three to ten years, depending upon the age of the horse at the time of acquisition by the taxpayer. Assuming the useful life of a particular stallion to be eight years, the unit total would be 240 services. Thus, should a stallion be at service forty times in one year, the depreciation for that year would be increased by the amount of depreciation per unit times the excessive number of units. Thus, where increased usage and therefore greater exhaustion, wear and tear occurs a larger amount of depreciation deduction should be permitted. To date the unit-of-production method has been in use mostly on machinery

The composite depreciation method is a form of straight line depreciation. Several cases were cited previously showing composite rates on livestock in connection with wagons, trucks, harness, etc. The deduction is determined by averaging the useful life of several, usually related, depreciable assets, and dividing the total cost basis by the average or composite life. The result would be the amount allowable as a depreciation deduction for all of the several items per year. Where the composite rate is used, normal retirement will not give a taxpayer a loss should one occur. In these cases, the cost or other basis of the property retired the depreciation reserve account should be charged. Due adjustment for salvage value, if any, must be made when the property is disposed of, but not in accord with a normal retirement plan. A deduction for the difference between the adjusted basis at that time and salvage value will be allowed.⁷⁹

The capital accounts which enter into the determination of a depreciation deduction are the fixed asset account and the depreciation reserve account.

The capital asset and depreciation reserve accounts may be single accounts, comprising all the depreciable assets of whatever kind or nature used in the business, and accrued depreciation set

⁷⁹ U.S. Industrial Alcohol Co., 42 BTA 1323, 137 F 2d 511 (1943); Reg. 111, Sec. 29.23 (e)-3.

up in one amount, or they may be broken down into groups and classifications with a separate reserve for each group. The grouping or classification of assets varies through all degrees of refinement, from a single composite account to the extreme line of item accounting which requires a separate account and reserve for each single item of equipment.

Dependent upon the extent to which assets are divided, depreciable property accounts fall naturally into the types indicated below:

(1) *Composite accounts*: All depreciable assets are included in one account with a single depreciation reserve. In computing depreciation an over-all composite rate is applied to the cost or other basis of all depreciable property. The depreciation rate is determined by applying the appropriate component rate to the cost or other basis of each classification or group included in the composite account and dividing the total amount thus obtained by the total cost of all depreciable property. Under this method, it is necessary to redetermine the composite rate whenever substantial changes occur in the relative proportions of different groups of assets. The method has the merit of extreme simplicity in application, and if the rate is adjusted to material changes in composition of the plant account, it is acceptable.

(2) *Classified accounts*: Depreciable assets are segregated into class groups where use is the guiding factor in the selection. This is merely a modification of composite accounting, since many items are included in the same account, regardless of life characteristics.

(3) *Group accounts*: Assets similar in kind which have approximately the same average useful lives are included in one account. This method is considered accurate and satisfactory for use in determining depreciation allowances, especially where large investments in depreciable property, containing many items of widely differing estimated useful lives, are involved. A separate reserve is carried for each group and computation of depreciation is simplified since the same depreciation rate is applicable to all items in the group. The greater the number of items that, because of life characteristics, fall in the same group, the more accurate are the results.

(4) *Item accounts*: Individual records are maintained in-

dicating the cost or other basis and depreciation reserve for each item of depreciable property. This method provides a current picture of the age and accrued depreciation for every item in the plant account. While simple in application, the method is expensive to maintain because of the multitude of detail required. Moreover it will be found that depreciation deductions based on life estimates of each item will not produce results as accurate as when estimated average life rates are applied to groups containing many items, since the law of averages is reflected in the result thus obtained.

Depreciation reserve.— This account should be credited with depreciation and obsolescence allowed or allowable, whichever is greater, in each taxable year. The full cost or other basis of all normal retirements adjusted for salvage should be charged to the account. When assets are sold, transferred, or retired because of casualty or special obsolescence, the account should be charged only with the depreciation and obsolescence accrued.

Salvage.— Salvage value is the amount realizable from the sale or other disposition of items recovered when property has become no longer useful in the taxpayer's business and is demolished, dismantled, or retired from service. When reduced by the cost of demolishing, dismantling, and removal, it is referred to as net salvage. In principle the estimated net salvage should serve to reduce depreciation, either through a reduction in the basis on which depreciation is computed actually or in effect, be a credit to the depreciation reserve. Where the basis or rate for depreciation is not reduced for estimated salvage, all net receipts from salvage should be considered income.

Replacements.— Amounts spent in restoring property or in making good the exhaustion thereof, for which an allowance is or has been made, or amounts spent for replacements which arrest deterioration and appreciably prolong the life of the property, are capital expenditures and, strictly speaking, should be accounted for by deducting from the asset account the cost of the item or part thereof which is replaced, and adding to the capital account the cost of the new part plus the cost of installation. The cost of the item removed (adjusted for salvage, if any) should be charged to the depreciation reserve. As a practical matter it is permissible to charge the cost of rehabilitations or small replacements directly

to the depreciation reserve, leaving the capital account undisturbed, provided there has been no material change in price levels and no substantial improvement in the new equipment. Replacements in the nature of betterments, however should always be added to the depreciable asset account.

Losses.— Accounting losses from the normal retirement of assets are not allowable under any method of depreciation accounting unless, in the case of classified or group accounting, the depreciation rate is based on the expected life of the longest-lived asset in the group, and in item accounting only when the maximum expected life of the asset is used, since correct item accounting requires an accurate determination of the life of each individual asset, which is a practical impossibility until near the end of its life.

Losses resulting from casualty are allowable in the year when the casualty occurred.⁸⁰

When property is discarded and salvaged, the depreciation allowance plus the salvage value may slightly exceed or fall slightly below the cost of the property. In the case of a gain over cost, this must be treated as income. If the depreciation allowance plus salvage value falls below the cost, the difference may be treated as a loss.⁸¹

The selling price determines the value rather than the taxpayer's estimate even though such estimate is shown on his accounts.⁸²

Appreciation in value as shown by a higher than normal sales price of property has no effect on the depreciation allowance. However, if the high sales price is the result of erroneous determination of the useful life or salvage value, the depreciation deduction for the year of the sale may be recalculated to allow for the previous miscalculation.⁸³

The declining-balance method has a much higher rate of depreciation than the straight-line since the rate is applied against the *depreciated* cost rather than against the cost less salvage value. The declining-balance rate may not exceed 150% of the normal straight line rate.⁸⁴ The Bureau now will approve the use of the

⁸⁰ Bulletin "F" (Revised 1942).

⁸¹ S. 1217, CB 1919, p. 120.

⁸² ARR 93, CB June 1920, p. 142.

⁸³ Long Leaf Lumber Co., 9 TC 990.

⁸⁴ Par. 76,004 P-H Fed., 1947, Letter ruling, 8/30/46.

declining-balance method provided it accords with the accounting method regularly employed in keeping the books of the taxpayer, and if it results in reasonable depreciation allowances and a proper reflection of net income for the taxable years involved.⁸⁵ The taxpayer must obtain consent from the Commissioner to change to this method.⁸⁶ The declining-balance method may best be applied to those accounts for property in which the greatest portion of the production or use is confined to the early part of the useful life.⁸⁷ Court approval has been given to this method.⁸⁸ To compute the rate, use this formula:

$$1. - \left(\text{estimated useful life} \times \frac{(\text{salvage value})}{(\text{cost})} \right)$$

Should any taxpayer be in doubt as to what may be required in this connection, the matter may be taken up with the local Internal Revenue Agent-in-Charge, or direct with the Bureau in Washington, D.C.⁸⁹

It is possible to reach an agreement with the Bureau as to the useful life and depreciation of a particular piece of property. If the taxpayer has agreed in writing, the Bureau will not attempt to set aside such agreed upon figures for several years.⁹⁰ However the taxpayer and his adviser should consider the consequences of applying for an adjustment of rate. The Bureau may require an audit and that audit may show that the rate of depreciation should be reduced. If this occurs the lower rate will be applicable to years open under the statute of limitations on prior returns.

Although the records of "farmers" accounts are not required to be as complete as other businesses, some record must be kept of specific animals, units, or groups of animals along with their cost and amount of depreciation for each animal, unit or group. If suitable records are not kept the depreciation generally allowable will be substantially less than the amount the taxpayer attempts to deduct.⁹¹ It is advisable in this listing of animals to indicate which are purchased and which are raised.

Depreciation affects the amount of loss the owner of Thorough-

⁸⁵ IT 3818, CB 1946-2, p. 42, modifying IT 2369, CB VI-2, p. 63 (1927).

⁸⁶ Reg. 111, Sec. 29.41-2.

⁸⁷ Bulletin "F" (Revised January, 1942).

⁸⁸ Albia Box and Paper Co., 4 BTA 1184. Good Mfg. Co., 7 BTA 202.

⁸⁹ IT 2838, CB XIII-2, p. 133.

⁹⁰ Mim. 5881, June 1945; IT 3639 CB-1944, p. 123.

⁹¹ Bell, 13 TC 344.

bred animals can claim. To determine loss upon sale or destruction of the property, the cost or other basis must be reduced by the insurance and the "allowable" depreciation, even though such depreciation has never been claimed or deducted on the return.⁹²

Careful planning of purchases of animals, by spacing such purchases over a pre-determined period in order to balance high depreciation against expected high income, will result in tax benefits for the taxpayer. The taxpayer should be wary of the trap lying in wait in IRC, Section 130. This statute, and the accompanying regulation,⁹³ will destroy even the best-laid plans for depreciation and other expense deductions. Entitled "Limitations on Deductions Allowable to Individuals in Certain Cases", it has been just that. Many of the instances of enforcement have occurred in the specialized animal industries previously mentioned.

⁹² Daniel G. Fenney, 42 BTA 1049; Reg. 111, Sec. 29.23 (e)-5.

⁹³ Reg. 11, Sec. 29.130-1 (added by T.D. 5399, August, 1944).