In the

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,)
)
Petitioner,)
)
v.) No. 73-263
)
IDAHO POWER COMPANY,)
)
Respondent.)

Washington, D.C.
February 27, 1974

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v. : No. 73-263

IDAHO POWER COMPANY, :

Respondent :

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Washington, D. C.

Wednesday, February 27, 1974

The above-entitled matter came on for argument at 1:40 o'clock p.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

KEITH A. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D. C., 20530, for the Petitioner.

FRANK NORTON KERN, ESQ., Reid & Priest, 40 Wall Street, New York, New York, 10005, for the Respondent.

C O N T E N T S

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in 73-263, Commissioner of Internal Revenue against Idaho Power Company.

Mr. Jones, I think you can proceed whenever you are ready now.

ORAL ARGUMENT OF KEITH A. JONES, ESQ.,

ON BEHALF OF THE PETITIONER

MR. JONES: Mr. Chief Justice, and may it please the Court:

This case raises the question of business income taxation, under the Internal Revenue Code of 1954.

The respondent taxpayer, the Idaho Power Company, is a public utility engaged in the production, transmission and distribution of electric energy.

In connection with this business, respondent performs a substantial portion of its own construction work.

In the years 1962 and 1963, taxable years in question in this case, the respondent itself expended approximately $13 million in new capital facilities. Primarily --

Q You go back a long way, Mr. Jones. I suppose the same issue is present in succeeding taxable years of the tax-payer?

MR. JONES: That's my understanding, Mr. Justice Blackmun.

In performing this construction work, the respondent uses essentially two different types of construction equipment. He uses automotive transportation equipment, such as passenger cars, pickup trucks, heavier trucks and trailers, and also what is called power operated equipment, which means primarily cranes, tractors, bulldozers, road graders, and so forth.

The depreciation of this construction equipment will, in this case, be referred to as construction-related depreciation.

Now, by construction-related depreciation, we do not mean all depreciation on construction equipment. What we refer to, in this case, is the depreciation on construction equipment used by taxpayer in the construction of his own capital facilities.

In performing construction work, the respondent incurs a wide variety of construction costs. It pays wages to construction workers, it buys tools and materials which are used up in the course of construction, and it also incurs wear and tear or exhaustion of the construction equipment itself, that is, the construction-related depreciation.

On its general books of account, the respondent capitalizes all of these construction costs, and does this in compliance with generally accepted accounting principles, which recognize that these construction costs, including construction-related depreciation, constitute capital outlays and not operating expenses.

This fact is also recognized by the Federal Power Commission and the Idaho Public Utilities Commission, both of which require the respondent to capitalize its construction-related depreciation for regulatory purposes.

However, on its tax returns, the respondent treats these matters somewhat differently. It capitalizes most of its construction costs. For example, it capitalizes the wages paid to the operators of the construction equipment, and does not deduct those wages as an ordinary and necessary cost of doing business.

It also capitalizes the cost of fuel used by the construction equipment. And it capitalizes the cost of repairs to that equipment, but it does not capitalize the depreciation, itself. It seeks, in this case, to take that depreciation as an immediate deduction against current income.

The Commissioner disallowed this depreciation deduction for the years in question, and the Tax Court sustained that disallowance on the ground that Section 263 of the Code requires the capitalization of all capital costs, including the construction-related depreciation.

However, the Court of Appeals of the 9th Circuit reversed.

I think it is fair to say that the opinion of the Court of Appeals came as a surprise to many tax practicioners.

The Internal Revenue Service has, for many years, taken the position, in formal rulings, that construction-related depreciation must be capitalized and is non-deductible, and this position of the Commissioner has been upheld in a long series of decisions, in the Board of Tax Appeals, Tax Court and the Court of Claims.

Because of this long history, almost all taxpayers who are engaged in the self-construction of their capital facilities, have complied with the Service's rulings and have capitalized their construction-related depreciation.

This long acceptance of the Commissioner's position makes the immediate revenue impact of this case quite substantial.

Most railroads and utility companies, and many large industrial corporations, as well, perform their own construction work. As I said, these taxpayers have, in the past, capitalized this depreciation item. But, if the decision below were left standing, it was anticipated that most of these taxpayers would file claims for refund on the basis of that decision.

The Internal Revenue Service estimated that these refund claims would amount to over $100 million for each of the taxable years currently open, and it was in large part to forestall the litigation which would arise from the filing of those refund claims, that the government petitioned for <u>certiorari</u> in this case.

I turn, now, to a discussion of the merits.

It should be first pointed out that the deduction which the respondent seeks in this case would result in a distortion in the reporting of its net income.

Construction-related depreciation is not an operating expense. It is a capital cost associated with the production of income only in the future, not with the production of income in the present.

Because of that, the deduction of this depreciation would tend to understate current net income, and it would postpone or defer the recognition of income which the respondent has already earned.

In other words, what the respondent is claiming in this case is the right to take an immediate deduction, which is not sanctioned by normal accounting rules, which would have the effect of postponing the recognition of income until future years.

This Court has never permitted such deductions of amounts which were not sanctioned by normal accounting rules which would have the effect of so postponing the recognition of income, except where such a deduction is clearly allowed by the explicit language of the statute, and is our position here, as I will now go on to discuss.

The statute does not permit the deduction of that item in this case.

Q What do you rely on in saying that this is not normal -- wouldn't be normal accounting practice?

MR. JONES: By normal accounting practice, we mean the generally accepted accounting rule that this kind of capital cost must be capitalized.

Q I know. That's what you say, but what's your authority for that?

MR. JONES: Well, we cited a couple of accounting texts in our brief, and we also cited the --

Q How were the books of this company kept?

MR. JONES: They were kept on the basis which we urge. In other words, they capitalized the construction-related depreciation.

Q So, their own accountant -- for purposes of its audit and its certificate -- treated this as you suggest it should be treated.

MR. JONES: That is correct, Mr. Justice White.

Q Is there an SEC accounting rule on this?

MR. JONES: Mr. Justice Douglas, I am not familiar with the SEC's rules. They may, but I can't answer that question. However, the Federal Power Commission, which regulates this company, does have a rule which requires capitalization. And the Idaho Public Utilities Commission, also a regulatory agency to which this respondent is subject, also requires capitalization.

Q It is not unusual, I suppose, for a taxpayer to treat an item one way for its internal accounting purposes and another way for taxes.

MR. JONES: There is nothing unusual about that, Mr. Chief Justice.

Q Held unconstitutional?

MR. JONES: We are not relying upon any constitutiona claim in this case.

Q All the depreciation taken by the company on its books is not allowed for tax purposes. For example, where property is put on books upon the basis of an appraised value, the accountants will depreciate that writeup annually and, of course, you can't take any deduction for it for tax purposes

MR. JONES: Certainly, where the Section 167 which governs depreciation, generally, would not permit a deduction. The taxpayer could not take such a deduction merely because he took it on his general books of account.

Q That's the only point I am making, that the fact the taxpayer took it is not necessarily controlling in this case.

MR. JONES: But he only took it on his tax returns in this case. The taxpayer here did not take the deduction on its general books of account.

Q Right.

I turn now to an analysis of the statute, which must begin with Section 263.

That section provides, and I shall quote: "No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

It is our position that this is not a technical provision to be read narrowly. To the contrary, this Court has historically read it broadly as the legislative expression of the accounting principle of capitalization.

This Court has recognized that in the course of holding such diverse items as brokerage commissions, stock appraisal litigation costs, and supplementary savings and loan insurance premiums to be capital, that Section 263 stands for the broad requirement that capital items must be capitalized.

And, there are, of course, statutory exceptions to this broad requirement. Section 263, itself, contains several such exceptions. Also Section 266 provides an exception for taxes and carrying costs, but there is no similar exception for depreciation. There is nothing in the Code which would except depreciation from the requirements of Section 263. There is, to be sure, provision for the deduction of depreciation. That is allowed in Section 167.

And, as we pointed out in our brief, Section 161 of the Code expressly makes all business deductions, including the deduction for depreciation under Section 167, subordinate to the capitalization requirement of Section 263.

In other words, if this construction-related depreciation falls within the general terms of Section 263, then it must be capitalized, notwithstanding the fact that it might otherwise be deducted under Section 167.

We believe that to view the matter in this light is practically to answer the question presented, because it is undisputed in this case that construction-related depreciation is a capital item. It is undisputed in this case that construction-related depreciation is a cost of construction. And, the regulations under Section 263 have historically required the capitalization of all costs of construction.

Moreover, as we have pointed out in our reply brief, regulations under Section 48 expressly state the requirement that construction-related depreciation must be capitalized, that it is not subject to immediate deduction.

Respondent, therefore, is essentially in the position of contending that the Secretary's regulations misconstrue the statute.

But, in making this contention, the respondent has fallen far short, we believe, of carrying the burden of showing that the Secretary's regulations are unreasonable.

The only statutory argument which the respondent makes in this case is that depreciation is not "an amount paid out" within the meaning of Section 263.

In the first place, we believe that this argument overlooks the fact that this Court in Lincoln Savings and Loan held that capital items must be capitalized whether or not they might fall within a strict reading of the literal language of Section 263.

But, we need not reach so far in this case because we believe it is clear that construction-related depreciation is an amount paid out within the meaning of the statute. The Secretary has construed that statutory phrase, "amount paid out," to mean being synonymous with cost incurred. And, that is really the only construction of the statute that makes any sense. That's the only construction of the statute which harmonizes the fundamental assumptions of the income tax system.

Congress couldn't have required the capitalization only of actual payments, could not have intended that only actual payments be subject to capitalization.

Historically, items such as the issuance of stock, the assumption of liabilities, the using up of construction materials, the exchange of property for other property, has given rise to capitalization, has not been immediately deductible, even though there is no actual payment that's taking place at the time that the capital asset is acquired.

What is important under the statutory scheme is simply that when a capital asset is acquired there be some cost-incurred liability assumed, or other responsibility undertaken which properly is a capital item.

In this case, the respondent, by using up its construction equipment, by physically exhausting that equipment, has incurred a very real cost in the course of acquiring a capital asset, and that cost which is incurred gives rise to the capitalization requirement here.

But, even if the statute were read literally as requiring an actual payment, it nevertheless does not require that payment to be made during the taxable year in question.

Thus, when the respondent pays, or incurs, wage expenses, in the course of constructing capital facilities, and those wages aren't paid out until the following year, nevertheless, there is a capital item in the first year. There is no actual payment. Payment is made in the following year, but it is the accrual of the wages in the first year which gives rise to a capital item.

Perhaps more to the point, in this case, if the respondent purchases construction materials in one year and then uses up those construction materials in the two following years, when those construction materials are used up, that is a capital item which has to be capitalized, as part of the basis of the capital facilities which are being constructed.

And, depreciation, really, is exactly the same as the consumption of these construction materials.

The payment is made in the first year when the construction equipment is acquired, but as the construction equipment is used up, depreciated, there gives rise to a capital item in exactly the same way as the using up of construction materials in subsequent years does.

In each case, you have a payment in an earlier year but a using up of the asset which you have already paid for in the course of constructing your new capital facilities.

And all of this physical exhaustion, or usage of materials, is part of the cost of construction, represents an amount paid out within the terms of the statute, and is a capital item.

We feel that this conclusion is supported by other provisions of the Code.

In our reply brief, we cited Sections 174, 182, 615, 616, and 617. All of these provisions permit a taxpayer to deduct items which would otherwise have to be capitalized.

And, each of these provisions does permit the deduction of construction-related depreciation in very limted circumstances.

We think it is clear that Congress, by providing for the deduction of this kind of depreciation in those limited circumstances, expressed -- in the first place, expressed its awareness that such depreciation would, otherwise, be a capital item, not subject to deduction.

Secondly, it indicated its intention that in all other circumstances not covered by those provisions this depreciation would still be subject to capitalization, and not be a deductible item.

Finally, I would like to emphasize that all we are trying to do in this case is to achieve a tax parity between this taxpayer and all other taxpayers who acquire capital facilities.

And, I think that can be seen through the following examples:

Q That is, who don't do their own construction work, you mean?

MR. JONES: I'll give you several examples, Mr. Justice Stewart, some taxpayers who do and some who do not.

For example, if the respondent, in this case, had rented this construction equipment instead of purchasing it and had used rented equipment in constructing its own facilities, those rental payments would all be capital. None of them could be deducted immediately. They'd all be part of the new capital basis of the new facility.

Similarly, if this respondent formed a subsidiary corporation, to construct the assets, the new facilities, although that subsidiary corporation would be entitled to a depreciation deduction, under Section 482 of the Code --

Q If the subsidiary corporation were in the construction business, it would be entitled to a full depreciation deduction from its ordinary income in the year depreciated without question, wouldn't it?

MR. JONES: That's correct.

But, under Section 482 of the Code, the parent corporation would be required to pay the subsidiary enough to offset that depreciation, so that the deduction would not give the subsidiary any advantage. It would simply be a watch. And the payment made by the parent to cover that depreciation would be a capital item and not be deductible to the parent because it would be part of the cost the parent expended in buying the new capital facilities from the subsidiary.

And, then, of course, where an outside independent contractor is hired to do the work, all payments to that contractor, including amounts necessary to cover depreciation on the contractor's equipment, would be capital. They would not be deductible.

Q Although the contractor, himself, the man in the contracting business, could obviously depreciate --

MR. JONES: And that points out the underlying thesis of our position. Where depreciation is incurred for the production of immediate income, then it is an expense of operations, which is properly deductible. When it is incurred, however, not through the -- not in the course of an ongoing business to produce immediate income, but to acquire a new capital asset which is only going to be used for the production of income in the future.

Q Yes.

MR. JONES: Then it is a capital item.

For these reasons, we ask the Court to reverse the judgment of the Court of Appeals.

I would like to reserve my remaining time.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Jones.

Mr. Kern.

ORAL ARGUMENT OF FRANK NORTON KERN, ESQ.,

ON BEHALF OF THE RESPONDENT

MR. KERN: Mr. Chief Justice, and may it please the Court:

In this case, Idaho Power Company uses its own equipment, such as trucks, cranes, etcetera, in part for operations and in part for maintenance, and in part construction of its own capital facilities.

That equipment has a life of approximately 10 years. It is the position of the taxpayer that it should be entitled to deduct depreciation on that equipment over its life of 10 years, while it is the position of the Government that such depreciation should be capitalized and added to the cost of the facilities produced which had a life of more than 30 years.

So that, the Government's position is that the depreciation on the equipment used in construction should not be deducted over its 10-year life but instead in aggragate over a period of 40 years, which would mean that the taxpayer couldn't recover depreciation, couldn't recover the cost of this property by depreciation for a period of more than 30 years after the property was no longer in existence.

Now, there are several -- we believe that the answer to this question turns not upon a question of accounting, but it turns on a question of interpretation of the provisions of the Internal Revenue Code, Section 167, on the one hand, which allows a deduction for depreciation of property used in the trade or business, and Section 263, on the other hand, which requires capitalization of the amount paid out for new buildings or for permanent improvements or for betterments to increase the value of any property or estate.

Now, turning first, however, since much has been made to the question of accounting in the briefs. I'd like to speak just momentarily to that.

This is not a question of the taxpayer's accounting per books under Section 446 of the Internal Revenue Code. That Section basically provides that taxable income shall be computed in accordance with the way the taxpayer keeps its books. But, under the regulations applicable to that section, Section 1.446--1A(1), it is stated that certain special items for which the Internal Revenue Code provides its own rules are not to be computed in accordance with the way the taxpayer keeps its books. And, included among those, are such things as research and experimental expenditures and depreciation, etcetera.

So this isn't a question of the way that we keep our books, the taxpayer keeps its books.

And, parenthetically there, I'd like to state that there are many things besides depreciation that are considered to be expenses -- that could be considered to be costs of property constructed, that the taxpayer does not capitalize.

These weren't mentioned. I don't know why, because they keep appearing in the briefs. In the briefs, it was mentioned taxes, pensions, those things. We didn't think it was important but all taxpayers in a profitable position deduct interest during construction.

And the Internal Revenue Code has always permitted taxpayers the permission of these deductions and interest and taxes could be deducted regardless of the existence of Section 263 of the Internal Revenue Code, since 1913, since the Code came in, and since the predecessors to the Code came into existence, and they were not made deductible by Section 266, as the Government would suggest. They were deductible because -- before Section 266 came in, which permits capitalization of interest and taxes, if the taxpayer elects to capitalize.

So, there are a whole series of things that can be deducted under the Internal Revenue Code, under the provisions of the Code, that, possibly, from a question of good accounting, should be capitalized.

Turning specifically to the question of financial accounting, it is suggested by the Government that depreciation should be capitalized because it is good accounting to capitalize it, and certain texts are cited to that effect.

However, it is respectfully suggested that the Government would not be willing to accept all of the various types of rules that are applicable under financial accounting, on the one hand, and that tax accounting does not accord with financial accounting on the other.

For example, the Government referred, in its reply brief, to Accounting Research Bulletin No. 43, which was issued in 1961 by the American Institute of Public Accounts.

Now, in 1961, in that particular bulletin it is pointed out that as costs increase -- as the costs of replacing equipment increase, as equipment is improved, as inflation occurs, historical costs of depreciation do not provide a fund for replacement of equipment.

And it is stated in that particular bulletin that it is proper for management to make an annual appropriation of net income in contemplation of replacement of such facilities at higher price levels.

This is what financial accounting does, in addition to the deduction for depreciation, in order to reflect properly the higher costs -- the higher expenses on its books.

Now, of course, the Government would not accept that. From the Government's point of view, that would be the creation of a contingent reserve, which has not been deductible, certainly, since the decision of this Court in Brown v. Helring in 1934.

So, I don't think that the Government is really interested in having all of the concepts of financial accounting applied for tax purposes.

Moving ahead, however, under the tax law, there are specific accounting rules which are really proper rules indicated by Congress in adopting the provisions applicable to depreciation.

Congress, recognizing, as long ago as 1954 that there were increased costs of replacement of equipment, that the method of depreciation, at that time, did not permit recoupment of the costs of assets in the expansion of American business, provided for methods of accumulating funds more rapidly by depreciation so those funds could be used in the business to earn other funds and replace equipment, or could be used for expansion.

For example, in 1954, various methods of accelerated depreciation were permitted, including declining balance, depreciation at twice the straight line rate.

That would allow the deduction of approximately 40%

of the cost of equipment in the first one-quarter of its life or about two-thirds of the cost of equipment in the first 50% of its life.

And then, added to that, coming ahead, up to the present time, Congress, in 1971, adopted the Asset Depreciation Range System. And that particular system permits taxpayers to adopt a class life which is in the first 30th percentile of lives previously used by taxpayers in the past, that is, the bottom 30, the quickest 30, and then to reduce that life by 20%, and then to apply accelerated methods of depreciation.

So, in the case of a 5-year property, such as lathe, for example, a taxpayer can deduct 50% of the cost of that lathe in the first taxable year.

Now, these are the kind of rules that apply to tax depreciation, and they are much more consistent with the deduction of depreciation on the taxpayer's equipment over its own useful life, as suggested by the taxpayer, then requiring the taxpayer to deduct depreciation on that equipment not over its own useful life, but not until a period of 30 years after the equipment is no longer in existence.

The taxpayer has as much need for funds to replace that equipment -- those automobiles -- those cranes -- that it uses for construction at the end of their useful lives as it has for -- as any taxpayer has -- for need -- has need to replace any other equipment, and the reasons for such replacement are the same.

Q Mr. Kern, are the automobiles that you refer to, are they used by the company 100% of the time in construction or are they used part of the time for construction, part of the time for other purposes?

MR. KERN: In part for operations, in part for maintenance, and in part for construction.

Q Do you understand what the Government's position is as to how that should be allocated, or whether it should be allocated?

MR. KERN: Yes, we keep -- the company keeps records on its books as to the usage, and those records are available and an allocated portion of depreciation is allocated to construction.

Now, it is the position of the taxpayer that this question is properly a question of statutory interpretation of Sections 167 and 263, as Congress manifested its intention in adopting those sections.

Now, to bring this out, we have to go all the way back to the beginning since these sections have been in the Internal Revenue Code. We go all the way back to the Civil War Act of 1864, and the legislative predecessor of Section 263 first appeared in that Civil War Income Tax Act which provided that no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments made to increase the value of any property or estate.

Almost exactly the same words that are used today in Section 263.

Now, quite clearly, at that time, these words were not intended to disallow a deduction for depreciation, because there was no concept of depreciation at that time, depreciation was not a deduction under the Act of 1864, and depreciation accounting, as pointed out by Mr. Justice Brandeis, in United Railways and Electric Company of Baltimore v. West, did not come into use in the United States until after 1900.

Now, I don't mean to say that the Civil War Congress' intention is carried over right up to the present time.

What I do mean to suggest is that then, in 1913, without going through all the acts at that particular time, in 1913, the Revenue Act in 1913, which is probably the direct predecessor of the present Income Tax Law, Congress chose to adopt exactly this same language to require capitalization. That is, no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments, made to increase the value of any property or estate.

Now this is, we believe, important, because in the same Act, Congress indicated its concept of depreciation. It stated in that Act that a deduction shall be allowed for losses actually sustained including a reasonable allowance for depreciation.

So that, in this Revenue Act of 1913, on the one hand, Congress indicated that it thought depreciation was a loss in value or a decrease in value, much as it's been described by this Court in numerous decisions, such as the Ludy decision, 1927, and Massey Motors, 1960, and other decisions, that Congress thought it was a reduction or loss or decrease in value, on the one hand -- depreciation was -- and on the other hand, it required capitalization only of any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate.

Now, this situation, this exact language, continued up until 1918, when the loss deduction and the depreciation reduction were separated, and then ahead, up to the present time, essentially the same situation has continued, but we believe that there is further indication that up to the present time Congress has continued to intend that depreciation shall not be considered an amount paid out and shall not be capitalized. But instead, is regarded as a reduction or loss in value.

And the reason we believe that is that -- we cite the opposite side, I guess, of the same sections that Mr. Jones pointed out, although we cited them first in our briefs.

Wherever Congress has intended that depreciation shall be treated as the equivalent of an expenditure, a word that is also used in Section 263 at the present time, the equivalent of an expenditure or of an amount paid, it has found it necessary to provide a definition in the section of the Code to that effect, while, on the other hand, where it has not intended that depreciation shall be considered an expenditure or an amount paid, there is no definition throughout the Internal Revenue Code to that effect.

Now, Congress has not found it necessary to define expenditures or amount paid in any other respect except in its consideration of depreciation, and in Sections 174, having to do with research and experimental expenditures, in Section 182, having to do with farm clearing expenditures, 615 and 617, having to do with exploration for minerals, and 616, mine development expenditures, in each of those cases where Congress has intended that depreciation shall be treated as an expenditure, it has used words to the effect that allowances for depreciation shall be considered for purposes of this section as expenditures paid or incurred.

And, on the other hand, this hasn't been done for any other type of deduction.

On the other hand, where Congress does not intend that depreciation shall be considered an amount paid, or the equivalent of expenditure, it does not so provide.

For example, in Sections 170 and 213, which have to do with charitable contributions and medical expenses, there is a deduction allowed for an amount paid or a payment.

And,in neither of these sections,is the word paid or payment defined to include depreciation.

And,in neither of these sections, is it treated by the courts as if including depreciation.

The cases come up in the use of automobiles, and where an automobile is used for medical or a charitable purpose, deduction is allowed for the gas, the oil, the maintenance, insurance, and all similar expenditures, but no deduction is allowed for depreciation on the automobile because it is not considered a payment, or an amount paid.

Now, of course, Section 263 does not have any definition to the effect that amount paid or expenditure shall include the term depreciation. And, we respectfully, suggest that, in the light of the legislative history of Section 263, in the light of the way it has been used since it first came into the Internal Revenue Code, that Congress did not intend that the terms "amount paid" shall include depreciation, as within the scope of Section 263 and, therefore, depreciation need not be capitalized.

Now, I'd like to turn to one other facet. The Government has in its briefs and Mr. Jones pointed out to the effect that there was -- well, that there is a long and consistent administrative history requiring capitalization of depreciation.

I, respectfully, suggest that's not true.

Section 263, the section that requires capitalization, came into Code in 1913 and also did the allowance for depreciation.

Going back to administrative history, administrative history itself, if you regard that as regulations or rulings, or that sort of thing, the Government didn't say a thing about capitalizing depreciation until 1955.

But, looking at administration, as perhaps encompassing what the Government litigated, back in the 1920's there are four railroad cases and which concerned -- in a sense, they have been cited as concerning the requirement for capitalization of depreciation, and what, in fact, they concerned was the movement of men and materials in work trains to a location in which the railroads were constructing new facilities.

And, apparently, buried in the cost -- the cost of this movement was accounted for on the books by saying it was one cent per man-mile for man, and six-tenths of a cent per ton-mile for material -- buried in that cost was an element of depreciation.

Now, the Government, at that time, stated that the railroads had to capitalize the costs of moving men and materials to these locations.

Q Tax cases or ICC cases?

MR. KERN: These are tax cases.

But, it was the ICC accounting that got the depreciation buried within the --

Q Right.

MR. KERN: Government said that these costs had to be capitalized and the court four times -- the courts four times -- each time, it started off with the Board of Tax Appeals -- held that they must be capitalized, but only in one of those cases was the term "depreciation" ever mentioned, and then it was just more or less mentioned in passing. There was no discussion, no analysis of the Code, no consideration of Sections 263 and 167.

Now, coming ahead up, after those four cases, the Government then came upon a case with a railroad which had -- had used equipment to construct its own facilities and in the Great Northern case, decided in 1934 by the Board of Tax Appeals, and the Government took the position that that depreciation should be capitalized. This was the first case directly concerning the matter.

Now, the case was actually argued -- the Government never took the position that Section 263 requires it be capitalized -- or its predecessor, as they do today.

It was, actually, argued on the question of whether or not construction was part of the railroad's trade or business and the Board held that it was, and the depreciation was permitted to be deducted.

Well, then, you go ahead up to 1955, and it's forty years since 1913, and at that point, came out a revenue ruling that said, to the effect, that taxpayers had to capitalize the cost of planting trees if they were engaged in forestry, and that included depreciation on the planting equipment, and there was a similar rule -- a revenue ruling -- not a regulation -- a revenue ruling a few years later concerning the capitalization of depreciation, which, again, did not rely on Section 263. It relied on a case that said that construction was not part of the taxpayer's trade or business.

And, I might say, of course, it is -- to make it clear -- that that question isn't before us today, because the Government has conceded the construction by Idaho Power Company of its facilities is part of its trade or business.

Q Let me get that straight. The Government has conceded it is part of the trade or business?

MR. KERN: Yes. I believe -- well, it is made most clear in the reply brief at page 9. Footnote.

Q But, what they haven't conceded is whether it is the principal trade or business. Is that the distinction?

MR. KERN: No. What they -- I think the Government concedes that -- Mr. Jones, I am sure, will correct me -- I think the Government concedes that this property, the property used for construction, would be depreciable in its use for construction, under Section 167, but that depreciation is

-- so far, we are entitled to the depreciation, that that depreciation must be capitalized under Section 263.

Q I assume there is no question of that.

MR. KERN: No question of that. We are arguing that Section 263,historically, was not intended by Congress to disallow or to apply to deduction for depreciation because the depreciation is not an amount paid out, and, by its terms, Section 263, requires only capitalizations of amounts paid out.

So that is where the point of departure is.

Well,I was discussing whether or not there was a long and consistent administrative history, coming then, and up to 1913 to 1955, the Government first asserted that depreciation should be capitalized, anyway, in 1955.

In 1958, the regulation to which Mr. Jones refers, was issued. That's regulation -- 1.263-2(a) -- and that regulation sets forth examples of costs which the Government states should be capitalized and includes, therein, costs of acquisition, construction or erection.

Now, this is an example of that which should be capitalized under Section 263, yet immediately before that, the regulations repeat the mandate of 263, that is, capitalization is required only of any amount paid out for new building or betterments, etcetera.

But, the regulation does say that costs should be capitalized.

It is respectfully submitted that in no place does it say that depreciation must be capitalized or that depreciation shall be treated as a cost for the purpose of Section 263.

Actually, the term "cost" as applied in the Internal Revenue Code means that which must be capitalized, under the Code, because certain items we would ordinarily consider to be costs, perhaps, from a popular or economic point of view, may be deducted and certainly may be capitalized.

So that cost as used in the regulation necessarily refers only to those items which must be capitalized.

Well, then, following ahead, along, through the regulations, up -- the last word which the Treasury Department has issued concerning whether or not depreciation should be capitalized has to do with the investment credit.

Now, the investment credit as allowed under Sections 46 and 48, is allowed as a percentage of the basis of property constructed or acquired, including property constructed by the taxpayer.

And the net effect of the regulations issued under Section 146-C(1) and 1.48-B(4) was to the effect that the taxpayer is entitled to take the investment credit on its construction equipment and is not entitled to take the investment credit on the facilities that it has constructed.

In other words, those regulations, in effect, are exactly in accordance with the position taken by the taxpayer, here, as to depreciation.

We believe we are entitled to depreciation on the equipment that we use in construction and we do not include such depreciation on the basis of facilities constructed.

Now, it is true,under the investment credit regulation, that they are written with certain self-serving provisions.

In other words, they are written in terms of if depreciation is sustained on property that should be capitalized, why, then, it won't be capitalized for the purpose of the investment credit, but, instead, will not be considered to be part of basis.

Now, if that were a proper interpretation of the law, it would be exactly contrary to the Investment Credit Law statute itself, because the statute requires that the investment credit be imposed on the basis of property constructed by the taxpayer, and the regulations, in net effect, say that the basis shall not include depreciation incurred by the taxpayer on its construction equipmant.

In consequence, what I am suggesting is, that there has neither been a long, nor a consistent, history of the Treasury Department in requiring capitalization of depreciation.

MR. CHIEF JUSTICE BURGER: Do you have anything further, Mr. Jones.

REBUTTAL ORAL ARGUMENT OF KEITH A. JONES, ESQ.,

ON BEHALF OF PETITIONER

MR. JONES: Mr. Chief Justice, I really have very little to offer, but something opposing counsel said casts Mr. Justice Powell's question in a somewhat different light for me, and I did want to respond to that.

We are not taking the position in this case that financial accounting is necessarily the guide to the interpretation of the Tax Code. What we are saying is that when the taxpayer is claiming a deduction which is not even permitted by financial accounting, then, he really ought to show very explicitly, very clearly, statutory language which permits that deduction.

And, it is our position here that no such statutory language has been shown, that to the contrary, we have pointed out that Section 263 explicitly bars the deduction here. That's the necessary impact of Sections 161, which makes the deduction for depreciation subject to the capitalization provision.

There are a number of small, little, points in this case which have been argued. I think they are all properly answered in our brief and in our reply brief, and I won't go into them at length here, with one exception, which is the taxpayer's argument that there is something about the cases under Sections 170 and 213 pertaining to the medical expense deduction and the charitable contribution deduction which is favorable to him here.

Well, those provisions provide for deductions of amounts paid during the taxable year, and the courts have construed depreciation as not being an amount paid out during the taxable year, for purposes of those deduction provisions.

The statute we are relying upon, Section 263, does not require payment during the taxable year. It merely requires an amount paid out at some time, and, as we have shown, there has been an amount paid out here and it is represented by the depreciation.

Q Would the same thing be true of State and local taxes paid upon this equipment?

MR. JONES: The history of State and local taxes and other carrying charges, such as interest, is a long one. The courts in the, I think, '20's and '30's, perhaps the '30's, were holding that those expenses were not capital items because they did not improve the value of the taxpayer's property. The courts held that those payments of taxes and interest were merely incurred to retain ownership of the property, and for that reason were not capital.

Q One of the costs of ownership of the equipment that was used in the construction of the capital asset.

MR. JONES: That's right, and I think that the holding that those items were not capital is subject to some question.

But, in our case, it is clear that the depreciation on the construction equipment was incurred in the course of improving the property, and, of course, in creating a new capital asset. And it is clearly capital.

And the earlier lower court decisions, holding that interest and taxes weren't properly capital was really a holding on economic grounds rather than legal grounds, I think, really aren't the point here, nor are, as I say, the cases with respect to the medical contributions and the medical deductions and the charitable contributions.

The purpose of those deductions provisions is to allow a deduction, to allow some tax relief, when a taxpayer incurs an expense which he wouldn't otherwise have to incur, and all the cases which the respondent cites involve the occasional use of an automobile or of an airplane, an automobile or an airplane which would have been depreciated anyway.

There was no reason in the purpose of the statute to provide a deduction or permit a deduction of that depreciation which would have been incurred anyway, and, therefore, I think, the courts properly held that it was non-deductible under those provisions.

Again, those decisions, it seems to us, have absolutely nothing to do with the issue in this case.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

(Whereupon, at 2:32 o'clock p.m., the case in the above-entitled matter was submitted.)