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CHAPTER 2

Basis for Determining Gain or Loss and for Depreciation and Depletion

ONE MAIN CAUSE OF DIVERGENCE BETWEEN TAXABLE INCOME and book profit lies in the different bases, or book values, at which property is carried for the two purposes. Basis is a technical tax concept that means essentially the amount at which assets are carried on the company's (or for that matter, the individual's) books for tax purposes. In business accounting there is no equivalent technical term; the comparable concept is the net amount at which assets are carried on the books for business purposes. For convenience, basis will be used in this chapter to refer to both tax and business accounts.

The tax basis of property, broadly speaking, governs the amount that can be recovered as capital in computing gain or loss on its sale. For depreciable assets the same basis usually, but not always, determines the maximum amount that may be charged against income as depreciation expense over the life of the property.[1] The distinctions that occasionally arise in tax accounting between basis for gain, loss, depreciation, and depletion are not encountered in business accounting.

In both business and tax accounting, the basis of an asset is usually in the first instance its cost, though the definition of cost may differ for the two purposes. Even when there is complete agreement on the cost of assets, basis may differ for tax

1 As with almost any generalization in this area, these statements must be qualified to cover a variety of special situations. The nature of most of these qualifications is indicated in the following discussion.

and business purposes because, in certain circumstances, there are business reasons for carrying assets at other than cost and there are tax requirements whereby assets must sometimes be carried at other than original cost.

Basis is one of the most technical as well as one of the most important aspects of income tax accounting. The tax treatment of basis is discussed in considerable detail for two reasons: first, to indicate its bearing on such crucial matters as the determination of gain and loss and of deductions for depreciation; secondly, to illustrate the types of technicality that are peculiar to income tax accounting and to give some of the reasons for these technicalities. To nonspecialists these details are by their very nature annoyingly complex. Only after recognition of them, however, can the concepts of taxable and business income be compared, and only after an understanding of the nonhomogeneous character of the taxable income data arising from statutory changes over time can statistical comparisons be made safely. Readers interested only in the general flavor of the differences between tax and business accounting may well prefer to pass over lightly some sections.

A Basis for Tax Purposes

General Rule

Section 113 of the Internal Revenue Code, defining basis, is divided into two subsections, the first relating to the 'unadjusted' and the second to the 'adjusted' basis. The unadjusted basis is defined in these terms: "The basis of property shall be the cost of such property; except that . . ." The subsection then goes on to list a formidable group of exceptions to cost as basis which, though important for the personal income tax, in most cases have little relevance in a study of corporate income. The main exception significant for corporate purposes arises from the requirement that in the case of certain exchanges of property in which gain or loss is not immediately recognized, the new property must take the basis of the old property. This use of substituted basis is covered below.

The cost or unadjusted basis of property is adjusted to take account of subsequent capital expenditures and for depreciation, obsolescence, and depletion. This net figure constitutes the tax basis under ordinary circumstances.

Separate provisions cover the calculation of basis for depreciation and for the determination of gain and loss. In general the same figure is used, and the basis for depreciation is stated to be the same as that for the determination of gain from sale [Sec. 114 (a)]. Certain differences, not of general application, exist between basis for gain and basis for loss.

Definition of Cost

The cost of property is ordinarily the amount paid for it, either in cash or in other property, with proper adjustment for subsequent capital expenditures. The determination of cost is thus largely a question of ascertaining whether specific expenditures are capital expenditures or expense items, and in this respect the law and common business practice substantially coincide. Capital expenditures, a part of the cost of the property, are capitalized; expense items are deductible in the year paid or incurred. The cost of acquisition and of installation of permanent assets is a capital expenditure to be included in the cost basis of the assets. Thus commissions and fees paid in acquiring assets are part of their cost. The decision whether an expenditure should be classed as capital or expense depends upon the exercise of judgment in the light of the circumstances and good accounting principles.

Property Acquired before March 1, 1913

One major exception to the use of cost as the basis of property occurs in the case of property acquired before the first income tax under the 16th Amendment, that is, before March 1, 1913. If the basis determined under the general rule would be less than the fair market value of the property as of March 1, 1913, the Code provides that the basis for determining gain shall be

the fair market value.[2] Inasmuch as the basis for depreciation is the same as the basis for determining gain, the fair market value as of March 1, 1913 becomes the basis for depreciation when it is higher than the adjusted cost basis on that date.

All the revenue acts beginning with the 1916 Act have contained some specific provisions for the basis of property acquired before March 1, 1913. The law has been changed several times to take account in varying ways of the March 1, 1913 value instead of cost. From 1924 to 1934 the basis for either gain or loss was the cost or fair market value as of March 1, 1913, whichever was higher. In 1934 the 1913 date was made to apply only to the determination of gain. For determining loss, cost is the basis, regardless of the date of acquisition. Thus, since 1934 a sale at less than fair market value as of March 1, 1913 does not give rise to a deductible loss provided the sales price is above cost, nor does it yield a taxable gain.

The theory of the provision is that profits which accrued, in a nontechnical sense, before the effective date of the 16th Amendment should not be taxed. That the provisions flow from a constitutional necessity under present interpretations is perhaps doubtful. Under the Court's concept, income is realized upon sale irrespective when the gain 'accrued'; the fact that part or all of the gain accrued before March 1, 1913 might not, according to R. W. Magill, logically prevent it from being taxed as income when realized after March 1, 1913.[3] In an important early case, Lynch v. Turrish, 247 U.S. 221 (1918), however, the Supreme Court held that the increase in value before March 1, 1913, though realized after that date, could not be taxed as income.

[2] Sec. 113(a) (14): "Property Acquired before March 1, 1913. In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining *gain* shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the asssets of the corporation as of that date."

[3] *Taxable Income* (Ronald Press, rev. ed., 1945), pp. 106-15, especially 111.

Substituted Basis

In order not to hamper unduly certain types of business transaction, such as reorganizations and liquidations, the tax law permits certain exchanges of property to be carried out without the immediate recognition of gain or loss. The intent is, of course, not to exempt the gain from taxation or to disallow the deduction of a loss, but to defer the recognition of gain or loss until some future sale or exchange of the property when the taxpayer will have funds at his disposal. This future taxation of the gain or allowance of the loss is assured by the provisions fixing a special basis, generally called a 'substituted basis', for the property acquired upon an exchange on which gain or loss is not recognized.

The Internal Revenue Code recognizes, Section 113(b)(2), two types of substituted basis. The basis of the property acquired may be fixed by reference to the basis of the property (a) in the hands of the transferor or (b) given in exchange. The significant point is that, in transactions on which gain or loss is not recognized, the basis of the property acquired is not its fair market value at the time of acquisition.

The circumstances under which a tax-free exchange is permitted and a substituted basis is correspondingly required are covered in detail in the tax law. Though some of the problems arising under these provisions are extremely complex, the main purpose, to assure ultimate recognition of all gain and loss, is relatively simple.

1 *Property acquired in tax-free exchanges generally*

Under the Internal Revenue Code, gain or loss is not recognized when property is acquired after March 1, 1913 in connection with exchanges involving (a) property held for productive use or investment for property of like kind, (b) stock for stock of the same corporation, (c) stock or securities for stock or securities in reorganizations, and (d) assets for stock when the transferor controls the corporation immediately after the ex-

change.[4] If such exchanges are not solely in kind, that is, if the property received consists not only of property permitted to be received without recognition of gain but also of other property or money, gain is recognized but in an amount not to exceed the sum of the money or fair market value of the other property received.[5]

The basis of property acquired in these tax-free or partly tax-free exchanges is specifically prescribed by statute to be the same as the basis of the property given in exchange with two modifications: First, if any money or 'other' property is received in the exchange, the basis is reduced by that amount. Second, when money or 'other' property is received, gain or loss is recognized but not in excess of the money or the fair market value of other property. If any gain or loss is recognized on the exchange, the basis is increased in the amount of the

[4] Internal Revenue Code, Sec. 112(b)(1)-(5). To retain control in the statutory sense the transferor or transferors must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation [Regulations 111, Sec. 29.112(b)(5)-1].

Reorganization, as used for tax purposes, covers a considerable variety of situations, many of which do not come under any generally accepted meaning of the word. The highly technical tax definition, Section 112(g)(1), may be quoted in full: "The term 'reorganization' means (A) a statutory merger or consolidation or (B) the acquisition by one corporation in exchange solely for all or a part of *its voting* stock, *of at least 80 per centum of the voting stock and at least 80* per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of *its voting stock* of *substantially* all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected."

[5] Internal Revenue Code, Sec. 112(c). In the converse situation, however, when the exchange is not solely in kind but involves 'boot', the loss is *not* recognized [Sec. 112(e)]. This provision is necessary to prevent the recipients of property from determining according to their own interest whether to take or defer a loss.

gain or decreased in the amount of the loss recognized.[6] The whole purpose of the basis provisions is to require the new assets to retain the lower basis of the old assets when the gain is not recognized. Consequently as far as gain is recognized, the basis of the new assets must be raised.

If, for example, property with a basis of $10,000 is exchanged solely for property of a like kind with a fair market value of $12,000, the $2,000 gain is not recognized, but the new property retains the lower basis of the property given in exchange. Since the property received retains the lower basis, the $2,000 gain, which is not taxed at the time of the exchange, is taxable when ultimately realized. But if the property with a basis of $10,000 is exchanged for property of a fair market value of $8,000 plus $4,000 in cash, the basis of the new property is $8,000, derived from the basis of the property given in exchange, $10,000; minus the money received, $4,000; plus the gain recognized, $2,000.

When the property received consists in part of property of the type permitted to be received without recognition of gain or loss and in part of other property, the basis must be allocated between the two properties. The statutory rule of apportionment is to allot as basis to the other property received its fair market value at the time of the exchange.[7]

One further special provision may be described to show the somewhat complex nature of the tax basis of property. To avoid loss of revenue through a stepped-up basis in transactions where one party assumes liabilities of another party to the exchange, the Code now provides [Sec. 113(a)(6)]:

"Where as a part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall,

[6] The amount of gain or loss by which the basis is adjusted is the amount recognized "under the law applicable to the year in which the exchange was made" [Internal Revenue Code, Sec. 113(a)(6)].

[7] Internal Revenue Code, Sec. 113(a)(6). See example of apportionment in Regulations 111, Sec. 29.113(a)(6)-1.

for the purposes of this paragraph, be considered as money received by the taxpayer upon the exchange."

This sentence was added by the 1939 Act to correlate the basis provisions with an amendment, also made by the 1939 Act, to Section 112 of the Internal Revenue Code, providing that in certain exchanges an assumption of liabilities on the part of the transferee was not to be considered as other property or money received by the transferor.[8] Since the amount held to be constructively received by the transferor through the assumption of his liabilities is not included in measuring his taxable gain at the time of the exchange, the basis of the property received (the same as the basis of the property exchanged) is reduced by the money equivalent of the assumed liabilities in order to avoid loss of revenue through a stepped-up basis.

2 *Property acquired by a corporation in connection with a reorganization*

The provisions discussed in the preceding section, dealing with tax-free exchanges generally, apply to most exchanges in connection with a reorganization.[9] Gain or loss is not recognized, but the basis of the property acquired may take the basis of either the property given in exchange or of the property in the hands of the transferor, depending on the exact nature of the exchange.

When a corporation that is a party to a reorganization exchanges property in pursuance of a plan of reorganization for stock or securities in another corporation, also a party to the reorganization, the stock or securities acquired retain the basis of the property given in exchange. Also when a corporation

8 The 1939 amendment to Section 112 of the Code was enacted to free reorganizations involving an assumption of liabilities from the restrictions imposed as a result of the decision in United States v. Hendler, 303 U.S. 564 (1938). See S. S. Surrey, Assumption of Indebtedness in Tax-Free Exchanges, *Yale Law Journal*, Vol. 50, p. 1 (1940).

9 Internal Revenue Code, Sec. 112(b)(4).

exchanges stock or securities it owns in a corporation that is a party to a reorganization solely for stock or securities in such corporation or in another corporation that is also a party to the reorganization, the stock or securities acquired take the same basis as that given in exchange.

In many reorganizations a corporation acquires property by issuing its own securities. The general rule for tax-free exchanges specifies that the property acquired takes the basis of the property given in exchange. Stock and securities issued by a corporation, however, typically have no independent basis in its own hands that can be used as the basis for the property acquired. Stock and securities issued not only have no independent basis to the issuer arising from a past transaction, but their value is in fact derived from the value of the property received in exchange, especially in the case of a new corporation or in any situation where a large proportionate increase in outstanding stock occurs. If the fair market value of the stock were deemed to be its basis, and used as a substituted basis for the property acquired, it would be established by the current value of the property acquired. A stepped-up basis could thus be obtained. For example, if X Corporation acquired property with a value of $100,000 and a basis of $10,000 in the hands of Y Corporation, in exchange for all its stock, it would properly be deemed to have given up stock worth $100,000 and this figure would be accepted as the basis of the property to it.

To meet the situation described above and avoid a stepped-up basis, Section 113(a)(7) provides that when the property is acquired by a corporation in connection with a reorganization in a taxable year beginning after December 31, 1935, the property retains the basis it had in the hands of the transferor. A provision to avoid a stepped-up basis for invested capital purposes was contained in the Revenue Acts of 1918 and 1921 and a provision with respect to basis for gain or loss and depreciation purposes, still very limited in form, appeared in the Revenue Act of 1924. These provisions have been substantially modified since and generally prevent a stepped-up basis

in a situation such as described above if the transaction occurred after December 31, 1917.[10]

One purpose of the special treatment of basis in reorganizations is essentially the same as that of the basis provisions for tax-free exchanges generally. The transferee corporation cannot obtain a stepped-up basis for the assets, but must use the basis the property had in the hands of the transferor. If gain or loss is recognized to the transferor on the transaction, the basis is increased in the amount of the gain or decreased in the amount of the loss. Another purpose of the provisions applicable to reorganizations and other transactions in which there is a continuity of interest is to avoid the uncertainty concerning the tax basis and the tax liability that would ensue if every transfer gave rise to a new tax basis determined by appraisal.

3 *Property acquired by a corporation on the complete liquidation of another corporation*

Two other situations requiring the use of substituted bases may be described more briefly. Under the present provisions of the Code, Section 112(b)(6), the liquidation of a subsidiary corporation is not, in certain circumstances, a taxable transaction. Gain or loss is not recognized upon the receipt by one corporation of property distributed in complete liquidation of another corporation; the distribution is considered in complete liquidation and comes within the provision only if the acquiring corporation has the specified control over the liquidated cor-

10 Originally, the Section covered the acquisition of property other than stock or securities and applied only if after the transfer an interest or control of 80 percent remained with the same persons. The percentage control required was first reduced, then dropped. The exception of stock or securities was dropped in 1928, and later reintroduced to apply if stock or securities were acquired by the issuance of stock or securities of the transferee. The rather awkward wording of the subsection is explained by its successive modifications. The original limited application has become one generally applicable to the acquisition of property of any sort by a corporation in connection with a reorganization by the issuance of its own stock or securities. The general limitation to acquisitions by the issuance of stock or securities is apparent only indirectly—through the definition of reorganization in Section 112(g).

poration, and the liquidation is completed within the specified interval.

Like the reorganization provisions, the Section permitting the liquidation of a subsidiary without the recognition of gain or loss postpones rather than foregoes recognition of gain or loss to the extent that the gain or loss arises from the difference between the basis of property to the subsidiary and its market value. But gain or loss to the extent of the difference between the basis of property in the hands of the subsidiary and the basis of the subsidiary's stock in the hands of the parent is never recognized for tax purposes: Section 113(a)(15) provides that when property is received by a corporation upon a distribution in complete liquidation of another corporation upon which gain or loss is not recognized, the basis of the property is the same as it was in the hands of the transferor.

4 *Assets for stock when the transferor controls the corporation*

A substituted basis is provided for also in the case of property acquired by a corporation controlled by the transferors of property and of property acquired as paid-in surplus or as a contribution to capital. The same rule is applied as in the case of certain reorganizations: the basis of the property acquired is the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon the exchange.[11]

5 *Effects of discharge of indebtedness on basis*

Another circumstance requiring a distinctive treatment of basis arises from the option granted in the Revenue Act of 1939, Sections 22(b)(9) and 113(b)(3), to exclude, under certain conditions, income arising from the discharge of indebtedness subject to commensurate adjustments in the basis of property.

[11] Internal Revenue Code, Sec. 113(a)(7)(A) and (8)(B). Sections 113(a)(7) and (8) were introduced as companion items in the Revenue Act of 1924 to prevent a stepping-up of basis through exchanges involving the issuance of corporate securities.

The amount of income excluded must be applied in reducing the basis of successively specified categories of property up to and including inventory and notes and accounts receivable [Reg. 111, Sec. 29.113 (b)(3)-1]. This is a further complication in the law but was designed to prevent the imposition of a tax burden on a form of gain that typically provides no disposable funds and that frequently arises at a time of financial stringency.

6 *Substituted basis arising from certain receivership and bankruptcy proceedings*

Under the Revenue Act of 1943, Sections 112 (b)(10) and 113 (a)(22) were added to the Code to provide for the nonrecognition of a gain or loss and for the use of a substituted basis by successor companies in the case of certain specified receivership and bankruptcy proceedings. This change, retroactive to "years beginning after 1933", was designed to carry further the liberalization introduced in 1939 by Section 22 (b)(9), described above, and is consistent with a similar treatment of railroad companies introduced by Section 22 (b)(10) in 1942. Some allowance of this sort was necessary to prevent receivership and bankruptcy proceedings from leading to a reduction of basis and consequent tax disadvantage arising from the restricted definition of reorganization under Section 112 (g). The tax disadvantage from loss of basis was serious enough to discourage the consummation of otherwise beneficial reorganizations under bankruptcy.

Adjusted Basis

Basis, as determined by cost or through a substituted basis, is subject to proper adjustment for capital expenditures and depreciation. Section 113 (b) of the Internal Revenue Code specifies in detail the required adjustments, many of which are highly technical and important only in rare cases.

The first provision, Section 113(b)(1)(A), is for adjustment for expenditures, receipts, losses, or other items properly

chargeable to capital account. These adjustments, illustrating the types of problem of cost allocation involved in calculating original cost, need not be repeated here.

Section 113(b)(1)(B) provides for "exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws". In view of the difficulty of determining 'correct' depreciation deductions in a particular year a rigid administration of this provision with reference to allowable depreciation not taken in prior years might lead to serious abuse if taxpayers had in good faith not determined and taken the maximum allowable depreciation in each year.

The rule that basis for gain or loss and for depreciation should be reduced by prior depreciation allowed or allowable would seem to require a taxpayer to establish clearly that he had taken all the depreciation he might conceivably have been allowed in each year. To do this, it might be necessary to claim a deduction in excess of the expected allowance on every item subject to depreciation so that evidence would be available that the final amount allowed was really the maximum allowable. In fact, conclusive evidence might be obtained only by appealing all adverse rulings or by getting closing agreements on all disallowed depreciation deductions. But presumably an extreme interpretation of the rule that basis must be adjusted for prior depreciation allowed or allowable is not intended, for its application would lead to a ridiculous and impossible administrative situation. When applied to cover the flagrant case in which depreciation is intentionally ignored or grossly understated, the provision is thoroughly justifiable to prevent improper postponement of deductions to years when the tax benefit would be maximized.

Taxable income and tax revenues are increased by reducing the basis for a past allowable depreciation that was not taken, thereby reducing the future allowable depreciation. The loss arising when the basis is adjusted downwards is not significant for tax purposes if attributable to years that are barred by the

statute of limitations. In computing total reported taxable income over the years these loss or deduction items would be omitted. The omission of such items is, in a sense, an example of one of the rare counterparts in tax accounting to direct charges to surplus in business accounting.

B Basis for Accounting Purposes

Meaning of the Accounting Basis of Property

Of necessity, all assets included in a company's accounts must be shown on the books at some specific figure. The accounting counterpart of the 'basis of property for tax purposes' is simply the stated net book figure at which the asset is carried, referred to as the accounting or book basis of property. The distinctions sometimes made for tax purposes between basis for gain, for loss, and for depreciation, have no parallel in business accounting. The figure at which assets are stated may represent original cost, original cost as changed by subsequent use, additions, or partial dispositions, or appraised value (defined in various ways) at some date subsequent to original acquisition. When the asset itself is finally disposed of, the asset account on the books must be closed out by a credit equal to any remaining balance. The treatment of the depreciation of the asset and of the gain or loss on its disposition will vary with circumstances and the accounting policy of the company. But whatever the accounting basis of property may represent at any time, that is, whether it is derived from cost, appraisal, or some other source, it is always indicated by the stated net balance in the asset account. This basis, furthermore, is identical whether the property is to be used, sold, or exchanged, and whether a loss or a gain is involved.

Accounting Problems in Determining Cost

Original cost is usually taken as the first basis of property in business accounting. If a company is to maintain itself, an outlay for property with a limited useful life must be recovered from operations or on its final disposition. Indeed, the expendi-

ture on depreciable property has come to be considered by many as analogous to a deferred charge in that liquid resources are converted into property useful in production for a limited time; a proper measure of the expense of each subsequent period requires an allocation of the appropriate share of the total cost of the depreciable property to each period. The straight line method of allocation and other less commonly used methods, such as diminishing balance and sinking fund calculations, are discussed in Chapter 4. The following sections are devoted to the problems of determining the total amount to be charged off. First, the measurement of original cost will be considered, then the reasons why it is sometimes desirable to use a figure other than original cost as the basis for depreciation.

1 *Problems of allocating indirect cost*

Though original cost may appear to be a simple and exact concept, it is not always easy to determine. When a piece of equipment is purchased for cash, the total cost of acquisition can be ascertained without difficulty since it is clearly equal to the amount paid to the seller plus delivery and other charges. But even in this simplest of all cases, complications may develop because the total cost must include the costs of installation. The outlay entailed in getting the equipment set up ready for use is as much a part of the cost of the subsequent production as the amount paid for it. Expenditures for material and labor employed directly on the installation are usually readily ascertainable and attributable to the cost of the equipment. The indirect expenses of general supervision and administration, however, may be allocated by any of numerous standard methods. Given reasonable administrative latitude in permitting for tax purposes the use of any accepted procedure, problems of divergence between tax and business figures in this area have not been great.

The problem of allocating total cost to the various items making up a single purchase is essentially similar in nature to the allocations required for tax accounting, but the incentives

for allocation of specific amounts to each asset may differ. Since land is not subject to depreciation, and since at various times the tax treatment of gains and losses on land has differed from that of gains and losses on property subject to depreciation, there may be real tax advantages, both immediate and long-run, in establishing certain allocations of cost. The smaller the proportion of total cost charged to land, for example, the greater will be the amount to be recovered through depreciation, and the smaller the reported taxable income before the land is disposed of. The restrictions on the deductibility of capital losses and the changing definitions of capital assets have also at times made it advantageous for tax purposes to attribute a large part of total cost to depreciable property and charge a minimum to land. Business reasons, on the other hand, may cause management to prefer to maximize or to minimize its statement of future income, depending on circumstances.

In view of the foregoing mixture of incentives, it is not surprising that opinion has differed concerning the proper allocation of the cost of a group of assets purchased in a single transaction. Exact appraisal is difficult because the value of all the elements of property to be incorporated into a going concern is different from the sum of the values of the individual items sold separately. The total cost represents a single transaction and constitutes a 'total basis', but it is a matter of opinion how this total should be divided. Likewise, it is probably much easier to get individuals to agree on total value than on how the total is reached when a group of items is being considered. It has become common in the past several years for the tax services to recommend some division of a total purchase price to serve as evidence in allocating basis, but the factor of judgment here is so important that room still exists for continuing discrepancies between the tax and the book basis.

2 *Current expenses and capital expenditures*

No invariable rules have been established for distinguishing current expenses from capital expenditures. A perfectionist

would insist that any outlay that will be of benefit for more than a year should be set up as an asset to be charged off over the entire period of usefulness. The cost of a biennial paint job should properly be divided between the two years, as should the cost of regularly recurring repairs or replacements on equipment, if they benefit more than the period in which they are made. But a multiplicity of accounts and separate depreciation rates would be required, and the refinements introduced into the measurement of income are usually not considered of sufficient importance to justify the expense and effort of operating the elaborate accounting system that would be necessary. In many of the accounting manuals prepared by trade associations are detailed rules for treating different types of expenditure on capital assets. Consistency, rather than absolute accuracy, seems to be the chief objective.

Maintenance charges may benefit more than one accounting period and they may vary from period to period; indeed, they may be deliberately made to vary with any of several factors. Maintenance work may be minimized in busy periods, and deferred maintenance made up and anticipatory maintenance performed in slack periods. During three-shift operations, for instance, it is likely to be physically impossible to keep up maintenance. Maintenance work may be timed to coincide with periods of maximum net income, either to smooth annual income or to get the maximum tax benefit from the deduction. Anticipatory maintenance when excess profits taxes were temporarily imposed would be not unlikely if it were physically possible; instances undoubtedly occurred during the war.

In general, a rule of reason is applied for both tax and business purposes in distinguishing between expense charges and capital expenditures; nevertheless, differences in judgment concerning borderline cases naturally arise from the different incentives imposed by the differing objectives of tax and business accounting. In general, if a repair or replacement is so large that it would distort income to treat it as an expense in a single year, as in the case of new boilers and engines in a ship,

the outlay must be treated as an additional capital expenditure. It would be preferable to treat the power plant and the hull of the ship as separate assets with distinct service lives. Any replacement in the nature of a betterment, lengthening the probable useful life of a piece of property over the original estimate, should also be treated as a capital expenditure. But ordinary maintenance, repairs, and replacements are usually considered as expenses of the period in which the work is done. The perfect theoretical treatment of each charge is too expensive and difficult. It may be presumed also that any errors in specific items will tend to balance out, as when different buildings are painted in different years, or when exterior painting in one year is more or less balanced by interior decoration in another year. A reasonable system consistently applied meets all requirements.

Property Acquired before March 1, 1913

Business accounting does not and cannot have any counterpart to the special tax treatment of property acquired before March 1, 1913. The use of value as of that date as the basis for gains constitutes a major exception to the general use of cost as basis. It is unnecessary here to discuss the refinements and niceties involved in this problem. In brief, the legal provisions are based on the proposition that gains developing before the effective date of the 16th Amendment should not be taxed.[12]

The special treatment of gains that had developed but not been realized before 1913 has probably served to prevent discrimination between taxpayers based on the fortuitous realization or nonrealization as of the date. It has, however, introduced much complexity and litigation into tax accounting. Important though the introduction of the income tax was in this country, it did not justify any assumption of universal quasi-reorganization at the moment of its effectiveness. And only such a fantastic assumption could have made the basis for book and for tax purposes correspond in this respect. The

[12] Magill, op. cit., pp. 108-9.

March 1, 1913 basis provision constitutes grounds for a continuing divergence between taxable and business income as long as any property is dated so far back.

Substituted Basis

The use of a substituted basis is a conspicuous example of the general statement in Chapter 1 that the taxable income concept differs from that of business income by including virtually all gains and losses at one time or another. Generally, a substituted basis as required for tax purposes would give altogether artificial results for business purposes. Changes in basis that have no counterpart in taxation are, however, sometimes made for book purposes. Thus a company may substitute a new for an old basis on its own books and regardless of its basis in the hands of any other holder. These problems of carry-over and modifications of the basis of property constitute some of the most complex and fundamental reasons for differences between taxable and business income. Before dealing with specific aspects, one general observation may be made.

For purposes of business accounting, the basis of property in the hands of a predecessor or any other prior holder is typically of no significance in determining the basis for the present holder. Basis, in the first instance, is determined by cost measured by the value of other assets given for the property or by liabilities assumed or securities issued to acquire it. Only upon this basis as a point of departure can the results of subsequent operations and developments be accurately measured with reference to the property-holding corporation.

For the foregoing reasons, it is not common for companies acquiring property in tax-free exchanges to use a substituted basis on their own books, thereby eventually showing gain or loss on the transferred property in its own income. However, the transferring company that originally held the property will not necessarily show the gain or loss on the property in its income account. Even if recognized on the transferor's books, the gain or loss is likely to be taken directly to capital or surplus

account on the ground that gains or losses on the disposition of a large part of a company's assets are so unusual and so enormous that they do not constitute income. To carry them through the income account, accordingly, would distort the income.

If a company exchanges property for securities of the transferee, then distributes the securities to its own stockholders, recognition of the gain or loss, as measured by the difference between the book basis of the assets transferred and the value of the securities received, may be entirely ignored on the books of the transferor. The fundamental difference between the taxable and business income concepts in respect of their relative inclusiveness is emphasized in this connection. For book purposes the charge or credit to surplus, or the complete ignoring of gain or loss in the case of the distribution of acquired property, may be proper and desirable in measuring business income. But for tax purposes all realized gain must be taken into account as income at some time or other; neither the unusual, nonoperating, and nonrecurring nature of the gain nor its distorting effect on income justifies its permanent omission in computing taxable income.

For business purposes what in effect would be a substituted basis may be appropriate in a few situations. For instance, the basis of assets to a predecessor company will be carried forward by a successor corporation if there is a continuity of identical interests, as when a corporation changes its name or place of organization. Such change of identity, form, or place is one type of tax-free reorganization, and in these instances tax and business practice will correspond.[13] When property is acquired in the process of the liquidation of another company and the acquiring corporation has previously owned the securities of the liquidating company, it might have the same basis to both corporations, but only when the book value of the investments equals the book value of the net assets acquired in liquida-

[13] Internal Revenue Code, Sec. 112(g)(1)(F).

tion—an improbable case. In the more common situation the book value of the investment differs from the book value of the assets acquired, and the gain or loss would probably be recognized at the time of liquidation and the assets stated by the parent company at the book value of the former subsidiary. If such a gain or loss is carried through the income account for book purposes, one of those rare situations is produced in which an item enters income for book purposes but, in effect, is carried directly to the surplus account for tax purposes to the extent that the basis of the stock of the subsidiary in the hands of the parent differs from the basis of the assets of the subsidiary in its hands at the time of liquidation.[14] These situations, however, are few and far between; for tax-free exchanges in which a new corporation without identical continuing interest is set up, or in which an existing corporation issues new securities to acquire assets, any use of the predecessor's basis of assets acquired will distort the reports of the acquiring corporation.

The exchange of property held for productive employment in trade or business or for investment for property of like kind to be held for the same purposes presents another special case in which something approximating a substituted basis as used for tax purposes might be used on a company's books. If the book value of property disposed of approximates its current exchange value, the new property may be stated as equal to the basis of the old property, plus or minus any boot given on the exchange. But a gain or loss on the old property, measured by the difference between the book basis of the old property and its trade-in allowance, will usually be taken up at the time of the exchange, and the new property will be stated at its value at the time of its acquisition.[15]

[14] The book treatment of gain or loss on the liquidation of a subsidiary and of the assets acquired depends in part upon the previous handling of undistributed earnings of the subsidiary, and the topic could not be presented satisfactorily without a full discussion of the rather complex methods of accounting for investments in subsidiaries.

[15] R. H. Montgomery, *Auditing Theory and Practice* (Ronald Press, 5th ed., 1934), p. 279.

Attention must be given to any remaining balance of the cost of the old equipment upon its disposition. Strong arguments can be advanced for each of several procedures: considering the gain or loss on the exchange as properly carried directly to surplus, carrying it to the income account of the year of the exchange, adding it to the basis of the new property to be written off over what would have been the normal life of the old property, or adding it to the basis of the new property to be written off over the life of the new property. The lines of analysis for these various treatments are similar to those for unamortized bond premium and discount, discussed in Chapter 6. For some business purposes, the best result is achieved by carrying forward the unrecovered cost of the old property—an accounting procedure somewhat similar to the substituted basis for tax purposes.

For an exchange in which a corporation gives up old securities for new ones, no precise rule can be laid down concerning the propriety of using a substituted basis for book purposes. At the one extreme is a situation in which stock certificates in a company are surrendered for new certificates when the issuing company merely changes its name or place of incorporation. The recognition of gain or loss would be pointless and inconsistent with a general policy of carrying assets at cost. At the other extreme is a situation in which first mortgage bonds, perhaps originally purchased at par, are exchanged in a reorganization for a small block of common stock, of infinitesimal value, in a successor company. Not to recognize gain or loss, if it has not been previously recognized, would be grossly misleading in public reports. Between these extremes, honest judgment must be permitted to determine whether the exchange is one in which gain or loss should be recognized. A substituted basis for book purposes similar to that used for tax purposes may or may not be appropriate; in any event, the exact definitions authorizing and requiring the use of a substituted basis in the tax law cannot serve as a guide for using or not using it for business purposes.

Effects of Reorganizations on Property Basis

The general subject of reorganization, raised in connection with a substituted basis for tax purposes, has been of major interest to accountants during the past twenty years. Much of the extensive literature in the field has been concerned primarily with the immediate and subsequent effects on various surplus accounts and with the nature of distributions made after reorganizations.[16] This aspect of the reorganization accounting problem is closely related to that of earnings and profits available for distribution and the taxability of dividends as income discussed in Chapter 7, Section III below. In the present context the effects of reorganization on stated asset values alone are relevant. Further consideration of the subject is appropriate here to describe the circumstances under which the basis of property may legitimately be changed for business purposes, though a change in basis for tax purposes is not permitted. This is the converse of the situations previously considered in which a substituted basis is required for tax purposes but is unacceptable in business records.

First, the scope and purpose of reorganizations may be reviewed. The most casual reading of the tax definition of reorganization reveals that in some respects it is broader and in others narrower than the business use of the term. The inclusion of "mere changes in identity, form, or place" goes far beyond either the popular or business connotations. On the other hand, technical requirements concerning the percentage of ownership before and after the transaction and of the particular forms of securities that must be handled in certain ways impose limitations on the term and its use in tax matters, as compared with its general meaning. This difference in definition does not justify elaboration, but it is fundamental to an adequate understanding of the difference between tax and business concepts.

[16] Accounting Research Bulletin 3, Quasi-Reorganization or Corporate Readjustment (1939).

It is especially significant that before 1943 most reorganizations in bankruptcy did not come within the tax definition of a reorganization. The higher basis of property to the predecessor company was lost to the successor company, even though the corporate losses at the time of bankruptcy did not reduce the income taxes of either corporation. Sections 112 (b)(10) and 113 (a)(22) were added in 1943 to remedy the situation in the case of certain receivership and bankruptcy proceedings.

In business usage, reorganization traditionally has been associated with financial distress: a reorganization was presumed to ensue upon bankruptcy or perhaps a voluntary agreement with creditors. It typically has involved a reduction of stated assets and liabilities, frequently in both the equity and creditor categories. In time, the term came to be applied to less radical and formal readjustments of financial structures. Quasi-reorganizations, as they were called, became acceptable procedures to wipe out accumulated deficits, permitting a company to make a fresh start. Along with the cancelation of accumulated deficit, it was frequently desirable to restate assets, especially depreciable assets, to reduce subsequent depreciation charges. If as a result of inadequate depreciation, a lower price level, or a decline in the industry, the remaining book balances were far out of line with current and prospective future values, such an asset reduction was acceptable, provided it was clearly revealed and that earned surplus in later years was shown as arising subsequent to a write-down on a specified date.

Any restatement of the balances in property accounts provides a new basis for the property. Opinion has differed concerning the correct grounds on which to determine the new stated property balances. Traditionally, accountants have emphasized that the balances in fixed property accounts do not represent values, and the phrase 'asset values' is avoided here for that reason. Rather, fixed asset balances represent cost or the remaining unrecovered or unexpired balance of cost when it is being written off according to some systematic plan, as

through depreciation.[17] But when cost figures are being abandoned, as in a reorganization, some form of valuation is necessary. Reproduction cost at current price levels, minus observed depreciation, is one possible standard; present market value, based presumably on a capitalization of earnings to be derived from the use of the property, another.[18] These two approaches would ordinarily yield different results. In other cases, a radical adjustment of a depreciation reserve may be appropriate to take account of unexpected obsolescence. Whatever method is adopted, however, it should be applied thoughtfully and with proper allowance for judgment, not haphazardly as has apparently been done at times in the past. Asset valuation set at a level to assure any desired degree of future profitability would clearly be unacceptable.[19]

The foregoing discussion of reorganizations and quasi-reorganizations may be most clearly related to problems of income determination by a general statement that for various reasons assets may be revalued upwards or downwards for business purposes.[20] There is first the situation of ultimate recognition of previous grossly deficient or excessive depreciation. Subsequent years can be made to reflect a correct picture without being colored by the errors of past judgment, if property accounts are adjusted and a corresponding amount charged or credited directly to surplus. The corollary of such an adjustment, that income over the years is incorrectly stated, may seem

[17] For a discussion of this approach to the treatment of depreciable property, see G. O. May, *Twenty-five Years of Accounting Responsibility, 1911-1936,* B. C. Hunt, ed. (Price, Waterhouse & Co., 1936), II, 309-18; see also T. H. Sanders, H. R. Hatfield, and Underhill Moore, *Statement of Accounting Principles* (American Institute of Accountants, 1938), p. 59.

[18] The importance of prospective earnings is developed in J. C. Bonbright, *Valuation of Property* (McGraw-Hill, 1937), I, 237. As an example of the approach see Securities and Exchange Commission, *Corporate Reorganization Release 29* (July 9, 1940).

[19] W. A. Paton, Aspects of Asset Valuation, *Accounting Review*, IX, 122-9 (June 1934), presents a criticism of irresponsible revaluation.

[20] See W. A. Hosmer, op. cit., for a study of the reasons for downward revisions of asset valuations.

less serious than a continuation of what has turned out to be an incorrect annual charge or the substitution of another incorrect annual charge so fixed as to offset previous errors. An important current instance of such an adjustment is the treatment recommended after World War II by the Committee on Accounting Procedure of the American Institute for fully amortized emergency wartime facilities with a substantial postwar usefulness.

A second occasion for revaluing assets arises from any drastic change in general price levels. If prices fall substantially, companies with property purchased at the lower level may at a profit undersell otherwise comparable companies whose plant was purchased at the earlier higher level. If the latter companies do not revalue their assets downwards they may continue to show annual losses for years. The loss is not to be denied but it may be argued that it occurred in the past, when the price level decreased, and should not be allowed to affect later years. The revaluation of assets, with a commensurate charge to surplus or if need be to capital, may permit a continuation of dividends and the resumption of an atmosphere conducive to management and stockholder decisions uninfluenced by an indefinite continuation of annual losses.

If the price level has risen substantially, and if the prices of a product are sufficiently high to allow profitable operation by companies using new and high-cost plants and equipment, the companies with older equipment will appear to be unusually profitable as long as they have the benefit of lower depreciation charges arising from their fortuitous earlier acquisition of property. The gain is as real as the loss in the reverse situation, but it may be argued that it is in the nature of a capital gain and that annual income may be more properly stated if plant and depreciation charges are revised upwards. If this revision is not made, the company will appear to be highly profitable only as long as the old equipment lasts; when it has to be replaced, depreciation charges will increase and profits decrease. The higher interim profits may meanwhile

have been misleading to both management and stockholders.[21] A somewhat analogous situation may develop if a company buys its plant much below going prices, as at a forced liquidation of some other company or as surplus property from the government. The latter source is of major importance at the moment and presents prospects of continuing problems in income determination for many years.

Accountants have been reluctant to approve any revisions of cost in the basis of assets. The revision downwards did, however, occur fairly frequently in the early 1930's and at the time it was usually accepted by financial and investing circles as a rather courageous move to 'wipe the slate'. The arguments in favor of revisions based upon price structures, relative competitive positions, and market reactions are far beyond the scope of this study. It is enough to note that such revaluation is sometimes made.

The postwar controversy about the effect of higher replacement costs on depreciation is not reviewed in this study. Some of the methods advocated would have the effect of introducing continuing new divergences between taxable and business income. Depreciation of present assets based on their replacement cost, for example, would not be acceptable for tax purposes. Some forms of accelerated depreciation, in which the total depreciation claimed over the life of the asset does not exceed the basis, may, however, be acceptable.

From the tax viewpoint, any such gain or loss upon the revaluation of assets would not, under current concepts, be a realized gain or loss. Since the gain or loss is not realized, the basis of the assets, for tax purposes, must remain unchanged in order that the entire gain or loss upon the disposal of the assets will be subject to tax and that neither more nor less than the capital actually invested in the assets will be returned taxfree through depreciation deductions. Any such revaluation

[21] See Accounting Research Bulletin 5, Depreciation on Appreciation (1940), for a discussion of the treatment of depreciation after upward revisions in stated asset values.

thus introduces permanent discrepancies between taxable and business income.[22] Only when a successor company is organized in such a manner that it does not carry forward the basis of assets of its predecessor, that is, when it is not a tax-free reorganization within the meaning of the tax law, will there be presumed identity of basis of assets for tax and business purposes after assets have been revalued downwards.

Adjusted Basis

In general, adjustments for capital expenditures, receipts, losses, and other items properly chargeable to capital accounts are as necessary for book as for tax purposes. The preceding discussion of problems arising in connection with the distinction between current expenses and capital expenditures in determining original cost is equally pertinent with reference to the adjusted basis. In view of the element of judgment involved in the distinction, borderline cases are frequent. A reasonable policy, systematically followed, is acceptable for all purposes.

The book basis of property is reduced for past depreciation also, as is required for tax purposes. For business records the tax provision that basis must be adjusted downwards for depreciation allowable, though not taken, is not acceptable as a general rule. When past depreciation deductions are found to have been inadequate, three procedures are open. Inadequate prior depreciation may be made up by larger subsequent depreciation, by a charge to the income of the year in which the inadequacy is discovered, or by a surplus adjustment. The third method is the only one analogous to the required tax treatment in that it would relieve aggregate reported income of part of the depreciation charge on the property. The arguments on the relative merits of different methods of adjustment for inadequate prior depreciation are similar to those on

22 The discrepancy between taxable and business income arising from this source is developed in G. O. May, The Relation of Depreciation Provisions to Replacement, *Journal of Accountancy* (May 1940), Vol. 69, pp. 341-7.

methods of adjustment when the estimated useful life of depreciable property is changed (see Ch. 3).

C Conclusions

The differences in the basis of assets as determined for tax and for business purposes are an important cause of divergences in net income figures. Unfortunately, in the statistical analysis divergences caused by differences in the basis of property cannot be segregated from those arising from different rates of depreciation, obsolescence, and depletion. Differences in basis are reflected also in gains and losses.

It should be apparent from the foregoing discussion that in fixing the basis of property neither tax nor business practice represents ultimate truth, and that divergences between the two figures do not indicate an aberration or deviation from some true figure. Tax practice could not be made to correspond to business usage unless fundamental tax concepts were violated. To compel business to use the tax procedures would give distorted income figures and negate the flexibility that is desirable on pragmatic grounds.

Statistically some of the income divergences arising from differences in basis may be expected to wash out over the years; for example, if there are no surplus charges or credits or unrecognized income items, and the differences arise simply from the timing of depreciation deductions. Even here, however, the balancing out over time would not necessarily occur for a single company, but rather would occur for a group of companies if there had been any tax-free exchanges of property. The major part of the divergences, however, would not be expected to balance out, since by their very nature they arise from a substituted basis and from adjustments involving surplus charges and credits.

The biggest differences between the bases used for tax and book purposes occur when the tax law prescribes a substituted basis that is not used for business purposes. The need for a substituted tax basis arises from the twofold intention of the

tax law that all gains and losses should eventually enter the computation of income and that gain or loss should not in all cases be recognized for taxation at the time of the exchange. Neither purpose is controlling in the computation of business income: for business purposes there is no compelling need for all gains and losses to go through the income statement; nor is there any clear advantage in postponing the recognition of gain or loss on what the tax law considers a nontaxable exchange. The business treatment of gains and losses is determined by other than tax necessities. From both the tax and the accounting viewpoints, the proper basis depends to some degree upon the treatment of gain or loss upon an exchange of property. Since gain or loss upon certain exchanges is determined quite differently for tax and business purposes, the basis of the assets too must be different.

The same fundamental difference in the treatment of gains and losses is responsible for the differing basis figures when assets are revalued for business purposes. For book purposes all gains need not go through the income statement; alternatively, gains and losses may enter income even though they are not realized in the tax sense. For tax purposes, with few exceptions, all gains and losses must enter income and must be realized. Thus, although for book purposes asset values can be readjusted and the gain or loss taken into income or credited directly to surplus, the revaluation cannot be accepted for tax purposes. For tax purposes the gain or loss cannot be taken into income in the year of revaluation because it is not realized in the tax sense at that time. The only way of providing for the taxation and deduction of all gains and losses is to require the assets to retain their original basis. If assets are revalued for book purposes, the requirement that for tax purposes they retain their original basis is analogous to the use of a substituted basis upon a tax-free exchange; since in the case of a revaluation the gain or loss cannot be recognized for tax purposes, the basis of the assets cannot be affected by the revaluation.