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SPECIAL REPORT

SIMON SAYS: A *LIDDLE* NIGHT MUSIC WITH THOSE DEPRECIATION DEDUCTIONS, PLEASE

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The article analyzes the Tax Court and Third Circuit decisions in *Simon* and *Liddle,* which allowed professional musicians to depreciate their antique musical instruments because they were subjected to a degree of physical wear and tear, even though they had substantial value in the collector market and were appreciating in value. The authors argue such assets should not be depreciable under current law, properly interpreted, unless the taxpayer can show that the assets predictably lose value in the collector market relative to original cost because of the business use. They conclude that both *Simon* and *Liddle* were wrongly decided in light of the evidence.

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In *Simon v. Commissioner,*[1] the Tax Court held, in a reviewed decision with several opinions, that professional musicians could depreciate under section 168 their 19th century violin bows made by the premier bow-maker, Francois Xavier Tourte. On the same day, the Tax Court in *Liddle v. Commissioner,*[2] citing *Simon,* held that a professional musician could depreciate his 17th century bass viol built by Francesco Ruggeri. These instruments had substantial value in the collector market. *Liddle* was recently affirmed by the Third Circuit.[3] The government is apparently hoping that the Second Circuit will overturn *Simon,* which is currently on appeal, thus creating an obvious split in the circuits, which may be necessary to pursue a writ of *certiorari.*[4] On the other hand, if one concludes that current law on the issue of depreciability is unchanged from pre-1981 law, a conflict among the circuits already exists.[5]

[Just as this article was going to press, the Second Circuit affirmed *Simon,* with one judge dissenting. *H&D,* Oct. 25, 1995, p. 1342 (October 13, 1995). The majority agreed with the Tax Court and Third Circuit that a finding of physical wear and tear was sufficient to justify depreciability. Unlike the Tax Court and Third Circuit decisions, the Second Circuit's opinion also directly addressed the issue of whether the Economic Recovery Tax Act of 1981 (ERTA) altered the determinable-useful-life requirement for depreciability. Contrary to what the authors argue in this article, the Second Circuit majority first concluded that depreciation was historically intended to provide solely for the proper "matching" of deductions and income as a mat-

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[1] 103 T.C. 247, *94 TNT 165-7* (1994) (reviewed) (10-7).

[2] 103 T.C. 285, *94 TNT 165-8* (1994) (reviewed) (9-8).

[3] — F.3d —, No. 94-7733, 76 AFTR2d Par. 95-5327, *95 TNT 179-9* (3d Cir. Sept. 8, 1995).

[4] *See* Tom Herman, "Federal Appeals Court Rules a Musician May Depreciate the Cost of a Bass Violin," *Wall St. J.,* September 14, 1995, at B2 ("The IRS probably will await the outcome of the *Simon* case before deciding on its next step. . . .").

[5] *See Browning v. Commissioner,* 890 F.2d 1084, *89 TNT 259-21* (9th Cir. 1989) (disallowing depreciation of Stradivarius violin in 1980 tax year when taxpayer failed to establish useful life or salvage value below purchase price).

ter of "accurate tax accounting." Thus, the court reasoned that the determinable-useful-life requirement was necessary under pre-ERTA law to further that purpose by allowing depreciation to be scheduled over the asset's income-producing life. The majority then concluded that because ERTA adopted artificial useful lives for assets and allowed accelerated depreciation in order to stimulate economic growth, it necessarily abandoned the pre-ERTA "matching" purpose for depreciation and thus necessarily dispensed with the determinable-useful-life standard for initial depreciability. The majority buttressed its conclusion that ERTA entirely abandoned the concept of useful life by citing ERTA's intent to simplify the law. The opinion also refused to credit legislative history indicating that the useful-life standard was retained. In his considered dissent, Judge Oakes did not believe that ERTA altered the requirement that assets have a determinable useful life to be depreciable.]

[We believe that the Second Circuit's decision confused the issue of depreciation methods (the scheduling of the depreciation deductions under section 168) with the issue of depreciability. The useful-life concept pertains not only to the "matching" of income and deductions but also to depreciability, i.e., whether the taxpayer is incurring an economic cost over time. There can be no "cost" for depreciation purposes unless it can be reasonably predicted that the asset will suffer at least some decline in value relative to taxpayer cost, and the possibility of establishing such a future decline in value requires positing the (conceptual) future time at which value is to be measured. Under prior law, such future value ("salvage") was measured at the end of the asset's "ascertainable useful life." The enactment of section 168 may (or may not) be deemed to have altered the conceptual valuation date (as it clearly did alter both the aggregate amount of depreciation deductions and their timing), but it did not abolish the requirement of future valuation. Unless it can be ascertained at the time of purchase that the taxpayer will necessarily incur a future cost due to business or investment use, there is no theoretical or statutory justification for depreciation deductions in a "realization"-based income tax.]

For an academic, these cases are great pedagogical tools to use in the classroom. The facts are not only interesting (a plus for Basic Tax students who often come to the study of income tax with the impression that we all carry calculators and wear green eye shades) but also wonderfully present the issue of "what is depreciable?" The several opinions offer varied ingredients for the classroom feast, ranging from tasty morsels to aromatic but unsatisfying portions.

The *Simon* and *Liddle* opinions also present a case study in statutory interpretation. A full menu of options was presented: textualism, structuralism, general statutory purpose, and specific legislative intent. We believe the majority opinions botched each approach on its own, misordered the priorities among them, and lost sight of the underlying structural rationale for tax depreciation. These failings don't necessarily mean that the Tax Court and Third Circuit reached the wrong results (although we believe that they did); courts sometimes reach right results for wrong reasons.[6] But bad analysis is nevertheless dangerous, because later courts often tend to parse the text of prior judicial opinions as if it were part of the statutory text (an unwise habit, we believe, but that's a topic for another article). Moreover, we believe that the facts found did not support the legal conclusions reached.

Our analysis demonstrates that no statutory interpretation tool can take the "decision-making" out of deciding cases; difficult lines must still be drawn and applied. Using correct analysis, however, makes it more likely that the "right" answer will result and — perhaps more important — less likely that bad analysis (supporting even a right result) will wreak havoc in later cases.[7]

Part I describes the cases and critiques the approaches to statutory construction adopted by the majority opinions. Part II explores tax depreciation theory as it might apply to the *Simon* and *Liddle* facts. We criticize both the majorities' and dissents' applications of depreciation theory. In Part III we dissect Judge Gerber's "bifurcated" approach in his separate *Simon* dissent. In so doing, we develop our own thoughts on what the proper standard of depreciability should be in cases in which the collector market determines the value of property used in income production. In short,

[6]For example, even those who think that the taxpayer in *Zarin v. Commissioner*, 916 F.2d 110 90, *TNT 213-10* (3d Cir. 1990), should not have been taxed think that the Third Circuit's analysis was singularly bad. *See, e.g.*, Daniel Shaviro, "The Man Who Lost Too Much: *Zarin v. Commissioner* and the Measurement of Taxable Consumption," 45 *Tax L. Rev.* 215, 254 (1990).

[7]Two examples from the debt-discharge area illustrate our point. Assuredly Justice Holmes came to the right result in *United States v. Kirby Lumber*, 284 U.S. 1 (1931), when he held for the Court that the redemption of bonds for less than their face amount resulted in the realization of debt-discharge income for the redeeming corporation. But Holmes's "freeing-up-of-assets" rationale resulted in the common-law insolvency forgiveness rule. It took a long time to discredit the freeing-up-of-assets rationale and turn the insolvency forgiveness rule into a deferral rule in section 108(b). Most commentators today base the theory of debt-discharge income on the prior receipt of value that went untaxed under the borrowing exclusion. The "freeing" of any assets from liabilities on the discharge may be descriptive but is not necessary to the realization of income in the tax sense. *See* Deborah A. Geier, "*Tufts* and the Evolution of Debt-Discharge Theory," 1 *Fla. Tax Rev.* 115, 144-56 (1992); Joseph M. Dodge, J. Clifton Fleming Jr., and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure and Policy* 75-78 (1995). Similarly, the "unenforceability" of debt obligations was a red herring in the analysis of debt-discharge income in *Zarin v. Commissioner*, 92 T.C. 1084, *89 TNT 109-6* (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990). Unenforceability should not preclude the realization of debt-discharge income when one understands the underlying structure of debt-discharge income. So long as value was received and excluded under the borrowing exclusion, relief from the obligation to repay — whether or not the debt is enforceable — should produce debt-discharge income. The unenforceability analysis has, however, since infected other cases. *See, e.g., Schlifke v. Commissioner*, 61 T.C.M. (CCH) 1697, *91 TNT 17-13* (1991). *See* Geier, *supra*, at 153-56.

we believe that the taxpayer must show that such assets predictably lose value in the collector market relative to original cost because of the business use, a difficult (if not impossible) task. In Part IV, we argue that the fact findings in the cases do not support depreciation deductions.

I. Statutory Construction

Richard and Fiona Simon were both professional violinists with the New York Philharmonic Orchestra. In 1985, they purchased from dealers two 19th century violin bows made by Francois Xavier Tourte, who is considered the premier violin bow-maker: the first for $30,000 and the second for $21,500. The seller of the Tourte bows had held them as collector pieces when the Simons purchased them, but the Simons used them in their performing and teaching careers.

Brian Liddle was a professional bass viol player in the Philadelphia Orchestra. He purchased for $28,000 a bass viol built by Francesco Ruggeri of the Cremonese School of violin builders that flourished in Cremona, Italy. (Antonio Stradivari is the most well-known member of this group.)

The taxpayers in each case sought to depreciate the musical instruments under the version of section 168 then in effect, which would allow deduction of the entire purchase prices over five years. The government apparently has not challenged the appropriateness of depreciation deductions taken by professional musicians with respect to new musical instruments without any value in the collector market.[8] It nevertheless contended that these particular musical instruments were not depreciable, because they had no ascertainable useful life due to the fact that their value, fixed by the collector market, appreciated.

The cases were controlled by section 168 as initially enacted by the Economic Recovery Tax Act of 1981 (ERTA). Section 168(a) then provided that "[t]here shall be allowed as a deduction for any taxable year the amount determined under this section with respect to recovery property." Section 167(a), the sole section authorizing the depreciation deduction prior to the enactment of section 168, provided that "[i]n the case of recovery property (within the meaning of section 168), the deduction allowable under section 168 shall be deemed to constitute the reasonable allowance provided by this section." Thus, the musical instruments could be depreciated under the schedule provided in section 168(b) if they constituted "recovery property" within the meaning of section 168(c).

Section 168(c) defined "recovery property" as "tangible property of a character subject to the allowance for depreciation" if the property was used in a trade or business or held for the production of income. The *Simon* and *Liddle* majorities agreed that these words referred back to the language in section 167(a), which allows "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of business or investment property.

What does 'reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)' mean?

What, in turn, does "reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" mean? That is the crux on which the cases turned. Pre-1981 law was clear that, under this language, assets without an ascertainable useful life could not be depreciated. Specifically, musical instruments were not depreciable by professional musicians when the taxpayer could not establish an ascertainable useful life and a salvage value below original cost because the instruments were also collector items.[9]

Both the 1981 Conference Report and Blue Book confirmed a reasonable reading of the statute that the enactment of section 168 was not intended to allow depreciation of assets that were not depreciable under old law:

> Assets used in a trade or business or for the production of income are depreciable if they are subject to wear and tear, decay or decline from natural causes or obsolescence. Assets that do not decline in value on a predictable basis or do not have a determinable useful life, such as land, goodwill, and stock, are not depreciable.[10]

In other words, section 168, as enacted in 1981, did not alter the standard regarding *which* assets were depreciable; it only prescribed the method of depreciation for assets that were governed by it.[11] That analysis persists under the current version of current section 168, as amended by the 1986 Tax Reform Act (TRA), which explicitly states that the issue of depreciability is determined under section 167 and not section 168.[12]

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[8]We could find no cases or rulings in which the government argued that musical instruments as a class are not depreciable because they lack ascertainable useful lives. The government has challenged such depreciation only in cases involving old instruments with a value in the collector market. *See, e.g., Browning v. Commissioner,* note 5 *supra;* LTR 9147049, *91 TNT 240-45* (Aug. 21, 1991); LTR 8641006 (July 1, 1986).

[9]*Browning v. Commissioner,* note 5 *supra* (Stradivarius violin; 1980 tax year). *See Massey Motors v. United States,* 364 U.S. 92 (1960) (new cars used by dealers for short periods); *Hawkins v. Commissioner,* 713 F.2d 347 (8th Cir. 1973) (artworks).

[10]ERTA, Conference Report, at 206; Blue Book at 41.

[11]Depreciable property that was not "recovery property" and thus not eligible for depreciation under section 168 continued to be depreciated under section 167. Only the excess of purchase price over the "salvage value" of the property could be depreciated under section 167, and the depreciation schedules were more closely aligned with actual useful life.

[12]Current section 168 does away with the concept of "recovery property." It now provides that "the depreciation provided by section 167(a) for any tangible property shall be determined by using" the methods, periods, and conventions contained in section 168. Thus, the issue in *Simon* and *Liddle* would lead back to the same question today: What does "reasonable allowance for . . . wear and tear" mean in section 167(a), the section authorizing the depreciation deduction?

The 1986 legislative history gives no indication that the 1986 act was intended to modify prior law on the depreciability issue.[13] The "wear-and-tear" language in section 167 that governs the standard of depreciability was not amended in either 1981 or 1986. Thus, a reading of both the statutory text and the specific legislative history indicates that the law regarding what was depreciable remained unchanged after ERTA. Moreover, the IRS has consistently followed this position, before and after 1981 and 1986.[14] ERTA merely simplified the depreciation calculations for those assets that were depreciable (and aimed to encourage investment in depreciable assets) by creating artificially shortened useful lives and allowing deduction of the full purchase price, without regard to salvage value.

The *Simon* and *Liddle* courts, however, concluded that the enactment of ERTA did, indeed, give new meaning to the words "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property. . . ." Whereas those words were interpreted to mean that depreciable assets must have an ascertainable useful life before ERTA (and a salvage value below original cost), those same words after the enactment of section 168 meant only, according to the Tax Court majority and Third Circuit, that assets must show some physical deterioration due to "wear and tear" from use in the taxpayers' professions.[15]

Even if the correct answer to the depreciability issue is to be found solely in the text of the statute, without regard to the specific 1981 and 1986 legislative histories, the majority opinions did a bad job of textual exegesis. The majority opinions focused exclusively on the "wear-and-tear" language, suggesting that a factual finding of physical deterioration from business use was sufficient to justify depreciation. But this approach detaches words from their context. Here, the majority opinions conveniently ignored the phrase "a reasonable allowance for" wear and tear, etc. Since the tax system cannot directly repair or replace tangible property, the phrase "reasonable allowance for" means something like "a tax deduction to account for the loss due to" wear and tear, etc. The "loss" must be an *economic* loss, not a physical loss, since the tax system deals only with economic facts.

In addition, since the taxpayer is allowed current expense deductions for "repair" outlays incurred to restore the physical condition of an asset,[16] the concept of "wear and tear" in section 167 must refer to wear and tear of a certain nature, not just any old wear and tear. Logically, depreciation deductions must "allow for" wear and tear that is not restored by ordinary maintenance and repairs.[17]

In sum, the majority opinions erroneously strip section 167 of its core concept, which is "economic loss due to use." To be sure, the majority opinions concede that there should be no depreciation on artworks and collectibles that suffer no wear and tear due to use, but that observation reinforces the earlier one that the majority opinions have substituted "physical" wear and tear for "economic loss." In virtually all cases, physical deterioration will cause eventual economic loss, but artworks and collectibles, even those subject to physical wear and tear, pose the possibility that this is not always the case.

If one still has difficulty in discerning the concept of "economic loss" in the text of section 167, we would maintain that the language regarding "reasonable allowance for . . . wear and tear" constitutes a term of art or is possibly ambiguous. In that case, resort should be had to nontextualist tools, such as legislative history, prior interpretation, and tax theory and structure, but each of these also point to the "economic-loss" concept. (We have already demonstrated that in the case of specific legislative history.)

The majority opinions did not rest on their inadequate textual rationale. They cited two reasons grounded in "general legislative purpose" for holding that physical deterioration alone justified depreciation. Aside from the arguments being unconvincing on the merits, it is odd that the courts would entertain these considerations after ignoring the linguistic context and specific legislative history discussed above.

One of the reasons advanced was Congress's purported purpose in enacting section 168 to simplify depreciation calculations by eliminating controversies over useful life and salvage value (the estimated value as of the end of the expected useful life). The extent of controversies over useful life and salvage was greatly overstated by the majority opinions, however, since the depreciation rules in effect from 1970 through 1980 (the ADR system) already placed assets in classes with prescribed useful lives.[18] Moreover, simplification

[13]TRA, Blue Book at 89-126. The 1986 changes appear to have shifted musical instruments from the five-year class to a longer-life class. *See* section 168(e)(3)(C)(ii); Commerce Clearing House, *1995 Depreciation Guide* 187, 224 (1995) (under ACRS, in effect from 1980-1986, tangible property not otherwise classified falls within five-year class; under MACRS, in effect after 1986, assets used in "recreation" are in the 15-year class, and personal property with no class life is in the seven-year class).

[14]*See* Rev. Rul. 90-65, 1990-2 C.B. 41, *90 TNT 167-8* (disallowing depreciation of precious metal whose cost would be fully recovered); authorities cited note 8 *supra.*

[15]*See Simon,* 103 T.C. at 259-61.

[16]*See* Treas. reg. section 1.162-4 (defining repair expenses as those "that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition").

[17]*See Lindheimer v. Illinois Bell Tel. Co.,* 292 U.S. 151, 167 (1934) (stating, in the context of utility regulation, that "[b]roadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property").

[18]*See* Commerce Clearing House, *1995 Depreciation Guide* 282-84 (1995). Under pre-1970 law, the same assets could have different "useful lives" in the hands of different taxpayers. For example, the taxpayer in *Massey Motors v. United States,* note 9 *supra,* was an auto dealer who lent cars to its executives

(Footnote 18 continued on next page.)

under section 168 did not avoid all disputes of the kind alluded to by the majorities; there can be disputes, for example, over which class a particular item falls into and thus which "artificial" useful life should be used. Indeed, under the current version of section 168, the depreciation life of (antique) musical instruments, if they are depreciable, is far from clear.[19] In any event, under prior law it was settled that an asset with an estimated salvage value in excess of cost (like the items in *Simon* and *Liddle*) could not be depreciated, since there was no "depreciable amount."[20] This approach was not only the law at the time but also sound policy, since an asset expected to appreciate during business use entailed no business "cost" to the taxpayer that would have justified recovery by way of depreciation deductions.

The "ascertainable-useful-life" test for depreciability under pre-1981 law required a showing that expected salvage would be less than cost at the end of the asset's useful life. It is clear that section 168 no longer requires a formal determination of useful life or salvage *once it is found that an asset is depreciable.* In fact, for computational purposes, salvage is ignored (deemed to be zero). Those in the *Simon* and *Liddle* majorities apparently believed that the determination of depreciability itself should likewise not hinge on findings of fact with respect to useful life and salvage.[21] But that conclusion would not necessarily be required under the statutory scheme enacted in 1981. We can think of three possibilities, explored below.

First, useful life for purposes of testing for depreciability could conceivably be deemed to equal the statutory depreciation period. In that case, it would not be necessary to compute actual salvage at the end of the period. The relevant fact inquiry would simply be whether the asset, because of business use, could be expected at the time of purchase to have a value lower than cost at the end of the section 168 depreciation period. This approach would concede — contrary to the legislative history — that the 1981 enactment of section 168 modified the "ascertainable-useful-life" test, but it would not violate the core of the prior-law test for depreciability, namely, the necessity of showing an expected decrease in value, relative to cost, on account of business use. Taxpayers using artworks and collectibles in income production would usually flunk this test, as such assets would rarely be expected to lose absolute value over a relatively short period of time.

Alternatively, the test for depreciability could be whether the asset has a useful life at all, where "useful life" would refer to an asset's *eventually* losing *all* value (other than residual raw-material scrap value). ("Eventually" would be construed in a reasonable fashion; thus, an asset would not be depreciable just because it would likely lose all utilitarian value in several hundred years.) Under this test, it would not be necessary to "ascertain" the useful life, and salvage also would be irrelevant. This test would also deviate from the prior-law "ascertainable-useful-life" standard, however, under which "scrap value" included "resale value" — here, the value on the collector market.[22] Just as with the first alternative, taxpayers would not like to have this modified-useful-life test applied to collectibles, since the test would hardly ever be satisfied, given that artworks and collectibles can usually be counted on to maintain a value in excess of raw scrap value indefinitely.

One shouldn't cite a 'simplification' purpose in the enactment of section 168 (or any other tax provision) as an excuse for abdicating the duty to perform elementary legal analysis.

A third possibility is that salvage value, simply for purposes of determining whether an asset is depreciable at all, means resale value (here, in the collector market). But if resale value is not to be determined at the end of the section 168 depreciation period, as we discussed under the first alternative, the only option left is that such value must be ascertained at the end of the asset's utilitarian useful life. If that's the case, we are back to the pre-1981 "ascertainable-useful-life" requirement, which ironically turns out to be the alternative most favorable to taxpayers (in relative, if not absolute, terms). Retention of the ascertainable-useful-life standard is the alternative most compatible with the legislative history of section 168. And it really does no violence to the "simplification" purpose of section 168, which is merely to simplify depreciation *calculations,* not to not avoid issues of depreciability under section 167 (or class ascertainment under section 168

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and sold them after about a year. The Court held that "useful life" under section 167 referred to useful life according to the *particular taxpayer's* business policy (if shorter than economic useful life), and thus useful life was one year on these facts. Because only the excess of realizable value over "salvage value" can be depreciated under section 167, the taxpayer was disallowed depreciation entirely with respect to the cars, since it sold the cars after its period of use at prices exceeding original cost. ERTA's main focus was not so much in eliminating factual disputes but in vastly simplifying depreciation computations and liberalizing depreciation allowances.

[19]For example, in *Browning v. Commissioner,* note 5 *supra,* the taxpayer argued that a Stradivarius violin fell within the then 12-year ADR class for "recreation assets." The court denied depreciation entirely but noted that there was no class for "musical instruments" as such. Current law is based largely on the asset guideline classes in effect under the pre-1981 ADR system. *See* section 168(e)(1) and (i)(1). Assuming (contrary to our view) that antique violins are depreciable, it is not clear if they would fall into the 15-year class, the 7-year residual class, or perhaps some other class. *See* note 13 *supra.* The class life of antique instruments was not at issue in *Simon* or *Liddle. See* 103 T.C. at 248 n.1 (noting that the parties settled all issues other than that of depreciability).

[20]*See Massey Motors v. United States,* note 9 *supra.*

[21]*Simon,* 103 T.C. at 258-59.

[22]The existence of even substantial scrap value is not treated as *per se* negating an ascertainable useful life. *See Massey Motors v. United States,* note 9 *supra,* at 97, 101-03.

itself).[23] In the larger scheme of things, the IRS would be able to raise the depreciability issue only in a very narrow class of cases.

In more general terms, one shouldn't cite a "simplification" purpose in the enactment of section 168 (or any other tax provision) as an excuse for abdicating the duty to perform elementary legal analysis, including determining relevant facts and making necessary classifications.

We believe that the Simon and Liddle majorities committed errors of statutory interpretation.

The second purpose-type argument discussed by the *Simon* and *Liddle* majorities is that section 168 deliberately overrides tax depreciation theory (by ignoring salvage and providing for shorter useful lives) to provide an investment stimulus for economic expansion. With accelerated depreciation of the entire cost of property, taxpayers will be more willing to invest in new plants and equipment, generating economic growth throughout the economy. Of course, Congress can override sound tax theory to achieve economic goals. But Congress didn't express a purpose to override tax theory *in all cases* or to encourage investment in collectibles and artworks. Such investments make no contribution to economic expansion; in fact, the contribution is negative, since investment in artworks and collectibles could have been directed at more productive ends. The cited "purpose" rationale is simply not applicable to the assets in question.

The *Simon* and *Liddle* majorities would likely respond that these assets weren't collectibles and artworks in the hands of the taxpayers; because they were used in the taxpayers' businesses, they did contribute to economic expansion. The response is that the collectibles simply changed hands. Allowing depreciation of these instruments doesn't mean that more of them will be created, thus stimulating economic growth. Indeed, the fact that there are only a finite number of these instruments is the reason why they have value in the collector market in the first place. Allowing depreciation of these antique instruments will likely mean that the demand for *new* quality instruments for professional musicians will decrease, dampening economic growth (but enriching those collectors lucky enough to own such instruments). (Ironically, the very tax benefit conferred by *Simon* and *Liddle* is likely to cause significant market appreciation in antique instruments, since practicing musicians will now bid up the price of them.)

A related "equity" argument not actually discussed by the majorities might be articulated as follows: Since taxpayers able to show *any* predictable absolute decline in economic value attributable to use (however slight) can depreciate the entire cost (without regard to high salvage),[24] it would be unfair to hold that taxpayers unable to bear the burden of proving any predictable decline in value, no matter how small, can't depreciate anything at all. But inequity is precisely the price one pays for "simplification." Moreover, acceptance of the argument that one bad tax rule deserves another opens the gates to the Barbarians. Although Congress can enact tax rules that conflict with tax theory, courts shouldn't extend them by analogy. Finally, on the merits, there is no "equity" in allowing a tax write-off where there is no cost.

Thus, we believe that the *Simon* and *Liddle* majorities committed errors of statutory interpretation. The textual approach was bungled, the specific legislative history was ignored, and expressions of general legislative purpose were inappropriately applied. The 1981 enactment of section 168 did not significantly change the test for depreciability under section 167, if indeed it changed it at all. In striving to find an answer to the question of what "reasonable allowance for exhaustion, wear and tear" meant, the Tax Court and Third Circuit should have more thoughtfully considered the theory underlying tax depreciation, discussed in the next section. If they had done so, they would have concluded that the pre-1981 interpretation of that language was sound and should not have been abrogated without compelling reason.

II. Tax Depreciation Theory

An understanding of the underlying structure of the income tax and components within it should inform interpretation of the statute's words.[25] The fundamental structure of the income tax seeks to reach personal consumption plus net wealth increases or less net wealth decreases. Net wealth decreases are potentially deductible[26] unless they represent personal consumption.[27] Personal consumption was not at issue in *Simon* and *Liddle*; the decrease-in-wealth concept was.

The initial purchases of the violin bows and bass viol did not represent net wealth decreases, i.e., they were nondeductible "capital expenditures" (rather than "expenses"),[28] creating a basis in the assets that

[23] *Accord Clinger v. Commissioner*, T.C. Memo. 1990-459, *90 TNT 178-11* (holding that 1981 enactment of ERTA did not eliminate ascertainable-useful-life test for depreciability).

[24] Thus, if the property is depreciable property, a court should not be troubled by the fact that the recovery period bears no resemblance to the actual useful working life of the property. The useful lives in section 168, as well as the recovery schedule, are intentionally crafted to accelerate cost recovery. *Simon*, 103 T.C. at 255.

[25] *See* Deborah A. Geier, "Commentary: Textualism and Tax Cases," 66 *Temp. L. Rev.* 445 (1993); Deborah A. Geier, "Commentary: Interpreting Tax Legislation: The Role of Purpose," 2 *Fla. Tax Rev.* 492 (1995) (both arguing that the underlying structure of the income tax can inform interpretation of the statute's words).

[26] *See* sections 162, 165(c)(1), (2), and 212.

[27] *See* sections 262 and 165(c)(3). Exceptions include the deductions for extraordinary medical expenses, charitable contributions, and extraordinary casualty losses. *See* sections 213, 170, and 165(c)(3), (h).

[28] *See* sections 162 and 212 (allowing deduction of business and investment "expenses") and 263 (disallowing deduction of all "capital expenditures").

could later produce offsets against the tax base. But the time and manner of such offsets are, conceptually, governed by the "realization" principle. Basis cannot be accounted for until there is a realization event with respect to the asset; mere increases or decreases in the market value of an asset while being held or used by the taxpayer are ignored. Under the code, losses cannot be deducted until they are "sustained."[29] A disposition of property for an amount realized less than the property's adjusted basis is the paradigm sustained loss.[30] But the concept of a "sustained" loss encompasses events short of disposition. Thus, destruction or abandonment of business or investment property produces a "sustained" loss, as does worthlessness.[31] A "sustained" loss thus means, in a realization-based income tax system, a final or irretrievable loss.[32] That is why mere fluctuations in the value of property during ownership cannot produce deductible losses.[33]

Depreciation in a realization-based income tax system allows — in theory — the deduction only of sustained losses in the value of business or investment property, and such sustained losses can arise prior to disposition, destruction, or abandonment only if the asset has an ascertainable useful life. Since financial theory tells us that an asset's value is the sum of the present values of all net future receipts expected to be realized from the asset, there are four possible causes for a loss in an asset's value.

First, the expected aggregate amount (as opposed to the number) of future net receipts may decline from the initial projection. Second, the discount rate may increase so that the present value of the future receipts may turn out to be less than expected. Third, the time at which future receipts are anticipated to occur may turn out to be later than previously estimated. Fourth, the number of future receipts may decrease, because the asset has a finite income-generating capacity.

The first three of these factors are subject to countervailing and transient changes from time to time, and thus losses attributable to them cannot, at any particular point in time, be considered "sustained." With respect to an asset *with a finite useful life,* however, the *number* of future receipts (the fourth factor above) *must* decrease with the passage of time: As the remaining income-producing life gets shorter, the number of remaining receipts must inevitably decline. Since value loss produced by this phenomenon is permanent, the loss is appropriately considered to be "sustained." Although the expected number of future payments may possibly increase (or decrease) with changes of circumstances, the important point is that the stream of payments *will* come to an end within a reasonably ascertainable period of time. Thus, revisions in estimates of useful life would at most affect only the calculation of depreciation,[34] not whether an asset is depreciable in the first place.

In sum, depreciation, under a tax system with a realization principle, is the method by which "sustained" losses due solely to the passage of time (factor four above) are reckoned. Thus, depreciation is necessarily a function of useful life, and the other factors that affect value are not decisive, including fair market value itself.

The insight that depreciability presupposes a finite useful life sheds light on the relationship between depreciation and repairs. Both depreciation and repairs relate to physical wear and tear. Repairs maintain the physical condition of the asset but cannot prevent the inevitable: the eventual cessation of income-producing capacity. Even nondepreciable physical assets may suffer wear and tear and require repairs, but it does not follow that they have a finite useful life.[35]

For example, consider a silver tea set used in a fancy restaurant. The surface will suffer nicks and scratches, some parts may be bent or broken, and the metal will tarnish. The foregoing constitutes wear and tear, but the entire cost of fixing the damage caused by this wear and tear is a deductible repair expense. The underlying asset has an indefinite life because of the precious metal content and/or collector value attributable to some combination of craftsmanship, age, scarcity, and provenance (but not, in this case, utility). (The fact that polishing and repairs might remove minute amounts of silver content so that the silver loss might be noticeable several decades or centuries in the future is *de minimis* and would be ignored.) Tourte bows and (especially) antique instruments are closely analogous to the silver tea set example. *The legal point is that physical wear and tear alone does not justify depreciation. Rather, the physical wear and tear must be such as to cause the asset to have a finite useful life.*

Our analysis confirms the point made (but overrated) by the majority opinions that the fair market value of property can actually *appreciate* at the same time that the property depreciates for tax purposes because time is passing. The (perhaps temporary) increase in value due to factors other than the passage of time may simply outweigh the sustained loss in value attributable to the passage of time. But even here depreciation deductions are justified, because the loss due solely to the passage of time remains a sustained loss, regardless of the fact that the first three factors described above may have produced a transient value increase.[36] (In other words, the appreciation due to the first three factors would have been even greater absent

[29]*See* section 165(a).

[30]*See* section 1001(a).

[31]*See* sections 165(g) and 166.

[32]*See* Treas. reg. section 1.165-1(b).

[33]*But see* sections 475 and 1256 (dispensing with the realization requirement in favor of a mark-to-market regime in certain limited circumstances).

[34]*See* Treas. reg. section 1.167(a)-1((b) (providing that depreciation calculated under section 167 takes into account changes in expected useful life only if significant and unforeseeable).

[35]*See* notes 16-17 *supra* and accompanying text.

[36]*See Noyce v. Commissioner,* 97 T.C. 670, *91 TNT 255-16* (1991) (allowing depreciation on private airplane that increased in value); *Appeal of Union Terminal Cold Storage Co.,* 4 B.T.A. 264 (1926) (holding that repairs sufficient to maintain value do not preclude depreciation).

the sustained loss resulting from the passage of time.) Thus, for example, rental real estate in California in the 1980s remained depreciable even though such property was appreciating at spectacular rates.[37]

The sustained-loss justification for depreciation in a realization-based income tax wholly supersedes the "matching" concept of depreciation familiar in accounting. To illustrate, assume that Alice buys an asset for $300,000 that will produce income for three years and then expire. Assume also that the asset is expected to generate three level payments that will yield a recovery of Alice's $300,000 outlay plus a return equal to the current discount rate (assumed to be 10 percent). Under these assumptions, Alice can expect to earn $120,634 of gross receipts in each of the three years:

Gross Annual Return on $300,000 3-Year Investment at 10 Percent Discount Rate[38]

Year	Gross Receipts	Present Value
1	$120,634	$109,668
2	120,634	99,698
3	120,634	90,634
		$300,000 Investment

Alice should be able to reduce those aggregate gross receipts by the $300,000 cost incurred to produce them, but how should that cost recovery be scheduled? Under a realization-based income tax, a deduction equal to the actual loss in the fair market value of the asset each year is off limits.

An accountant might suggest that the cost should be deducted according to the expected scheduling of gross receipts, so that if Alice expects to receive exactly equal receipts of $120,634 each year of the asset's three-year life, then the cost should be matched against that income stream in equal amounts of $100,000 each year to measure income "accurately." The "matching" principle operates in the world of financial accounting to carry out the latter's purpose, namely, to convey relevant and accurate *information* about the financial health of a business to interested parties, such as shareholders and creditors, so that they can make informed decisions about whether to invest or lend money. The concept of depreciability in this world, derived from the matching principle, is merely a means to avoid misleading "bunching" of income and losses in years in which assets happen to be acquired or disposed of.

Though the matching idea is mentioned often in tax depreciation cases, including the Tax Court majority opinions in *Simon* and *Liddle*,[39] it only crudely describes what tax depreciation is all about: Matching merely denotes that basis recovery is somehow "spread out" and does not occur all at once.[40] Straight-line depreciation (even proration over the recovery period) as well as "accelerated" depreciation (such as the methods described in section 168(b)(1) and (2)) happen to deviate from the realization principle.[41] The fact that accounting and tax have been both lenient and/or arbitrary, in the sense of deviating from the realization principle, when it comes to methods of *calculating* depreciation[42] does not establish, however, that the *concept of depreciability* under the income tax is loose or arbitrary. Careless application of the matching idea to the issue of what is depreciable leads one down false paths. Matching, in the sense of proration, would suggest, for example, that there be basis recovery against interest receipts from debt obligations. Of course (and ignoring OID and bond premium), basis is *not* offset against interest, because the aggregate present value of all future interest and principal receipts under the debt instrument (using the original discount rate) doesn't decline with the passage of time. More seriously, the prorationing idea taken to its ultimate conclusion

[37]Much of the preceding text and the example following is taken virtually verbatim from Dodge, Fleming, and Geier, note 7 *supra*, at 684. *See also* Joseph M. Dodge, *The Logic of Tax* 229-39 (1989); Joseph M. Dodge, "Normative Depreciation Run Into the Ground," *Tax Notes*, Mar. 23, 1992, p. 1567 (letter to the editor).

[38]Dodge, Fleming, and Geier, note 7 *supra*, at 647.

[39]103 T.C. at 253, 289.

[40]It might be *descriptive* of an income-tax value in certain contexts, however. For example, the matching idea may be relevant to the issue of whether a cost must be capitalized in the first place (whether or not later depreciable) — but not because matching income to cost is a tax value but because preventing deductions in excess of sustained losses *is* a tax value. (The fact that the outlays will produce income in the future indicates that there is no sustained loss.)

[41]The straight-line method, which appears reasonable simply by virtue of simplicity, deviates from the realization principle by ignoring the changes in present values due solely to the passage of time. Thus, in the table in the text, note 38 *supra*, straight-line depreciation ($100,000 per year) overstates "realization" depreciation in the early years and understates it in the later years. The overstatement of depreciation in the early years is even more pronounced under the 200 percent declining balance method and 150 percent declining balance method prescribed in section 168(b)(1) and (2). "Correct" realization depreciation in year one would be $90,634: the excess of $300,000 (the value at the beginning) less the sum of $109,668 and $99,698 (or $209,366), which is the present values at the end of year one, using the original discount rate, of the two remaining receipts. Alice's "correct" depreciation deductions in years two and three would be $99,698 and $109,668, respectively, applying the same principles. *See* Dodge, Fleming, and Geier, note 7 *supra*, at 647. Other, more sophisticated versions of proration are flawed under the realization principle, because they implicitly take into account temporary fluctuations of income. Thus, under the unit-of-production or income-forecast methods, the remaining basis of the asset is multiplied by a fraction, the numerator of which is units of use (or dollars of income received, as the case may be) and the denominator of which is total remaining expected units of use (or dollars of income).

[42]Financial accounting traditionally allowed the business to elect among several methods of computing depreciation, so long as the methods were rational and were followed consistently. The pre-1981 version of section 167 likewise allowed considerable leeway in selecting methods of depreciation for tangible personal property. Current section 168(g) allows an election to use "alternative depreciation."

would justify depreciation of land and other assets having an indefinite useful life,[43] contrary to clearly established tax principles. Any such depreciation would seriously violate the realization principle, since there is no predictable or foreseeable end to the line of future receipts.[44]

In the most basic sense (and looking past the problem of depreciation calculations), depreciation is a method of recovering "economic costs." Since depreciability is determined *ex ante* (when the asset is placed in service), economic cost in an income tax is keyed to the concept of *expected economic loss* (due to the passage of time) by reason of business or investment use. The language in section 167 that an asset must be subject to exhaustion, wear, and tear in order to be depreciable is the code's way of limiting depreciation deductions to "wasting" assets, i.e., assets possessing a finite useful life, for only those assets generate sustained losses due solely to the passage of time.[45]

For policy and political reasons (whether wise or unwise), section 168 departs from theory in the actual *scheduling* of depreciation deductions by allowing accelerated depreciation, by using shorter depreciation periods than actual useful life, and by allowing deduction of the entire basis without regard to salvage value. That fact shouldn't diminish the important theoretical point that for property to be depreciable in a realization-based system, it must have a finite useful life, thus generating a series of sustained (partial) losses merely with the passage of time.[46] Of course, Congress can modify or overturn the core principle of depreciability as well. But unless it is clear that Congress has done so, the code should be construed in a manner that preserves the concept of depreciability.[47] Thus, in evaluating the 1981 changes in depreciation law, courts should not have concluded that an asset immune from passage-of-time economic loss (because of its high collector value) could be depreciated. Such a fundamental change in law would surely have appeared on the face of the statute, not to say the legislative history — *particularly* since it is inconsistent with the structural premises underlying tax depreciation in a realization-based income tax. By way of contrast, section 197, enacted in 1993, *very clearly* abolishes the "ascertainable-useful-life" test for amortization of certain intangible assets in the interest of tax simplification.

III. Combined Utilitarian and Collector Value

Just because we think the Tax Court majorities got it wrong, however, doesn't mean that we think the Tax Court dissents got it right.

Judge Hamblen's Tax Court dissent in *Simon*[48] is remarkable in that it contains both on-point observations and irrelevant red herrings. He is right on point when he notes that the "matching principle" is an accounting concept that is not a "guiding principle"[49] in the income tax. But then he goes on to display a lack of understanding of what tax depreciation is all about when he concedes that tax depreciation, "in a sense, departs from realization principles."[50]

Just because we think the Tax Court majorities got it wrong doesn't mean that we think the Tax Court dissents got it right.

Along the same line, Judge Hamblen appears to suggest that a taxpayer must show that an asset actually declines in aggregate fair market value for the asset to be depreciable when he complains that the majority's opinion allows depreciation "irrespective of whether it declines in value."[51] If what he meant to say there was that an asset cannot have a finite useful life *unless* it *eventually must* decline in value (assuming normal

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[43]Even Professor Douglas A. Kahn, who has taken issue with the theory of tax depreciation described here, believes that there are good reasons to limit depreciation to wasting assets. *See* Douglas A. Kahn, "Accelerated Depreciation — Tax Expenditure or Proper Allowance for Measuring Net Income?" 78 *Mich. L. Rev.* 1 (1979); Douglas A. Kahn, "Further Kahn-Tributions to the Depreciation Debate," *Tax Notes,* Mar. 30, 1992, p. 1689.

[44]*See generally* Calvin H. Johnson, "Soft Money Investing Under the Income Tax," 1989 *U. Ill. L. Rev.* 1019, 1039-62 (1989); Marvin A. Chirelstein, *Federal Income Taxation* 147-49 (1994).

[45]Although the "ascertainable-useful-life" language in the regulations, Treas. reg. section 1.167(a)-3, applies explicitly only to intangible property (where it is largely rendered inconsequential by the recent enactment of section 197), the "wear-and-tear" test that applies to tangible property, Treas. reg. section 1.167(a)-2, necessarily translates to, at the minimum, "finite" useful life.

[46]Depreciation can therefore be thought of as the inverse of includable original issue discount (OID) by the holder of an OID obligation. OID is includable as earned, because it is a final or sustained gain due solely to the passage of time. OID is thus "realized" in the tax sense as time passes and the obligation nears its maturity. *See* Dodge, Fleming, and Geier, note 7 *supra,* at 684.

[47]*See* Kevin M. Cunningham, "Which Concept of Depreciation Should Guide Us? Trying To Develop a Consistent Framework for the Federal Income Tax System," 14 *Va. Tax Rev.* 753, 777 (1995).

[48]Judges Hamblen, Gerber, and Halpern wrote separate dissents in both *Simon* and *Liddle.* Although Judge Beghe concurred in *Simon,* he dissented in *Liddle,* concluding that the bass viol was not subject to substantial wear and tear, as were the bows in *Simon.*

[49]*Simon,* 103 T.C. at 275.

[50]*Id.*

[51]*Id.* at 268. Judge Hamblen wrote:

> The majority opinion concludes, as a matter of law, that if a taxpayer uses in his trade or business tangible personal property which suffers some wear and tear, irrespective of whether the wear and tear can be restored by ordinary maintenance, irrespective of whether it has a determinable useful life, and irrespective of whether it declines in value, the taxpayer is entitled to depreciate the property under ACRS (section 168). . . .

Id. at 268. Because he apparently requires a showing that the asset *both* has an ascertainable useful life *and* declines in value, he doesn't seem to appreciate that an asset with an ascertainable useful life necessarily declines in value merely because of the passage of time.

repairs and maintenance), then he is correct in his conclusion although his logic is backwards: An asset with a finite useful life *must* lose value at some point.

At the same time, as will be developed more fully below, the fact that an asset maintains its value over time may be *evidence* that the asset does not have a finite useful life: An asset that can be expected to maintain perpetual value as an artwork or collectible has no finite useful life. The running dialogue in the opinions about whether the Tourte bows are "works of art" and *thus* nondepreciable (with Judge Hamblen turning to the dictionary to determine the meaning of "work of art")[52] puts the cart before the mule. Instead of playing definitional games, the judges should have just gone to the heart of the inquiry: whether these Tourte bows, used in playing the violins in the taxpayers' businesses, were wasting assets.[53]

Judge Gerber's separate dissent in *Simon* focuses on the fact that the reason why these cases are so hard is because the bows really have two facets to them: as working equipment and then as collector items. If section 168, like section 167, allowed deduction of only the excess of cost over salvage value, *Simon* would be an easy case in principle. If we make the reasonable assumption that the "salvage value" (which would be their value as collector items at the end of their playing lives, that being the only plausible concept of "ascertainable useful life" in the present context) would approximate (or be higher than) their original purchase prices, none of the cost would be deductible as depreciation.

Judge Gerber seems to imply, however, that the Simons merely had a proof problem here; he suggests that if it could be shown how much of the purchase price was allocable to the collector-value portion of the bows and how much was allocable to the playing-value portion of the bows, then the latter should be a depreciable cost under current law. Although he doesn't cite *Newark Morning Ledger*[54] for this proposition, perhaps he might have.[55]

The taxpayer in *Newark Morning Ledger* purchased a newspaper and allocated $67.8 million of the purchase price to the value of a customer-based intangible called "paid subscribers," which is one strand of goodwill. Prior to the enactment of section 197, goodwill was not depreciable, because it does not have an ascertainable useful life.[56] The taxpayer successfully argued that paid subscribers was a separate intangible asset having a finite useful life, and thus its cost could be depreciated, notwithstanding the general rule that goodwill was not depreciable.[57] *Newark Morning Ledger* stands for the general proposition that if the taxpayer can identify a specific portion of a larger nondepreciable asset that has a finite useful life, and can identify the basis of that intangible asset, then the asset can be depreciated.

Under this approach, professional musicians would try to prove how much of the purchase price of their antique instruments was allocable to the "strand of value" pertaining to their finite working life. They might argue that this amount would be close to the amount paid for first-rate new instruments without any collector value.[58] This approach could be phrased in an appealing manner: We musicians should be able to deduct as depreciation the same amount deducted by our colleagues with respect to new bows and bass

[52]*See id.* at 263 n.14 ("[W]e conclude that the Tourte bows are not 'works of art' because, *inter alia*, the bows were used by petitioners in their trade or business as professional violinists."); *id.* at 274 ("One definition of 'work of art' contained in *Webster's New 20th Century Dictionary* (unabridged 1983) is 'anything beautifully made, played, sung or acted.' . . . To say the least, I expect the Smithsonian curator of musical instruments would be shocked to learn that a Stradivarius violin or a Tourte bow is not regarded as a treasured 'work of art.'"). The Third Circuit also held that the viol was a "tool of the trade" in the taxpayer's hands, not a "work of art."

[53]The same type of argument was made in *Newark Morning Ledger*, notes 54-57 *infra* and accompanying text, where Justice Souter in dissent argued that because customer-based intangibles are part of goodwill, and goodwill is not depreciable, customer-based intangibles are not depreciable. The reason that goodwill, like works of art, is not generally depreciable is that it does not have a finite useful life. Justice Blackmun, for the majority, properly went directly to that issue, although whether the majority got it right is another matter. Section 197, mentioned *supra* in the last paragraph of the section entitled "Tax Deprecation Theory," was enacted in part in reaction to *Newark Morning Ledger* and cases like it. It allows depreciation of certain types of purchased goodwill that would otherwise be nondepreciable for lack of a determinable useful life. Congress was very clear in enacting section 197 that it was abandoning the useful-life concept in this particular context, because it led to expensive and inefficient litigation. As mentioned earlier, this history is further evidence that Congress can clearly manifest its intent to depart from tax depreciation theory and eliminate the useful-life requirement when it wishes to. No such intent was made clear in ERTA, however. ERTA did not amend the section 167 language governing the standard of depreciability, which had uniformly been interpreted to require a showing of ascertainable useful life.

[54]113 S. Ct. 1670, *93 TNT 87-1* (1993).

[55]*But see* notes 59-60 *infra* and accompanying text (noting Judge Halpern's argument that these facts are distinguishable); text following notes 60 through 65 *infra* (containing our argument that even if the *Newark Morning Ledger* approach is available as a legal matter, it would be of no help on these facts).

[56]*See* Treas. reg. section 1.167(a)-3.

[57]The government argued alternatively that the asset was nondepreciable under the "mass-asset rule." Under the mass-asset rule, assets will not be considered to have a finite useful life if they, as a mass, continue to live indefinitely, even though individual components of the asset come and go. The Court accepted the district court's approach to the mass-asset rule, which renders it essentially nugatory. The district court said that if replacements come only through "substantial efforts" by the taxpayer, then the mass-asset rule does not apply. Since there are few (if any) truly self-regenerating assets in the sense implied, the rule seems to be dead, for all intents and purposes.

[58]As mentioned earlier, note 8 *supra* and accompanying text, the IRS has not maintained that new bows and bass viols, with no value in the collector market, are not depreciable by professional musicians; it has challenged only the depreciation of old instruments with collector value.

viols. Only the excess purchase price, which is attributable to the collector value of the items, would not be depreciable.

As Judge Halpern pointed out, however, this is not really an allocation issue, such as where a personal residence (nondepreciable personal-use property) contains a home office (depreciable), and the taxpayer is allowed a depreciation deduction calculated on a square-footage basis. Here (and unlike in *Newark Morning Ledger*, we would add), the same "square footage" is used for *both* purposes.[59] The *Newark Morning Ledger* Court found that "customer base" was a distinct asset "within" the asset complex commonly known as "goodwill." In *Simon* and *Liddle*, by contrast, the working lives of the assets were not distinct "assets" that were separate from their second lives as collectibles.[60]

But there is an even more incisive response that illustrates what we think is the key to the entire issue. Judge Gerber hypothesizes a guitarist — call him Pluck — paying $11,000 for a guitar that has $1,000 of utilitarian value and $10,000 of collector value (for having been used by Elvis). He would conclude that if the $1,000 utilitarian value can be established, it can be depreciated (assuming, we would add, that new guitars are depreciable by professional musicians, because they have ascertainable useful lives); only the $10,000 collector-value portion of the asset fails to have an ascertainable useful life.

The market, however, does not necessarily simply add the two value components together; instead, the price Pluck will pay will most likely be the greater of its collector value or its utilitarian value. (In an auction setting, a unique item might fetch a price based on the high subjective values of two or more bidders, but the items involved in *Simon* and *Liddle* were purchased out of dealers' inventory; also, certain kinds of assets, like antique automobiles, might conceivably possess a value based on both collector and utilitarian factors, but this would be an issue of fact.) In the guitar example, the association with Elvis prompts collectors to bid the price up to $10,000 regardless of utilitarian value. Even if the guitar is subjectively worth $11,000 to Pluck, he will pay only the market price as determined by collectors, namely, $10,000. The common situation where a buyer's subjective value exceeds market value is referred to as "consumer surplus," which the tax system — keyed to market transactions — rightly ignores.[61] In short, the utilitarian value may well be wholly absorbed into the collector value. In that case, allocation would not be proper, and Pluck would possess no depreciable asset or identifiable component thereof.[62]

One might re-interpret Judge Gerber's theory as simply demonstrating that an asset can appreciate and depreciate at the same time; the fact that an asset goes up in value doesn't preclude depreciation. This observation perhaps explains the Third Circuit's conclusion that "in Brian Liddle's professional hands, his bass viol was a tool of the trade, not a work of art."[63] Put abstractly, if an asset is both a work of art and a tool of the trade, then the latter characterization wins. But economic analysis indicates exactly the contrary: If an asset can be expected to hold value because it is an artwork or collector item, then it looks like it does not have a "finite useful life" in the sense that it will eventually lose value. In other words, the taxpayer may not be able to establish that he is incurring any cost (decrease in wealth) whatsoever by reason of holding the asset, notwithstanding that it might be a tool of the trade. Even if a Tourte bow or Strad is "played out," it might still be held for appreciation or rental (to collectors or museums). Without inevitable decline in value due to use, there is simply no deductible business cost.

Unimproved land provides an apt analogy. Land has agricultural, recreational, and residential value. Land *can* suffer wear and tear with respect to its agricultural value — the soil may be depleted or erode — or its recreational value may permanently deteriorate for a number of reasons. But the tax law does not allow unimproved land to be depreciated, because the market value does not *necessarily* decline with the passage of time by reason of use; some other facet of value may emerge due to the permanent "thereness" of land to supersede the aspect that deteriorates. Thus, there is no sustained net wealth decrease

For example, the taxpayer in *Duda*[64] purchased farmland with a rich topsoil of peat reaching to a depth of four or five feet. The jury found as a matter of fact that 50 percent of the land's purchase price was allocable to the peat soil and the remaining 50 percent

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[59] *Simon*, 103 T.C. at 284-85.

[60] *See also* Rev. Rul. 90-65, 1990-2 C.B. 41, *90 TNT 167-8* (ruling in the case of precious metals used in production processes that the cost of the precious metals should be divided between the recoverable portion, which is not depreciable, and the nonrecoverable portion, which is depreciable); *accord Arkla, Inc. v. United States*, 765 F.2d 487 (5th Cir. 1985), *cert. denied* 475 U.S. 1064 (1986) (natural gas used in extracting natural gas). These situations also involve a physical division into identifiable components. Interestingly, the Service's holding in Rev. Rul. 90-65 was justified by its accounting power under section 446(b) to alter a taxpayer's accounting method so as to "clearly reflect income." Presumably, the clear-reflection-of-income standard applies only to the allocation issue, which is one of "accounting," and not to the issues of depreciability or recovery methods, which are questions of "law."

[61] *See* Louis Kaplow, "Human Capital Under an Ideal Income Tax," 80 *U. Va. L. Rev.* 1477, 1503 n.61 (1994); Joseph M. Dodge, "A Democratic Tax Manifesto," *Tax Notes*, Feb. 27, 1995, pp. 1313, 1314.

[62] *See Browning v. Commissioner*, note 5 *supra*, at 1086-87 (concluding that Cremona-school violins possess value independent of tonal qualities that indefinitely extend their useful lives). As explained below, however, we would not hold that collector items used in business are nondepreciable *per se*; rather, they should be depreciable if, at the time of purchase, the taxpayer could show that the collector-dominated market value was likely, at the appropriate future date, to be lower, because of the business use, than the taxpayer's original cost. *See* text following notes 65 through 69 *infra*.

[63] Note 3 *supra*.

[64] *A. Duda & Sons, Inc. v. United States*, 560 F.2d 669, 678-79 (5th Circ. 1977).

was allocable to the substrata. It also found that the peat was naturally subsiding and that it would disappear within 35 years. The taxpayer claimed that the land would no longer be suitable for farming after the peat was exhausted. The court nevertheless disallowed depreciation deductions for the wasting aspect of the land, i.e., for the naturally subsiding peat, under the general rule that land is never considered to have an ascertainable useful life and thus is never depreciable. In essence, the *Duda* court rejected just the kind of argument that Judge Gerber suggests. The land had an afterlife for other uses for which the land would not have an ascertainable useful life, and diminishment of the peat through business use would not affect the land's value for these other uses.[65]

In the case of collectibles, the outcome should, in theory, depend on whether use of the collectible in the taxpayer's business would predictably reduce the value of the asset in the collector market below the original purchase price. Suppose that Pluck pays $10,000 for the guitar, but playing the guitar regularly in Pluck's business would reduce the collector value of the guitar to $3,000. In that case, we can be comfortable that using the guitar in Pluck's business will result in a true "cost" (of $7,000), justifying full depreciability. The residual collector value of $3,000 might be viewed as the functional equivalent of "scrap value" in the case of a conventional asset. (Scrap value, another *de minimis* notion, is the portion of permanent value, below the asset's cost, that does not negate a finding of finite life.)

The enactment of section 168, however (as well as inherent evidentiary problems), somewhat obscures what the precise test for depreciability should be. As mentioned earlier,[66] there are basically three choices: (1) deem the section 168 class life to be the ascertainable useful life and require the taxpayer to show *some* predictable absolute decline in the value of the asset as of that date; (2) require the taxpayer to show only a finite useful life (that the asset will possess only raw-material scrap value at some reasonably foreseeable point of time); or (3) require the taxpayer to show an ascertainable utilitarian life (in the present context, the point at which the instrument will be played out) and show that the salvage value (i.e., resale value as a collectible) at that time will predictably be somewhat less than original cost. None of these tests will be easy (or perhaps possible) to satisfy, but the third one is not the worst from the taxpayer's point of view, and it is the one that is most compatible with the proposition that the pre-1981 test for depreciability continues in force.

On the evidentiary level, it would probably be insufficient to show that the particular instrument under dispute is likely to play out (or has played out by the time of trial). The government would justifiably assert that the taxpayer must show an "ascertainable" useful life for the *type* of asset in question so that the case could at least establish a rule for a class of assets. Also, under the third (and most plausible) test described above, salvage value (even in the liberal sense of value-as-an-antique-nonutilatarian object) cannot be determined unless the useful life is ascertained. Establishing an ascertainable (or even a finite) useful life would be difficult if the government can prove that *some* bows and instruments have never become "played out" despite a very long period of use (possibly because of regular care and maintenance). And successfully establishing a (long) useful life might ultimately be futile, since the value on the collector market may be expected to increase significantly as the supply of these assets diminishes due to attrition and museum acquisitions.

Moreover, even if we assume that antique instruments might (but might not) be "played out" eventually (but will certainly maintain substantial collector value), depreciation appears to be an inferior cost recovery mechanism compared to one of allowing a loss deduction at the time an individual instrument becomes "played out." One would want more information on the "play-out" phenomenon. Thus, if (1) the played-out condition can be indefinitely postponed by exercising due care and undertaking normal repairs, (2) the playing quality of the instrument does not deteriorate gradually (perhaps on account of such care), and (3) the (sudden) occurrence of the played-out condition is uncertain to occur (and therefore unpredictable when it does occur), then the sudden occurrence of being played out would manifest a realized (partial) business loss.[67] The loss rule is actually favorable to taxpayers, since the deduction would equal the entire decline in value (if any) attributable to becoming played-out (but, of course, not in excess of total adjusted basis).[68] In other words, the loss deduction could well derive from unrealized appreciation.[69]

In sum, a test that would deny depreciation where there is no sustained loss of value due to business or investment use accords with both tax theory and the structure of the code. If an asset does not inevitably and predictably decline in value on account of business or investment use — because, for example, the collector value is (or may become) higher than the utilitarian value — the taxpayer has sustained no cost of earning current income by reason of purchasing and using the asset. Rather, the taxpayer is an investor that will realize gain or loss only on disposition of the asset or other realization event.

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[65]Nevertheless, the result in *Duda* was not the only possible one. *See* note 60 *supra* (discussing Rev. Rul. 90-65). Thus, the peat layer might have been treated as a separate asset and only that part depreciated. Nevertheless, the general rule concerning the nondepreciability of land assumes multiple uses but no physically distinct components, such as minerals or special soils. (And the assets in *Simon* and *Liddle* could not have been segregated into such physically distinct separate assets.)

[66]*See* text at notes 21-23 *supra*.

[67]*See* Treas. reg. section 1.165-2 (referring to sudden termination of usefulness of nondepreciable property).

[68]*See* section 165(b); Treas. reg. section 1.165-1(c)(1).

[69]*See Cox v. United States*, 537 F.2d 1066 (9th Cir. 1976); *Teacher's Manual* for Dodge, Fleming, and Geier, note 7 *supra*, at 125.

IV. Evidence; Standard of Review

In our view, the crucial factual issue upon which the trials in *Simon* and *Liddle* should have focused (and upon which the opinions should have turned) was whether use of the bows and viol by the Simons and Liddle would reduce their values in a collector-dominated market below the items' original cost as of the legally relevant future date (end of section 168 life; end of actual useful life, if any), assuming normal maintenance and repairs. A crude way of putting it is that the taxpayers might have sought to prove that at some reasonably foreseeable future date the value would fall below original cost *as a result of* being played out. These are simply different ways of stating that they would have sought to prove a predictable decline in absolute value. That is, it should not be sufficient to prove merely that an asset subject to business use loses value relative to a comparable asset not being so used, instead of relative to original cost. A truly depreciable asset *must* depreciate relative to cost eventually, i.e., the asset must have a finite useful life, and the taxpayer must suffer some economic loss because of the use. If such loss in value can be expected to occur, then that loss in value would be a true "cost" sustained in the same manner and for the same reasons as the costs sustained by musicians depreciating new instruments.

Simon and Liddle failed to establish depreciability. These are the rare cases where physical 'wear and tear' does not equate with depreciability.

In the cases at hand, there were two problems. First, there was insufficient proof that the items would ever be played out. In *Liddle*, the Tax Court found that, although antique stringed instruments are subject to general wear and tear, "there is no evidence that such wear and tear exhausts the utility and value of the instruments over definite time periods."[70] In *Simon*, the Tax Court stated that "frequent use of a violin bow will cause it to be 'played out.' . . . From the point of view of a professional musician, a 'played out' bow is inferior and of limited use."[71] These statements fall short of establishing an *ascertainable* useful life concerning collector-item bows in the legally relevant sense. Moreover, there was little evidentiary basis for these findings, as Judge Hamblen's dissent explains in considerable detail.[72] While professional musicians owning new instruments without any value on the collector market apparently may depreciate the cost of their instruments without proving when they would be played out, we can be more comfortable in that context with the *assumption* that they will be played out within a reasonable period of time and thus — since they have no value on the collector market — they should be depreciable.[73]

Second, the assets' market values apparently were unaffected by any wear and tear incurred from playing the instruments — even if they should become played out. The Tax Court in *Simon* found that the Tourte bows had actually appreciated (and had not decreased in playability, although showing signs of wear).[74] As the *Liddle* Tax Court majority stated, "Being nonplayers, [collectors] do not overly concern themselves with the physical condition of the instrument; they have their eye only on the market value of the instrument as a collectible."[75] The Third Circuit included this same sentence in their opinion, verbatim.[76]

Thus, the facts found contradict a legal conclusion of depreciability under any of the legal standards suggested above. The taxpayers failed to establish, *ex ante*, that they incurred any cost by reason of the business use of the instruments.

Finally, a reviewing court should not be satisfied that a "factual" finding of "wear and tear" erects the hard-to-overcome "clearly erroneous" standard of review when the "wear-and-tear" language is a statutory term of art embodying the concept of a depreciable asset. A reviewing court could accept the factual finding that the assets suffered some physical deterioration (as in the earlier hypothetical of the silver tea service) and yet conclude that the "wear-and-tear" standard for depreciability has not been met. The "wear-and-tear" standard for depreciability should not be equated simply with modest physical deterioration — especially when such deterioration can be overcome by normal maintenance and repairs. Whether an asset suffers "wear and tear" in the *statutory* sense is an issue of law, and trial court findings on this point should be subject to plenary review.[77]

In sum, the facts found in *Simon* and *Liddle* failed to establish depreciability. These are the rare cases where physical "wear and tear" does not equate with depreciability.

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[70]103 T.C. at 288. Judge Beghe, who concurred in *Simon*, dissented on this ground. 103 T.C. at 306.

[71]103 T.C. at 252.

[72]103 T.C. at 276-81 (testimony on wear and tear referred to perishable portions of bow other than the stick, ignored effect of maintenance and repairs, and ignored distinctions between normal bows and collector-item bows; testimony as to petitioners' bows indicated no decline in utility from purchase to time of trial).

[73]On the other hand, perhaps depreciation is not warranted with respect to new instruments either if it cannot be shown that they become played out within, say, a generation. The Service may simply be opting to focus its enforcement efforts on the most egregious situations: where the instruments are, essentially, sure never to lose value — even if they are played out — because of the collector market.

[74]103 T.C. at 252.

[75]*Liddle*, 103 T.C. at 287.

[76]Note 3 *supra*.

[77]*Cf. Olk v. United States*, 536 F.2d 876 (9th Cir.), *cert. denied*, 429 U.S. 920 (1976) (holding that trial court's finding that tokes received by casino dealers were given out of "disinterested generosity" — the legal test for an excludable "gift" under section 102 — was a conclusion of law unsupported by underlying facts).

V. Conclusion

Whether an item used in a trade or business increases or decreases in aggregate fair market value should not be controlling for purposes of determining whether it is depreciable, so long as the item is a wasting asset. If the asset is a wasting asset, its value will necessarily decrease — permanently and irretrievably — as it nears the end of its useful life. These value losses are sustained losses and justify the depreciation deduction in a realization-based income tax.

The assets at issue in *Simon* and *Liddle,* however, had two aspects, both a utilitarian business use (which may or may not have possessed a finite useful life) and a permanent sidelife as a collectible. The Tax Court and Third Circuit chose to ignore the infinite lives as collectibles, focusing entirely on the assets' current working lives and allowing depreciation of the entire purchase price, just as if the assets were new musical instruments with no collector value.

We believe that an antique collectible costing more than a new business asset of comparable quality (that being a plausible measure of utilitarian value) is not depreciable under the statute unless the taxpayer can show that the business use of the asset will predictably reduce the value of the asset in the collector-dominated market below original cost as of the end of the section 168 life or, more honestly, at the end of the "ascertainable useful life" (when the asset ceases to have utilitarian value). Only then can the taxpayer substantiate the existence of an economic loss that will be "sustained" prior to disposition or other realization event due to the business or investment use, which is the necessary theoretical predicate for depreciation in a realization-based income tax.

Until and unless Congress clearly alters the standard of depreciability, courts should use the theoretical structure of depreciation to help guide their statutory analysis with respect to that issue. [Although we had hoped that the Second Circuit would reverse *Simon,* the "political" aspects of the case led us to predict affirmance.[78]] But one can hope that the Supreme Court will nevertheless be tempted to order consideration of this juicy tax issue from the menu of items presented them (notwithstanding the justices' prior published views that tax cases were a bit unappetizing)[79] and that the Supreme Court, having properly digested this article, will give us our just desserts. Bon appetit!

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[78]*Tax Notes* correspondent Lee Sheppard wrote:

> The truly scary aspect of the *Simon* and *Liddle* decisions is that the two circuits to which they can be appealed, the Second and Third Circuits respectively, would probably affirm them. For the best of reasons. For the sake of the performing arts. . . .
>
> The Second Circuit, especially, is a product of its environment. People in New York City value the arts, and partake and participate in them. For many New York City residents, the city's rich and extensive cultural scene is the primary reason to live there. The Second Circuit is unlikely to want to hold that musicians in the city's flagship orchestra — itself near the end of a long climb back from artistic disarray — have to pay tax that the Tax Court said they did not have to pay. . . . Certainly these sympathies propelled the Second Circuit's illogical and since overridden decision in *Drucker v. Commissioner,* 715 F.2d 67 (2d Cir. 1983), that a musician with the Metropolitan Opera Orchestra could take a home office deduction for the corner of his apartment that he used for practice.

Lee A. Sheppard, "News Analysis: The Musician's Tax Shelter," *Tax Notes,* Sept. 5, 1994, p. 1259, 1260. She notes that the American Federation of Musicians paid the Simons' legal costs.

[79]*See* Erik M. Jensen, "Of Crud and Dogs: An Updated Collection of Quotations in Support of the Proposition That the Supreme Court Does Not Devote the Greatest Care and Attention to Our Exciting Area of the Law; Or Something That the *Tax Notes* Editors Might Use to Fill Up a Little Space in That Odd Week When Calvin Johnson Has Nothing to Print," *Tax Notes,* Mar. 1, 1993, p. 1257.