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Simon v. Commissioner of Internal Revenue, 1995 WL 604602 (2d Cir. 1995)

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INTRODUCTION

Richard and Fiona Simon ("Simon"), professional musicians, brought suit against the Commissioner of Internal Revenue ("Commissioner") seeking a redetermination of a notice of deficiency issued to them for taking depreciation deductions for two nineteenth century violin bows. The United States Tax Court held that plaintiffs were entitled to depreciation deductions, finding that the bows qualified for business depreciation deductions.[1] The United States Court of Appeals for the Second Circuit affirmed, holding the violin bows were subject to the allowance for depreciation under the Accelerated Cost Recovery System ("ACRS").[2]

FACTS

Plaintiffs Richard and Fiona Simon are nationally recognized and accomplished concert violinists. Since 1965, Mr. Simon has been a member of the first violin section of the New York Philharmonic Orchestra, as well as a soloist, chamber musician and teacher. Ms. Simon joined the New York Philharmonic in 1985 as a member of the first violin section and has also been a soloist, chamber musician, teacher and full-time performer.

In 1985, the Simons' purchased two antique violin bows ("the Tourte bows") created in the nineteenth century by Francois Tourte, a legendary bowmaker renowned for his improvements in bow design. When purchased, the Tourte bows were in relatively pristine condition and had rarely been used since their creation. The Simons used these bows regularly in their occupation as professional musicians. In the 1989 tax year in question, the Simons performed four concerts a week in addition to numerous rehearsals with the Philharmonic. This use subjected the bows to substantial wear and diminished their value as playable musical instruments. Accordingly, the Simons claimed depreciation deductions

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1. Simon v. Comm'r, 103 T.C. 247 (1994).

2. In a similar but unrelated case, the United State Court of Appeals for the Third Circuit in *Liddle v. Comm'r*, 65 F.3d 329 (3d Cir. 1995), decided the same issue as the present case. Brian Liddle, a professional musician, challenged the Commissioner's denial of a depreciation deduction for a seventeenth century Ruggeri bass violin. Mr. Liddle claimed he was entitled to a depreciation deduction under the ACRS for the wear and tear of the antique instrument he used in his trade. The Tax Court held in favor of the plaintiff, and the Commissioner appealed. On appeal, a unanimous court held that the antique violin was property subject to exhaustion and wear and tear and therefore, was "recovery property" that could be depreciated under the ACRS. Following the court's decision, the Commissioner for Internal Revenue withheld comment in anticipation of the holding in the case at bar.

for the two bows on their 1989 Tax Form 1040 in the amounts of $6,300 and $4,515.

The Commissioner issued a notice of deficiency to the Simons in 1991, contesting the Simons' depreciation deduction for the wear of the antique violin bows under the Accelerated Cost Recovery System of the Economic Recovery Tax Act of 1981 ("ERTA").[3] The Commissioner claimed the bows were depreciable under ACRS only if the plaintiffs could prove the "useful life" of each bow under the law which applied prior to the enactment of the ARCS in 1981. Additionally, the Commissioner argued that the useful lives of the bows were indeterminable because the bows were works of art which appreciated in value and therefore, did not have useful lives. The United States Tax Court held that the standard for a "determinable useful life" which the Commission sought to employ no longer applied. The United States Court of Appeals for the Second Circuit affirmed, holding that the ACRS "recovery property" standard was the correct means of determining whether property was entitled to a depreciation deduction.

LEGAL ANALYSIS

The issue before the Second Circuit was to what extent, if any, the ACRS modified the determinable useful life requirement, allowing goods to be considered as depreciable property. In allowing depreciation deductions for the Tourte bows, the court held that the bows could be considered "recovery property" under the ACRS. The court, in formulating its conclusion, addressed and discounted three principle contentions of the Commissioner. First, the court rejected the Commissioner's claim that the application of "recovery property" to musical instruments is contrary to the intent of the ERTA. Second, the court refused to accept the Commissioner's assertion that the word "character" should be read into the requirement that tangible property have a demonstrable useful life. Third, the court rejected the Commissioner's claim that his interpretation of the statute de-emphasizes useful life by mandating "the establishment of demonstrable useful life for only a 'narrow category' of property."[4] Finally, the court discussed the potential ramifications of its holding.

The court began its analysis with a discussion of the text of the ACRS provision of Internal Revenue Code, section 168, which provides for a depreciation deduction for "recovery property" placed into service after 1980.[5] "Recovery property" is defined as "tangible property of a character subject to the allowance of depreciation" when "used in a trade or business, or . . . held for the production of income."[6] Both parties stipulated that the phrase "of a character subject to depreciation" must be read in light of I.R.C. §167(a).[7] The United States Tax

3. 26 U.S.C. § 168 (1995).

4. Simon v. Comm'r, 1995 WL 604602 *1, *4 (2d Cir. 1995).

5. The court explained that this appeal was concerned only with Internal Revenue Code as it existed prior to the Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085.

6. I.R.C. § 168(c)(1) (1995).

7. I.R.C. § 167(1). The relevant portions read:

Court held that when read in light of the plain language of section 167, the Tourte bows may qualify as recovery property under section 168 if they suffer wear and tear from the Simons' trade.[8]

The court dismissed the Commissioner's primary contention that the Tax Court's interpretation of section 168 was contrary to congressional intent. The Commissioner argued that because all property used in a trade or business will suffer wear and tear, the Tax Court's interpretation of section 168 would effectively render the phrase "of a character subject to the allowance for depreciation" contrary to congressional intent. The court summarily dismissed this claim, explaining that "some tangible assets used in business are not exhausted, do not suffer wear and tear, or become obsolete."[9] The court explained that many assets, such as art in a law firm, do not generally suffer wear and tear and do not possess a determinable useful life. The court reasoned that the Tourte bows are not museum pieces, but playable musical instruments. Had they been placed in a for-profit museum, the bows could not have a claimed depreciation value because they would not have been used in a trade or business. Consequently, the court held that the bows were used in a trade, as well as subject to wear and tear.

The court also discounted the Commissioner's second contention that congressional intent and the notion of depreciation itself mandate reading the word "character" into the definition of "demonstrable useful life."[10] The court explained that throughout their history, tax laws have always allowed depreciation deductions for certain income producing assets used in a trade or business.[11] Traditionally, the rationale of the deduction was to allow taxpayers to match the cost of an asset to the income derived from the asset. In its modern form, the depreciation deduction was determined by the "period of time that the asset would produce income in the taxpayer's business."[12] The court cited precedent exclaiming that the congressional intent for the depreciation allowance was not to serve as a tool for taxpayer profit, but as a means of protection from losses. In

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General Rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) — (1) of property used in the trade or business, or (2) of property held for the production of income. In 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.

8. Simon v. Comm'r, 103 T.C. 247, 260 (1994).

9. Simon v. Comm'r, 1995 WL 604602 *1, *2 (2d Cir. 1995).

10. I.R.C. § 168. The relevant portions read:

(a) Allowance of deduction. There shall be allowed as a deduction for any taxable year the amount determined under this section with respect to recovery property. — (c) Recovery Property. For the purposes of this title — (1) recovery property defined. Except as provided in subsection (e), the term "recovery property" means tangible property of a character subject to the allowance for depreciation — (A) used in a trade or business, or (B) held for the production of income.

11. *See, e.g.*, Act of Oct. 3, 1913, 38 Stat. 167; Revenue Act of 1918, 40 Stat. 1067; I.R.C. § 23(1)(1939); I.R.C. § 167(a)(1954).

12. *Simon*, 1995 WL 604602 at *3.

order for profitable accounting practices, the court explained that "correct tabulations, not artificial ones, [must] be used."[13]

Furthermore, the court explained that the concept of "determinable useful life" evolved because it was a necessary element in the equation to calculate proper annual allowances to compensate for the original cost of an item over time. The court elucidated two reasons why it was rejecting the determinable useful life requirement relied upon by the Commissioner. First, Congress created the ACRS accelerated depreciation periods as a stimulus for economic growth.[14] Under ACRS, a predetermined period is created to recover the cost of an asset which is unrelated to and often shorter than the useful life of the asset. Additionally, the court noted that the depreciation deductions often do not remain consistent throughout the asset's life. As a result, the court held that the determinable useful life requirement was no longer needed to calculate depreciation under the ACRS.[15]

The court cited that congressional intent to simplify depreciation rules served as a second reason for rejection of the determinable useful life requirement. The court reasoned that numerous attempts failed to simplify a working definition for concepts such as useful life and salvage value, which resulted in numerous disputes between taxpayers and the Internal Revenue Service.[16] The court then affirmed the conclusion of the Tax Court that to require a taxpayer to prove the useful life of personal property before it may be depreciated over the 3-year or 5-year period required by the statute would "bring the [Tax] Court back to pre-ERTA law and reintroduce the disagreements that the Congress intended to eliminate by its enactment of ERTA."[17]

The Second Circuit rejected the Commissioner's third contention that by holding the determinable useful life requirement applicable, only a "narrow category" of property would be affected. The Commissioner contended that depreciation deductions should not be taken for property which retains value after use in a business. In rejecting this theory, the court explained that "useful life is measured by the use in a taxpayer's business, not by the full abstract economic life of the asset in a business."[18]

In reaching its conclusion, the court, once again, acknowledged and rejected the Commissioner's claim that Congress intended to maintain the determinable useful life requirement. The Commissioner cited a house conference report stating that business assets "that do not decline in value on the predictable basis or that do not have a determinable useful life, such as land goodwill, and stock, are

13. *Id.* (citing Massey Motors, Inc. v. United States, 364 U.S. 92, 104 (1960)).

14. *See* H.R. REP. NO. 215, 97th Cong., 1st Sess. 206 (1981); S. REP. NO. 144, 97th Cong., 1st Sess. 47 (1981).

15. The court stated that the useful life concept could be applied under the ACRS to determine whether recovery property is a 3-year or 5-year class property. *Simon*, 1995 WL 604602 at n.4 (citing Simon v. Comm'r, 103 T.C. 247,264 (1994)).

16. S. REP. NO. 144, *supra* note 14, at 47.

17. *Simon*, 1995 WL 604602 at *4 (citing *Simon*, 103 T.C. at 263).

18. *Id.* (citing Massey Motors, Inc. v. United States, 364 U.S. 92, 97 (1960)).

not depreciable."[19] Without contesting the congressional intent of such a statement, the court stated that it "cannot employ two sentences in a legislative report to trump statutory language and a clearly stated legislative purpose."[20] The court stated that it must rely on the overall legislative history repudiating the scheme of "complex depreciation rules" and not the remarks of one legislative statement. In affirming the statutory integrity of ERTA, the court held that for the purposes of the recovery property provisions, "'property subject to the allowance for depreciation' means property that is subject to exhaustion, wear and tear, or obsolescence."[21]

As a final note, the court discussed the potential ramifications of its conclusion that the determinable useful life standard is not to be used in conjunction with defining recovery property under section 168. The court acknowledged that its holding may allow the cost of some business decisions regarded as "wasteful," such as a law office's purchase of expensive desks, to be depreciated under the current holding. The court rationalized that the congressional intent of ERTA was to simulate the economy and such purchases and subsequent deductions are the results of such a policy. Finally, the Court cautioned that its holding would not promote or encourage taxpayers to "hoard and depreciate valuable property that a taxpayer expects to appreciate in real economic value."[22] Instead, the court re-stated that the test is "whether property will suffer exhaustion, wear and tear, or obsolescence in its use by a business."[23] The court noted that its decision is limited only to "recovery property."

CONCLUSION

The Court of Appeals for the Second Circuit held that for purposes of defining recovery property, the ACRS precludes the usage of the determinable useful life requirement in determining whether business property is allowed a tax deduction for depreciation. The plaintiffs' Tourte bows were held as recovery property and subject to the allowance for depreciation provided by ERTA. Furthermore, while the court rejected all of the Commissioner's arguments for incorporating the determinable useful life requirement into section 186 of the ERTA, the court did restrict its holding as applicable only to business goods purchased between January 1, 1981 and January 1, 1987.

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19. H.R. REP. NO. 215, 97th Cong., 1st Sess. 206 (1981).
20. *Simon*, 1995 WL 604602 at *4.
21. *Id.*
22. *Id.*
23. *Id.* at *5.