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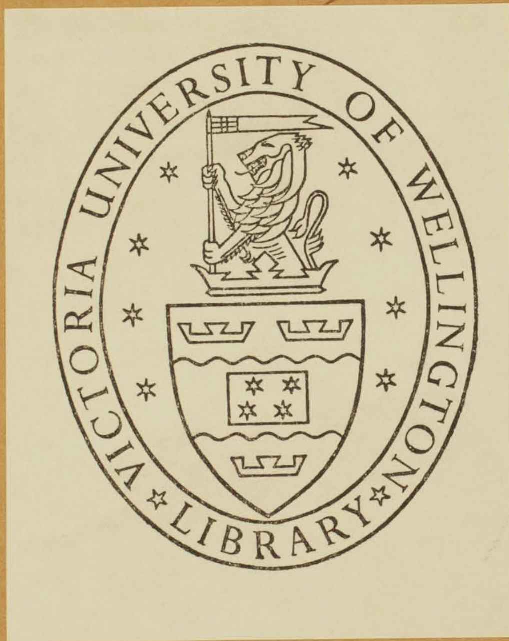
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RESEARCH PAPER

ON

DEPRECIATION

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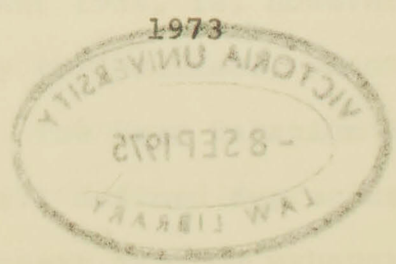
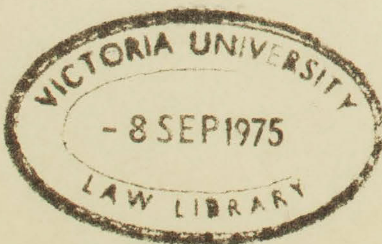
Victoria University of Wellington,
Wellington,
New Zealand.

1973





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I DEFINITION

Depreciation in an accounting sense is merely a book-keeping device for spreading the original cost of an asset (less any disposal value) over its estimated useful life in a systematic and rational manner irrespective of whether such amounts represent physical depreciation, deterioration, obsolescence, depletion or inadequacy: Depreciation of Fixed Assets, by G.T. Webb.

The general practice of economists is to regard depreciation as the amounts required to replace worn out or obsolete assets: The Depreciation of Capital, by R.F. Fowler.

The legal concept of depreciation is "broadly speaking the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence" - per Hughes, C.J. in Knoxville Water Co, case [(1909) quoted by George O. May, Financial Accounting - New York. p.135]

In New Zealand the concept of depreciation from the taxation point of view, defined in the Land and Income Tax Act 1954, is, however, more limited. It applies only to "premises, plant, machinery and equipment". The Ross Taxation Review Committee of New Zealand (1967) defined depreciation in the New Zealand taxation context as "the exhaustion, wear and tear and obsolescence of fixed assets [which could not be made

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good by repair] comprising [premises, plant,] machinery and equipment used in the production of income."

II DEPRECIATION AS A TAX DEDUCTION ITEM - JUSTIFICATION

Income tax is a tax on income. Since capital receipts are not income, it follows that any enhancement of the value of a capital asset is not income and therefore cannot be treated as income for taxing purposes. The corollary of this proposition is that capital outgoings and capital losses cannot be taken into account when the taxable income is being calculated: In re Addie & Sons (1875) 1 T.C. 1.

To an accountant, the net income of a business for any period is the credit balance shown in a correctly compiled profit and loss account. That balance, however, is often arrived at by charging against the gross income a number of items some of which are, while others are not, real costs of earning it. Two commercial principles santified by universal approval are:

(a) that, the cost of plant and machinery must be entirely excluded from the computation of income which it helps to produce;

(b) that charges for depreciation of plant and machinery used in a business are proper debits in the profit and loss accounts.

Adherence to the second principle means that what originally appeared as a capital item is written

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year after year until it eventually disappears. A capital cost thus becomes transformed into a succession of annual charges against revenue. The accounting attitude is to regard the amounts expended on fixed assets as deferred charges to revenue to be written off over the effective life of the assets concerned and to approach the question from the revenue side (profit and loss) rather than from the asset side (balance sheet). As a result the debit side of the entry for depreciation - the charge to profit and loss account - is stressed, and depreciation is looked upon as a means of amortizing the original cost of the assets: Hendriksen Accounting Theory.

This accounting practice is recognised in the New Zealand tax system and it is, of course, fully justifiable from a commercial point of view. It is incorrect to compute net profits of a business without calculating loss to capital which is consumed in producing the profits in the accounting period. This loss must be treated as an expense before profits can be said to exist at all.

III METHODS OF CALCULATING DEPRECIATION

There are a number of widely accepted methods used by accountants to calculate depreciation. Although depreciation is usually figured by some exact formulae, every accountant knows that such formulae are very rough and arbitrary for estimating the amount of cost which expires in each accounting period. Thus, although depreciation arises from knowledge that fixed assets tend

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to lose value progressively throughout their life, no attempt is made in normal practice to determine the actual fall in value during a particular period by revaluing fixed assets at each period end. The more obvious reasons are the vast labour which would be involved, and the uncertainty and differences of opinion which would arise.

The most common methods used to calculate depreciation are:

(a) The straight line method.

(b) The reducing balance or diminishing value method.

(c) The sum of the digits method.

The Straight Line Method

Under the straight line method of depreciation working on the unit basis, an equal amount is provided each year for depreciation of each asset until the asset has been written down to nil or to its estimated scrap value. The annual amount of depreciation is obtained by dividing the cost (or cost less estimated residual value) by the estimated working life of the asset. In practice the scrap value is usually disregarded in calculating the annual depreciation charge. Thus in the case of an asset purchased for $10,000, with an estimated working life of 10 years (ignoring any scrap value) the depreciation charge would be $1,000 (10%) per annum. For each asset the amount provided for depreciation each year is equal in amount, and the original cost of the asset less depreciation provided

to date diminishes by a series of equal steps. Hence the name "straight line" is applied to the method because if a graph of the diminishing book value of the asset was drawn, it would result in a straight line.

The Reducing Balance Method

Under the reducing balance method a fixed percentage is written off each year, calculated upon the reducing balance brought down on the asset account at the commencement of the period. The annual charge against revenue thus becomes gradually less as time goes on. This method is based on the assumption that depreciation of an asset is greatest in the first year and less in each succeeding year. When this method is used a rate double that of the straight line rate is generally adopted. In such a case the depreciation charges of an asset costing $10,000 with an estimated working life of 10 years, would, therefore, be $2,000 (20%) in the first year, $1,600 the second (20% of $8,000) and so on.

The Sum of the Digits Method

This method is similar to the reducing balance method but allows for smaller provisions in the first year and larger in the subsequent years. Digits representing the estimated working life of the asset are totalled and depreciation is computed each year by a successive diminishing fraction of the original cost. Assume the estimated working life of the asset is 10

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years, the first year is then given a digital value equal to the number of years of the asset's estimated working life, i.e. 10; the second year's digital value will be 9 (10 minus 1) and so on. The digital values are then totalled. In the case of an asset with an estimated working life of 10 years, the total will be 55 (10+9+8+7+6+5+4+3+2+1.) Where the asset costs $10,000, the first year's provision for depreciation charge would be 10/55 of $10,000 = $1,818; in the second year it will be 9/55 x $10,000 = $1,636, and so on.

A table showing the contrast between the three methods is given below:

	Straight Line		Reducing Balance		Sum of Digits	
Year	Annual Charge	Cumulative Charge	Annual Charge	Cumulative Charge	Annual Charge	Cumulative Charge
1	1000	1000	2000	2000	1818	1818
2	1000	2000	1600	3600	1636	3454
3	1000	3000	1280	4880	1455	4909
4	1000	4000	1024	5904	1273	6182
5	1000	5000	819	6723	1091	7273
6	1000	6000	655	7378	909	8182
7	1000	7000	524	7902	727	8909
8	1000	8000	419	8321	545	9454
9	1000	9000	336	8657	364	9818
10	1000	10000	268	8925	182	10000

The first point that becomes apparent is that using the diminishing value method, the asset is never fully depreciated by the end of its estimated working life. The question then arises: "Is such a method in fact conceptually acceptable? If we accept that the purpose of depreciation is to allocate the cost of the asset, less any residual value on scrapping, over its productive life,

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then clearly this method is only acceptable where there is a positive residual value. Where the residual value is nil or negative then this method does not do what depreciation purports to do. It allocates only part of the cost of the asset over the life leaving a residual loss on scrapping. It may be thought that this problem may be overcome by increasing the rate of depreciation to be applied to this method until it is possible to write the asset down over the estimated life to a book value that is negligible. To do so may, however, give rise to two objections: the first being that the pattern of the write-offs may be so extreme that it could not be regarded as a reasonable method of allocation except, perhaps, in very special circumstances; and secondly, charges for the early years would be so high that they may be unacceptable to the taxing authorities in most cases.

The second point is that more or less the same effect of a rapid write-off in the early years is obtained in both the reducing balance and the sum of the digits methods, but that there is no residual value at the end of the estimated life of the asset in the case of the latter method. This means that the sum of the digits method is conceptually acceptable where there is a negligible or zero residual value. In addition, the cumulative depreciation charge after the second year is greater than under the reducing balance method.

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Thirdly, the reducing balance and the sum of the digits methods by accelerating depreciation over the early years of the estimated life of the asset shift the outflow of cash for taxes from earlier years to later years thereby improving liquidity for the period when the payment of such taxes is deferred. There is also a benefit in interest on savings but this decreases rapidly until in the tenth year the total discounted tax saving under the straight line method equals the total to date under the sum of the digits method and exceeds that under the reducing balance method.

Of the three methods it is suggested that the sum of the digits method is the best method of depreciation where the residual value is negligible or zero. It does not suffer from the conceptual fault of the reducing method and it gives the advantage of accelerated depreciation during the early years of the estimated life of the asset.

There can, however, be instances where it is not necessarily desirable for the depreciation provision to be greater in the initial years of an asset's estimated life, for example, heavy depreciation provisions in the early years can distort the profit position of a business. The use of the straight line method as an alterative in such a case would overcome this objection.

IV SCHEME OF THE EXISTING LEGISLATION IN NEW ZEALAND RELATING TO ORDINARY DEPRECIATION

Depreciation is a deduction allowed in calculating

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assessable income and the primary provision of the Land and Income Tax Act 1954 governing deductions is s.110. This section provides a blanket prohibition of all deductions for expenditure or loss "except as expressly provided in this Act". Then follows s.111 in permissive terms which lays down the general requirements that have to be fulfilled before a deduction is allowed. Under it any expenditure or loss may, "except as otherwise provided in this Act", be deducted from the total income derived in any year if it is incurred in, or is necessarily incurred in carrying on a business for the purpose of, gaining or producing the assessable income for that year.

Even where an expenditure or loss complies with the requirements of s.111, s.112 states that: "Certain deductions (are) not permitted". Amongst these are: "(a) Investment, expenditure, loss, or withdrawal of capital, money used or intended to be used as capital ..." The provision of this section thus prohibits any deduction in respect of the items therein listed "except as expressly provided in this Act."

The first proviso to s.113 provides for the allowance for depreciation. The depreciation allowances in this context represent no more than a deduction against the profit of the year for the capital invested in the assets, namely, premises, plant, machinery, or equipment, consumed in the production of income. The granting of the allowance is, however, determined by either one

or both of two factors, namely, that the depreciation is caused (a) by fair wear and tear which cannot be made good by repair, or (b) by the fact of the asset becoming obsolete or useless.

Sub-section 2 of s.113 confers a discretion on the Commissioner to "refuse in whole or in part to allow any deduction ... where he is not satisfied that complete and satisfactory accounts have been kept by or on behalf of the taxpayer."

It should be noted that the granting of a deduction for depreciation is, in a sense, provisional only in that s. 117 permits "Revised assessments where assets (are) sold after deduction of depreciation allowances."

V. SOME PROBLEMS OF APPLICATION

Wilson J. in Clifford v. Inland Revenue Commissioner (1966) 10 A.I.T.R. 229 interpreted the operation of the broad scheme of s.110 to s.113 (inclusive) as follows:

> "When one thus considers the sections as a group (as I am satisfied was the intention of the legislature) it becomes clear to my mind that the substantive right of deduction is conferred by s.111 and that, although that right is restricted by s.112 and s.113 it is not enlarged. When the legislature used the words "notwithstanding anything to the contrary in s.111 of this Act" in s.113(1) it did so with reference to the benefits conferred by s.111 with the intention that the wide scope of those

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benefits should not apply to prevent the limitations imposed by s.113(1) from taking effect, and not with the intention of removing the limitations of those benefits. A deduction claimed under s.113 must, therefore, be a deduction permitted by s.111."

If, and assuming for the moment that, Wilson J.'s approach is correct, at least two problems would immediately arise. Firstly, the provisions of s.111 and s.113 are not only not complementary to each other but mutually contradictory. One of the conditions of deductibility under s.111 is that the "expenditure or loss" is incurred in "producing assessable income for any income year", while s.113(1) only requires that such "sums or matters ... (are) used in the production of income". Two points may at once be noticed, namely, (1) that "assessable income" in s.111 is far more restrictive in its meaning and application than "income" in s.113; ("Income" may either be (a) assessable, or (b) non-assessable. Non-assessable income represents income which is exempt from income taxation. Although "income" is not defined by the Act, s.86(1) sets out a list of the various classes of income that are exempt from taxation. Thus comparatively "income" must necessarily be wider in scope than "assessable income") and (2) that s.111 provides that the "expenditure or loss" must be incurred in "any income year" whereas this requirement is not necessary in s.113, (so long as the premises, plant, machinery or equipment are being

used "in the production of income".) Now if s.113 imposes a limitation on the deductions which might be made under s.111, as Wilson J. claims it does, it is inconceivable that the legislature would have enacted a liberalising provision in s.113 enlarging the more restrictive conditions of s.111. To take Wilson J.'s conclusion one step further let us assume, for example, that a depreciation item fully qualifies for deduction under s.113(1) but that because that particular item was not incurred in the production of assessable income or that it was not incurred in any income year it is therefore not a deduction permitted by s.111. The answer to such an anomalous situation is either that s.113 does not mean what it says and is therefore redundant or that Wilson J.'s decision, with respect, is erroneous.

The second problem is with reference to s.112. It must be noted that the prohibitions against deductions which were set out in s.112 are in no way expressly modified by s.113. Depreciation of capital assets (that is, premises, plant, machinery and equipment, in the context of the Land & Income Tax Act 1954) is a capital outlay: In re Addie & Sons (1875) 1 T.C. 1. Such an outlay is a "loss", according to Wilson J., within the context of s.111. Since it is a loss of capital it must also come within the provision of s.112(a). Section 112(a) specifically prohibits the deduction of loss of capital and thereby expressly excludes the application of s.111 to the extent

prohibited by s.112, as envisaged by s.111 by the clause "except as otherwise provided in this Act". Therefore, the operation of s.113 at least in so far as the question of depreciation is concerned, must necessarily mean the expressed modification of s.112. However, as can be noted, s.113 expressly modified s.111 instead - a section which has, as has been pointed out, been specifically excluded by s.112 from applying to s.113.

Moller J., in Auckland Trotting Club v. Commissioner of Inland Revenue [1968] N.Z.L.R. 193 at page 199 seems to think that there is no difficulty at all to this problem when he has this to say:

> "The matter may be simply disposed of if regard is had to the words 'except as expressly provided in this Act' used in s.112 for it seems to be clear that, if an appellant can bring itself within the provisos to section 113(1), it must be held to do so notwithstanding the provisions of s.112."

With the greatest respect it is submitted that the purported answer of Moller J.'s to the present problem is purely begging the question. The fact that a case could be brought within the provisos to s.113(1) does, in no way, solve the problem. It is just like calling a person a criminal if he fits the striped uniform of a prisoner.

A careful and proper consideration of s.113 would clearly indicate that there is nothing whatsoever in the

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nature of an expressed provision for the deduction of loss of capital. The most that can be said, perhaps, is that the proviso to s.113(1) relating to depreciation can, by some rather remote inference or implication, be interpreted to mean to provide for the deduction of loss of capital. But this certainly is not the expressed provision s.112 or s.111 contemplate. If despite the positive injunction contained in s.112, s.113, nevertheless, authorises the deduction of loss of capital, it would have been expected the legislature would have expressly prefaced the proviso with some such words as "notwithstanding anything to the contrary contained in s.112" or "notwithstanding that the same may be of a capital nature". The legislature has done nothing of this sort. On the basis of Wilson J.'s approach s.113(1) will not only be rendered redundant but totally in-operative and useless.

One is thus left with this question: "Is there a proper and logical answer out of all these confusions in interpretation?" Or, is one to throw up one's hands in desperation and allege the obscurity of the draftmanship of the relevant provisions as the cause of the whole problem and, like the Court of Appeal in Auckland Trotting Club v. Commissioner of Inland Revenue (supra), "respectfully hope that these sources of contention might be remedied by a plain declaration by the Legislature as to the correct view to be adopted, and indeed originally intended, to be set forth in an early amendment to the statute": (at p.977).

If there is a right answer to the present issue then it must come from the true intention of the legislature as indeed the Courts in the two cases under reference have endeavoured to discover. But in so doing the Courts have, in the opinion of the writer, erred in four respects. Firstly, they assume, at the very outset, that ss.111, 112 and 113 are inter-related, in that s.112 substantially erodes the right of deduction conferred by s.111 and s.113(1) relaxes the restrictions imposed by s.112 but such relaxation is, nevertheless subject to the terms of s.111. This assumption is, no doubt, based on the opening words in both ss.112 and 113, namely "Notwithstanding anything to the contrary in section 111 of this Act." It is submitted that this clause does no more than what it says and, that is "Even, if the prohibitions (or the deductions, as the case may be) are caught by the provisions of s.111, the provisions of s.112 (or s.113) are the over-riding ones". The Courts, however, have not only attributed much more emphasis to this particular clause than it deserves but have given it a totally opposite meaning from what the legislature appear to have intended. In deciding that s.111 is the all-embracing provision in relation to ss.112 and 113 the clause in question must be taken to have been interpreted by the Courts as "Subject to the provision of s.111" - which, of course, is erroneous.

Secondly, the Courts further assume: (1) that "expenditure and loss" in s.111 include those of income as well as those of a capital nature; and (2) that

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"depreciation" in s.113(1) means "loss of capital". Just as it was decided in <u>Strong & Co.</u> v. <u>Woodifield</u> [1906] A.C. 448, 453 that for an "expenditure" to qualify as a deductible item it must only be the <u>immediate</u> cost of producing assessable income so also must the word "depreciation" be considered in the same context, namely the immediate effect of depreciation; and in the context of s.113(1) it means the wear and tear, and obsolescence (which cannot be made good by repair) of certain capital assets. It is this kind of depreciation - that is, the physical deterioration of the assets - that s.113(1) seems to envisage. In order that deductions may be made such depreciation must, of necessity, be reduced to the form of some monetary value. But the fact that some value is allotted to the depreciation is purely incidental. Looking at "depreciation" in this light it will, therefore, be seen that it is neither an expenditure nor a loss as no money is expended and no money is lost; nor is it an investment, expenditure, loss or withdrawal of capital as no capital whatsoever is involved; nor is it money used or intended to be used as capital as here again no money whatsoever is involved. It is purely and simply the wear and tear (or obsolescence) of an asset and nothing more. This interpretation is highly consistent with the word "depreciation" being only used in s.113(1) and not in ss.111 and 112. The legislature must have intended to use "depreciation" in contradistinction with "expenditure and loss" in s.111, and "Investment, expenditure, loss or withdrawal of capital" in s.112. If the word "depreciation"

means "loss", as the Courts hold it does, then surely the two words are inter-changeable; and the legislature would, no doubt, have used the word "loss" in s.113(1) to avoid any confusion - as the Courts' mis-interpretation seems to have caused.

Thirdly, the Courts appear to have overlooked the contradictions and inconsistencies in ss.111 and 113. As has already been pointed out above it is inconceivable that if the legislature intended the operation of s.113 to be subject to the provisions of s.111 it would have enacted s.113 with powers over and above those in s.111.

Fourthly, and lastly, the Courts have further overlooked to consider the historical background of these relevant provisions in determining the intention of the legislature.

VI THE HISTORICAL DEVELOPMENT OF SECTIONS 111, 112 and 113

The historical development of the New Zealand taxation legislation relating to deductions commenced with the Land and Income Assessment Act 1891. This saw the introduction of a provision under "Schedule F" of the Act allowing deductions to be made in respect of:

"1. All losses and outgoings actually incurred by any person or company in production of income shall be deducted from the gross amount of his income;

2. But, in estimating the balance of the income liable to tax in the case of any business, employment, or emolument, no sum shall be deducted therefrom

for -

(a) Any sum expended for repairs of premises occupied for the purposes of the business or employment, nor for any sum expended for the supply of or repairs to or alterations in any implements, utensils, or machinery employed or used for the purposes of such business or employment, beyond the sum usually expended in any year for such purposes.

(b) Nor on account of loss not connected with or arising out of such business or employment; nor on account of any capital withdrawn therefrom, nor for any sum used or intended to be used as capital in such business, or employment, nor for any capital used in the improvement of premises occupied for the purposes of such business or employment.

...."

Then comes the Land and Income Assessment Act 1900 which repealed the Act of 1891. In this new Act a specific provision for the deduction of an allowance for depreciation was first introduced:

"S. 66. In ascertaining the income derived from business, employment, or emolument, no deductions shall be made in respect of any of the following items:

(1) Repair of premises, or supply or repair of or alterations in implements, utensils, or machinery used for such business, employment, or emolument

beyond the sum usually expended in any year for such purposes;

Provided that in cases where depreciation (whether caused by fair wear-and-tear, or by the fact of any such implements, utensils, or machinery becoming obsolete or useless) cannot be made good by repairs, the Commissioner may allow such deductions as he deems just.

(2) Any loss or outgoings not actually incurred in New Zealand or not exclusively arising out of such business, employment or emolument.

(3) Capital withdrawn therefrom; money used or intended to be used as capital therein; ...."

Section 66 was re-enacted as s.87 of the Land and Income Assessment Act 1908 without any change in the provision. In the Land and Income Tax Act 1916, s.87 of the 1908 Act was re-enacted as follows:

"S.86(1) In calculating the assessable income derived by any person from any source no deduction shall be made in respect of any of the following sums or matters:-

(a) Expenditure or loss of any kind not exclusively incurred in the production of the assessable income derived from that source.

(b) The repair of premises, or the repair, alteration, or supply of implements, utensils, or machinery used in the production of income, beyond the sum usually expended in any year for those purposes:

Provided that in cases where depreciation

of such premises, implements, utensils, or machinery, whether caused by fair wear-and-tear, or by the fact of such premises, implements, utensils, or machinery becoming obsolete or useless, cannot be made good by repair, the Commissioner may allow such deduction as he thinks just.

(c) Investment, expenditure, loss, or withdrawal of capital; money used or intended to be used as capital; money used in the improvement of premises occupied;...."

Section 86(1) of the 1916 Act was repealed by the Land and Income Tax Act 1923 and replaced by section 80 of the latter Act in the following terms:-

"S.80(1) In calculating the assessable income derived by any person from any source no deduction shall be made in respect of any of the following sums or matters

(a) The repair of premises, or the repair, alteration, or supply of implements, utensils, or machinery used in the production of income, beyond the sum usually expended in any year for those purposes:

Provided that in cases where depreciation of such implements, utensils or machinery, whether caused by fair wear-and-tear or by the fact of such implements, utensils, or machinery becoming obsolete or useless, cannot be made good by repair, the Commissioner may

allow such deduction as he thinks just:

Provided ..." (this proviso provided for the assessment of excess depreciation on the sale of an asset on which a deduction had been allowed)

"(b) Investment, expenditure, loss or withdrawal of capital; money used or intended to be used as capital; money used in the improvements of premises occupied;....

(2) In calculating the assessable income of any person deriving such income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income year may be deducted from the total income derived from that year ... save as herein provided, no deduction shall be made in respect of any expenditure or loss of any kind for the purpose of calculating the assessable income of any taxpayer".

The Land and Income Tax Act 1954 repealed the 1923 Act. It is interesting to note that s.80(1) and (2) of the latter Act is to re-appear in the existing Act as five different and separate sections. Part of s.80(2) now becomes s.110 as follows:

"S.110. Except as expressly provided in this Act no deduction shall be made in respect of any expenditure or loss of any kind for the purpose of calculating the assessable income of any taxpayer."

Part of S.80(2) was re-enacted as:-

"S.111(1) In calculating the assessable income of any person deriving assessable income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income year may, except as otherwise provided in this Act, be deducted from the total income derived for that year.

(2) In calculating ...."

S.80(1)(b) - (h) becomes:-

"S.112 - Notwithstanding anything to the contrary in s.111 of this Act, in calculating the assessable income derived by any person from any source, no deduction shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters:

(a) Investment, expenditure, loss or withdrawal of capital, money used or intended to be used as capital, money used in the improvement of premises occupied; ...."

S.80(1) (a) and the first proviso thereto replaced by:

"S.113(1) Notwithstanding anything to the contrary in s.111 of this Act, in calculating the assessable income derived by any person from any source no deduction shall, except as expressly provided in this Act, be made in respect of any of the

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following sums or matters, - namely the repair of premises, or the repair, alteration, or supply of plant, machinery, or equipment used in the production of income, beyond the sum usually expended in any year for those purposes:-

Provided that in cases where depreciation of any such asset, whether caused by fair wear and tear or by the fact of the asset becoming obsolete or useless, cannot be made good by repair, the Commissioner may subject to s.113A and also to s. 117 of this Act, allow such deduction as he thinks just:

...."

Finally, the second proviso to s.80(1)(a) becomes s.117 of the new Act. These five new sections have, to date been subject to certain amendment, which, however, are irrelevant to the present issue. For this reason they will not be considered here.

Looking back over the historical development of the present ss.111, 112 and 113 it will be noted that the "forerunners" of these respective sections had, all along been grouped together under one single section under the heading of "deduction". However, these "forerunners" had always been treated as separate sub-sections or paragraphs within the particular parent section and were always independent of one another. There were never any "link" between them except for the fact that they all derived their substantive rights direct from the "parent"

section. The corollary of this is that it was and had always been the intention of the legislature to treat them as distinct items catering for different aspects of deductions. Thus it is submitted the item of "expenditure or loss" in s.111 must necessarily be limited to expenditure or loss of a nature other than "capital" or "depreciation" as envisaged by ss.112 and 113 respectively. S.112 covers those items not brought within ss.111 and 113 particularly expenditure or loss of a capital nature; and s.113(1) is restricted so repairs and depreciation which are outside ss.111 and 112.

Only when these "forerunners" were split up in to separate sections in the current Act that the so-called "link-words", namely, "Notwithstanding anything to the contrary in section 111", are first introduced into the Act. The intention of the legislature in inserting these words is obvious. It is to maintain the hitherto independent and distinct aspects of the three separate sections. The relevant words are not meant and have never been intended to mean as subjecting the provisions of ss.112 and 113 to s.111. On the contrary they must be interpreted as meaning "irrespective of what may have been provided in s.111", s.112 (or s.113) are the over-riding provisions. It therefore follows that ss.111, 112 and 113 are intended by the legislature to be separate from and independent of one another.

If the scheme of these three sections were to be approached from this point of view, all the confusions and contradictions heretofore discussed will be dispelled

completely. In the light of the above consideration it is submitted that this is the only approach intended by the legislature. In conclusion it is noteworthy to observe that if the Court of Appeal's interpretation of the three sections were correct its plea to the legislature in the case of Auckland Trotting Club v. Commissioner of Inland Revenue (supra) for a declaration of the true intention of the legislature in that respect would have long been attended to. However, to date the legislature had not - and most probably, will never - respond to that plea for the simple reason that the legislature's intention on this matter is and has always been manifestly clear.

VII THE TEST OF DEDUCTIBILITY IN RESPECT OF ORDINARY DEPRECIATION: S.113(1)

The statutory provisions relating to such a test are contained in s.113(1) of the Land and Income Tax Act 1954 which provides that in order to qualify for deduction of depreciation charges the following conditions must first be met, namely:

(1) the assets on which depreciation is claimed must either be "premises, plant, machinery, or equipment";

(2) such assets are used in the production of income;

(3) (a) Depreciation of any such asset, not being plant, machinery, or equipment, or a temporary building, is caused by fair wear and tear, or

(b) Depreciation of any such asset, being plant, machinery or equipment or a temporary building,

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is caused by fair wear and tear or by the fact of the asset becoming obsolete or useless; and

(4) the depreciation of such assets cannot be made good by repair.

Even when these four conditions are met the taxpayer is further required to satisfy the Commissioner of Inland Revenue that complete and satisfactory accounts have been kept in respect of the assets on which depreciation is claimed, otherwise, the Commissioner may refuse in whole or in part to allow any deduction of depreciation that the taxpayer may be entitled to: s.113(2).

VIII DISCRETIONARY POWERS OF THE COMMISSIONER OF INLAND REVENUE UNDER THE FIRST PROVISO TO S.113(1)

The granting of discretionary powers to the Commissioner arises out of the inability of the legislature to cover every possible contingency and still produce an enactment which is reasonably clear. "The legislature is faced with three courses of action open to it when drafting revenue statutes:

(1) To try to cover every contingency - which results in very complex legislation.

(2) To draft the statute in general terms which results in simplicity and considerable opportunity for avoidance.

(3) To take a middle course with the allowance of discretionary powers to an official to deal with marginal cases:"

Prof. I.M. Richardson, Inaugural Address, V.U.W.

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In respect of the first proviso to s.113(1) while the word "discretion" has not been specifically mentioned it is, nevertheless, apparent that the clause "the Commissioner may ... allow such deduction as he thinks just" requires a judicial discretion to be exercised: Inland Revenue Commissioner v. Bladnoch Distillery Co. Ltd [1948] 1 All E.R. 616 at 639. This is an example of the third approach above quoted.

In exercise of this discretion "schedule rates for various classes of assets are prescribed and reviewed from time to time by the Commissioner. Furthermore, the Commissioner recognises that, in individual cases, factors such as abnormal wear and tear or obsolescence can justify higher rates than those set out in the schedule and special rates have been approved where they have been shown to be warranted": Ross, 'Taxation in New Zealand' (1967) para. 578.

The question, then, is whether such an exercise of the Commissioner's discretion is proper or is it ultra vires? In the exercise of his discretion the Commissioner is, no doubt, the sole judge of what is just; however, his discretionary "power is not an arbitrary one to be exercised according to fancy but according to the rules of reason and justice, not according to private opinion; according to law and not humour. It is to be, not arbitrary, vague and fanciful, but legal and regular": Minister of National Revenue v. Wrights' Canadian Ropes Ltd. [1947] A.C. 109.

The rules of reason and justice provide that a discretionary power must be exercised:-

(1) in accordance with the conditions prescribed in the relevant statute; and

(2) in a judicial manner - Inland Revenue Commissioner v. Bladnoch Distillery Co Ltd (supra).

As has been pointed out above, the granting of this discretionary power to the Commissioner by the legislature is to meet the need for individualised justice, where the Commissioner can, and is required to, fully take into account the facts, circumstances and merits of each particular case.

The statutory provisions which prescribe the conditions the Commissioner must comply with in exercising his discretion are to be found in the first proviso to s.113(1). These conditions have been discussed above under the heading of "The Test of Deductibility".

The practice and policy adopted by the Commissioner as mentioned above with respect to his discretionary power under the first proviso to s.113(1) is simply to codify a schedule of rates of depreciation for various items of assets, which, presumably, in his opinion may come within the prescribed conditions heretofore stated. This approach necessarily entails arbitrary decisions on the part of the Commissioner without any regard whatsoever to the facts, circumstances and merits of each individual case. It further follows that doing

what he does the Commissioner must necessarily ignore the relevant statutory conditions by purportedly exercising his discretion before the facts, circumstances and merits of each individual case come up before him for his consideration. Even when these factors are made available to the Commissioner before he exercises his discretion, they are, as a matter of practice, treated by him as irrelevant. For example, in the case of companies, all profit and loss account of the companies are required by s.153(1) of the Companies Act 1955 to "give a true and fair view of the profit or loss of the company for the financial year". Prima facie, therefore, depreciation items which form part of such account should be taken as reflecting the true state of depreciation therein. However, since 1969 there has been no requirement that depreciation for tax purposes relate to the amount actually written off in the company's (taxpayer's) account. The taxpayer may claim full schedule rates provided by the Commissioner even though these may be in excess of what the taxpayer's account actually shows. No doubt it would not be inaccurate to summise that in the majority of New Zealand industry and business, actual depreciation as shown in profit and loss account and depreciation allowed by the Commissioner for tax purposes now vary considerably. An example is given by Schmitt (1971) 49 Accountants' Journal, 228, where N.Z. ForestProducts Ltd deferred paying tax on $9.1 million during 1970 by claiming for tax purposes depreciation higher than that shown in company's profit and loss

account. Thus, the amount of depreciation allowed by the Commissioner bears no relation to the actual depreciation of the assets of the company. Also the statutory condition that such assets "cannot be made good by repair" is totally ignored by the Commissioner. To properly exercise his discretion the Commissioner must, firstly determine whether the facts as prescribed by the statutory provision are present in a particular case; and secondly, when such facts are found to be present, decide what reasonable amount may be allowed for deduction. Without complying with the first requirement the Commissioner has, however, performed the second. In consequence thereof the Commissioner has not only failed to conform to the statutory basis of the exercise of his discretion but has not exercised his discretion judicially: Inland Revenue Commissioner v. Bladnoch Distillery Co. Ltd. (supra)

Three arguments may, however, be presented in favour of the proposition that the Commissioner has properly exercised his discretion. Firstly, it may be suggested that the schedule of rates of depreciation contains statements of the Commissioner's intent only and is not tantamount to an exercise of his discretion. The immediate answer to this suggestion is, of course, to consider what the Commissioner intends the schedule to be. No where in the schedule has the Commissioner indicated that the schedule rates are merely statements of his intent. In point of fact, at the very outset - in the second paragraph of page 3 of the schedule - "The Commissioner has fixed rates of depreciation

for various types of assets", pursuant to the authority of ss.113 to 117; and this must be taken to mean that he has exercised his discretion there and then. This conclusion is strengthened by the fact that in practice unless higher rates than those in the schedule are claimed the Commissioner never examines the assets on which depreciation is claimed with the view of applying the relevant statutory conditions to the particular case.

Secondly, it may be argued that the compliance of the statutory conditions would involve an impossible task for the Commissioner. While it may be too great a task for the Commissioner to obtain satisfactory evidence to enable him to comply with the relevant statutory conditions, it will not absolve him from his duty to seek for such information: Inland Revenue Commissioner v. Bladnoch Distillery Co. Ltd (supra) In treating the compliance of the statutory conditions as irrelevant the Commissioner has misconceived the statutory basis of his discretionary power. Therefore, even in cases where the Commissioner has in fact complied with the statutory conditions, particularly in abnormal cases where higher rates of depreciation are claimed, the purported exercise of his discretion in these instances does not obviate his misapprehension of the proper basis on which to exercise the power, nor does it affect his failure to exercise the discretion judicially in the matter under consideration. The propriety of the Commissioner's exercise of his discretion is not tainted so much by the subject matter he takes into consideration as by his misapprehension of

the statutory requirements: Inland Revenue Commissioner v. Bladnoch Distillery Co. Ltd. (supra)

Thirdly, it may further be said that the exercise of the Commissioner's discretion must be assumed to have been judicially exercised because although no facts are available to justify the exercise of his discretion, there may be unstated reasons which influenced the decision he arrives at. If this contention is accepted, it would mean that the Commissioner can, as and when it favours him, remain silent and would thereby render the taxpayer's right of appeal given by the Act completely nugatory. Moreover, it would mean that the tribunal, to which an appeal may be taken, is required to speculate as to what influenced the Commissioner's mind, which no tribunal is entitled to do: Minister of National Revenue v. Wrights' Canadian Ropes (supra). Even if it can be shown that the relevant material is available to the Commissioner when he exercises his discretion, he cannot be said to have acted judicially if in fact it was not before him when he exercises that discretion: In re "Income Tax Acts" (No. 4) [1932-33] S.R.(Q) 166. Finally, even if it is assumed that a tribunal is at liberty to speculate what influenced the Commissioner's mind when he exercised his discretion, in the light of the foregoing discussion relating to the actual exercise by him of his discretion, it is inevitable to arrive at the conclusion that his mind cannot possibly be properly influenced at the relevant time.

In commenting on the Commissioner's discretionary

powers under the first proviso to s.113(1) the Ross Taxation Review Committee (1967) has this to say at paragraph 601:

> "In some countries the various bases and rates of deductions for depreciation are written into legislation. This practice could be regarded as an expression of the taxpayers' rights in the matter whereas in New Zealand it might be argued that since the whole question of deductions for ordinary depreciation is left to the discretion of the Commissioner of Inland Revenue the taxpayers' rights are not stated or protected. The Commissioner, has, however, codified his policy and practice in depreciation matters and ensured that interested taxpayers are fully informed. Furthermore the present system permits not only a continuing review of depreciation policy but also the immediate implementation of revisions where these are found desirable. It further allows immediate consideration of special cases. The flexibility in this system outweighs, in our opinion, any apparent disadvantages which might be said to stem from a failure to spell out in the legislation the basis and rates to be used in calculating deductions for depreciation."

With respect, the flaws of the Committee's conception and interpretation of the Commissioner's discretionary power are not only glaringly apparent but many. Firstly, it is assumed that in exercising

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his discretion the Commissioner is authorised to codify "his policy and practice in depreciation matters"; but, as has already been pointed out, this assumption has no validity whatsoever. Secondly, the Committee appears to be of the view that in the exercise of his discretion the Commissioner is entitled to, and so should he, be influenced by his policy and practice. These are matters completely extraneous, and having no bearing whatsoever to, the proper exercise of the Commissioner's discretion and must, therefore, be irrelevant. In the exercise of his discretion the Commissioner should and must only be guided by the relevant statutory conditions and nothing else. Finally, according to the Committee, the commissioner is empowered not only to review his own policy of depreciation but also to revise, legislate, and implement it. If the Committee is correct then the Commissioner is the legislature and the enforcement agency rolled into one. No wonder it was impressed with the flexibility of the system and advocated its retention. It is impossible to comprehend the basis of the Committee's interpretation, or rather misinterpretation of the Commissioner's discretion. Suffice it to say that there is not the slightest evidence in the relevant statutory provision to support the Committee's view. On the contrary, as was seen in the foregoing discussion, the Commissioner not only has none of the powers the Committee suggested he has but his discretion is strictly limited by the material statutory conditions. Moreover, it is inconceivable that the legislature would ever submit this very important tool of fiscal policy - depreciation policy - to the

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unfettered discretion of the Commissioner in the manner suggested by the Committee.

In order to avoid the present anomaly three possible courses of action immediately come to mind:

(1) the Commissioner should regularise the exercise of his discretion in conformity with the statutory requirements;

(2) Amend the statutory provision and regularise the present improper method of exercising the discretionary power by the Commissioner;

(3) Repeal the existing statutory provision and in its place adopt by way of legislation the schedule rates of depreciation at present published by the Commissioner.

In respect of the first course of action, the relevant statutory provisions - the first proviso to s. 113(1) - as they stand now require the Commissioner to consider each and every case, where a claim for deduction of depreciation is made, on its own merits. This will, no doubt, create an administrative impossibility for the Commissioner if he were to strictly complywith the statutory requirement. Perhaps the only solution for him is to continue to adopt his present improper method of exercising his discretion. This, of course, does not solve the problem at all.

With regard to the second proposal, to authorise the Commissioner to do what he is currently doing would mean the almost total removal of the need for

individualised justice although, of course, any taxpayer can still raise objection to the exercise of his discretion. Hence there is no necessity for the legislature to empower the Commissioner with any discretionary powers to deal with each individual case as was originally intended except, perhaps, in abnormal cases where higher rates of depreciation are claimed.

The third course of action appears to be the most desirable. The legislature could do just as well, and indeed with more propriety, in doing what the Commissioner is currently doing, namely, prescribing the different rates of depreciation, except, again, in abnormal cases, where the granting of discretionary powers to the Commissioner may still be necessary. If and when the allowable rates of depreciation are written into legislation, as is at present done in some provisions relating to special depreciation, it will, certainly create more certainty for the taxpayers. Besides, and most important of all, the legislature could manipulate the rates of depreciation so as to influence economic development.

IX ESTOPPEL AND EXHAUSTION OF COMMISSIONER'S DISCRETION

The way in which the Commissioner exercises his discretionary powers in relation to depreciation is discussed by Staples:

> "The allowance of depreciation is a discretionary power vested in the Commissioner and once exercised may not be reviewed except where he has been

> misled by fraud or deception. Where the allowance has been made without obtaining information which could have been asked for, it is not competent for the Commissioner afterwards to reopen the assessment on the grounds that he did not have full information and was under a misapprehension. Where the Commissioner has been deceived or misled by fraud or mistake, as to the subject matter under consideration, he is entitled to amend the assessment and claim additional tax"
>
> <u>A Guide to N.Z. Income Tax Practice</u>, p.141

The first proviso to s.113(1) endows the Commissioner with the discretion to "allow such deduction as he thinks just". This discretion is conditional upon certain statutory conditions relating to the test of deductibility being met, in other words, the discretion arises if, and only if, these conditions are satisfied and not otherwise. The determination of the facts of any particular case by the Commissioner as to whether the statutory conditions are satisfied, is, therefore a legal duty required of him by the statute and in so doing he has no discretionary power whatsoever. Only when he had decided that these conditions are met that he could "allow such deduction as he thinks just". Now, with reference to the above extract from Staples, the statement must necessarily refer to the later quantification by the Commissioner only. It cannot, however, relate to the Commissioner's determination of whether or not the facts of the particular case are in compliance

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with the statutory requirement. In this later instance, the question of estoppel or the exhaustion of the Commissioner's discretion are irrelevant as (a) the Commissioner cannot be precluded by the doctrine of estoppel from performing his duty as directed by statute; and (b) there is no question of the exhaustion of his discretion as no discretion has been exercised by him.

Thus, where the Commissioner, after having reached the conclusion that a case has satisfied the statutory condition, proceeds to quantify the amount of depreciation deduction allowable thereto, except for fraud or mistake as to the subject matter under consideration, estoppel will operate against him in so far as the quantum allowed by him is concerned for the reason that he had already exercised and exhausted his discretion. This appears to be the view of the Supreme Court in <u>Wood Brothers Ltd v. Commissioner of Taxes</u> (1909) 11 G.L.R. 484, where it held that, where the Commissioner had during a course of years dealt with the deductions for depreciation of implements etc., under "The Land and Income Tax Assessment Act, 1908", and it appeared that he appreciated what he was dealing with, that he had inspected the machinery periodically and that he had exercised the discretion given him by the statute, and made allowances for depreciation of the machinery, and the taxpayer had from time to time supplied the Commissioner with sufficient particulars to enable him to make such allowances the Commissioner has judicially exercised his discretion, and cannot recover income tax alleged to have been short paid in past years.

If, on the other hand, the Commissioner were to claim that in the light of newly discovered evidence, he could not have decided that the case has satisfied the statutory requirements the matter would be quite different. As was pointed out above, the question here then is not one of the exercise of the Commissioner's discretion but purely one of the performance of a legal duty by him. This point was brought up in Europa Oil (N.Z.) Ltd v. C.I.R. [1970] N.Z.L.R. 321. In that case the Commissioner after having conducted an investigation into the appellants' affairs advised them by letter that he would "take no action to disturb the present position" which in effect, allowed the appellants deductions on certain expenditure items in pursuance of s.111. Subsequently however, these deductions were disallowed and an amended assessment in respect of the items and period originally allowed was issued. The appellants argued, inter alia, that by his written advice the Commissioner had judicially exercised and, therefore, exhausted his discretion and for that reason he is estopped from reviewing his earlier assessment. The Court rejected this contention and held: "Section 111 is clear that only any expenditure exclusively incurred in the production of the assessable income for any income year may be deducted from the total income derived for that year. I accept Mr Richardson's submission that liability for income tax is imposed by the statute itself and in his assessing function the Commissioner merely quantifies the existing liability.

In Reckitt & Colman (N.Z.) Ltd v. Taxation Board of Review [1966] N.Z.L.R. 1032, McCarthy J. considers the general scheme of the legislation. He there says:

> 'I agree with Mr Richardson that the general scheme of the Acts is as follows. Liability for tax is imposed by the charging sections, ss.77 to 79 of the Land and Income Tax Act 1954. The Commissioner acts in the quantification of the amount due, but it is the Act itself which imposes independently the obligation to pay. The assessment and the objection procedures are merely machinery for quantifying, they do not cast liability ....'

....[T]he Commissioner cannot waive in particular cases liability for payment of tax. He is under a duty to assess the tax payable, the Act itself imposing independently the obligation to pay. In my opinion the objector in the instant matter cannot rely on any principle of estoppel for the reasons ... that the Commissioner here was not exercising any discretion when in 1963 he decided that there would then be no re-assessment ...

On this aspect of the case there is a further principle which must be considered. 'An estoppel must fail, if its establishment must result in an illegality, so it cannot be set up if its establishment results in preventing the performance of a statutory duty' ... Maritime Electric Co. Ltd v. General Dairies Ltd [1937]

A.C. 610, 619 ...

In my opinion the Commissioner was here under a duty to assess the objector for tax in accordance with the provisions of the Act, and again it is not a case where he was exercising a statutory discretion."

Similarly, depreciation deductions are allowed by the statute itself and such deductions are restricted to those assets which satisfy the statutory conditions imposed by the first proviso to s.113(1). The Commissioner acts in the quantification of the amount to be allowed only when the assets qualify and not before. The Commissioner's discretion merely relates to quantification; it does not in any way relate to the allowance or disallowance of depreciation deductions which, in the context of the first proviso to s.113(1) is purely a legislative act. Thus in so far as this legislative act is concerned the Commissioner cannot waive in particular cases the compliance thereof. He is under a duty in all cases to determine the compliance or otherwise of the statutory conditions before his discretion of quantification becomes relevant.

Now, in the case of the first proviso to s.113(1) it was pointed in the preceding discussion that the Commissioner in practice, gives no consideration whatsoever to the statutory requirements stipulated therein when he purportedly exercises his discretion "in allowing such deductions as he thinks just". His failure in this respect must mean, in the light of the foregoing authorities, that his discretionary power

never arises as the condition precedent to that discretion in the nature of the duty imposed on the Commissioner to apply the statutory conditions, has not been performed. It is therefore submitted that all depreciation allowances made by the Commissioner under and by virtue of the first proviso to s.113(1) in the present manner are null and void. As no discretion has ever been exercised by the Commissioner in such cases the question of estoppel and exhaustion of the Commissioner's discretion consequently does not arise at all.

It may, however, be suggested that once the Commissioner has exercised his discretion it must be deemed to have been properly exercised and that only in exceptional cases could such an exercise be challenged. Since, however, the extent of the Commissioner's discretionary powers are relevant to many other matters in addition to depreciation, and involve questions of administrative law, it is not proposed to follow that line of enquiry further in this paper.

X COMMENTS ON Ss. 113A and 117

S.113A(1) deals with the depreciation allowance that may be allowed in respect of an asset which is second hand and on which depreciation has been granted by the Commissioner. It provides that the Commissioner shall not allow any greater deduction in respect of the depreciation of the asset than that which would have been allowed to the person from whom the property was acquired if that person had retained it. The purpose of

this provision is probably to deal with sales of "depreciated" assets in excess of book value where such sales were not at arms length. If not for this provision a group of taxpayers could buy and sell assets amongst themselves and then claim depreciation based upon the inflated cost price.

This subsection is effective only in cases where a deduction for depreciation has been allowed for the assets in question prior to the relevant subsequent acquisition by the taxpayer. If no such allowance for depreciation has ever been made, then the Commissioner would have to allow depreciation based upon the full cost price of the assets to the lattest owner. However, the Commissioner is entitled to rely on the first proviso to s.113(1) where he may "allow such deductions as he thinks just" and in doing so he probably will take into consideration the actual conditions of the assets.

S.113A(2) provides that the provisions of subsection (1) shall not apply where the Commissioner is of the opinion that the circumstances are such that the actual price to the purchaser should be used. In practice, this provision - s.113A(2) - is applied in all cases except where the Commissioner considers that the transactions are not at arms length.

S.117 provides that where a deduction for depreciation has been allowed in any year, and the asset (including a building) is subsequently disposed of at a price greater than the written down value, the Commissioner may make revised assessment without allowing any or such part

of the deduction as he thinks fit, with the proviso that in the case of a building (other than a temporary building) ordinary depreciation allowed under s.113 and special or initial depreciation allowed under s.113A will not be recovered.

The Commissioner's practice in such cases is to recoup the excess depreciation in successive backward steps, whereby past assessments are amended by disallowing all the depreciation originally allowed on a particular plant until the excess is extinguished. However, as a matter of convenience, the Commissioner, in practice, assesses the depreciation recovered in one lump sum in the year of the sale if the taxpayer includes it as income in his return for that year: C.A. Staples. A Guide to N.Z. Income Tax Practice, p.146.

The practice adopted by the Commissioner is certainly convenient for him but it is difficult to see where he obtains his authority to do so. It is submitted that any "revised assessment" must comply with the provisions governing deductions for depreciation in s.111 (so long as Clifford's case remains authority) and s.113. In other words, the taxpayer is entitled to an annual deduction for the loss due to depreciation in every year in which the asset was used in the production of assessable income. The Commissioner is entitled to reduce the allowance but not to extinguish it unless the asset was disposed of for a sum in excess of its cost, i.e. no depreciation occurred at all.

XI SHOULD DEPRECIATION BE BASED ON HISTORIC COST OR REPLACEMENT COST?

In discussing the problem of what basis should be used for computing depreciation, broadly speaking, there are two schools of thought. One school regards depreciation as the charging to current operating expense of an appropriate part of the original (historic) cost of a fixed asset for the purpose of amortising that cost. The other looks upon depreciation as a provision for the replacement of worn out and obsolete fixed assets for the purpose of maintaining capital in tact.

Three principal arguments have often been advanced in favour of the replacement cost basis. First comes the proposition that a correct definition of income or profit should allow for the computation of wear and tear on a replacement cost basis so that capital could be maintained. In analysing this proposition A.R. Prest in his book on Public Finance concedes that: "If we approach the definition of business income from that of social income there seems to be some case for saying that the replacement cost basis is the right one. Social income can be taken as the flow of goods and services which can be consumed without running down the nation's stock of capital. The national capital can in turn be thought of as remaining in tact if the aggregate discounted value of the flow of services expected from it is the same at the end of a year as at the beginning of a year, after making sure that the calculation of expected returns is in terms of common prices and interest rates and that any changes, up or down, of a windfall

character are left on one side. Although the calculation of depreciation on a replacement cost basis does not give any exact correspondence with this theoretical concept, the degree of correspondence obviously is far greater in times of changing prices than if the original cost basis is used. On this basis, therefore, we must conclude that there is some theoretical case for replacement cost depreciation when we come to the determination of business income."

However, from the point of view of the ordinary shareholders in a firm the situation in Prest's view, is totally different. "If inflation develops after a piece of capital equipment is bought, there must be a tendency for a rise in the price of the product made by the capital equipment and hence of the value of that equipment, as well as a rise in the price of new equipment of the same sort. Either the increase in demand for the products of firms will tend to bid up the prices of new capital equipment used by them, or the rise in the price of new capital equipment will itself tend to force up the prices of products. In both cases we shall have an increase in the value of old as well as a rise in the price of new equipment....If this point is accepted, an important conclusion follows. Any increase in the value of existing equipment during a period of inflation will mean that capital gains are being made by the owners as their assets gradually increase in value. If, therefore, any policy is adopted of allowing depreciation to be claimed on a replacement cost basis, this is tantamount to

exempting accrued gains of this kind from taxation": A.R. Prest (Ibid. p.308).

From the point of view of the consumers of the firm's products, assuming that the firm can recover the increased depreciation charges - in a situation where the replacement cost basis is adopted - by increasing prices, it would mean that they have to protect the firm and its partners against any rise in the price of capital equipment. If this principle was once recognised by the authorities, there would, perhaps be no logical reason to refuse its extension to other sectors of the community. Further, if the replacement cost basis of depreciation were adopted the price received by the producer would then contain not only a portion of the costs of the capital equipment but also a portion of the estimated cost of replacement. This is tantamount to making a capital levy on the community to enable a business to replace its capital equipment.

The second argument for the adoption of the replacement basis of depreciation is that unless firms are allowed to depreciate on a replacement cost basis, they will have insufficient funds to keep their capital equipment in tact in terms of rising prices.

In discussing the question of the relationship of depreciation to replacement of capital equipment, S. Gilman in his book on Accounting Concepts of Profits at page 348 is emphatic that the accountant is not concerned whether assets he is depreciating are replaced. In line with other authorities quoted in his book, and with modern accounting thought, he considers depreciation to be

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"the recovery of an expenditure through its equitable apportionment to the accounting periods". However, he maintains that the purchase of a new asset is "a separate and distinct transaction having no possible connection with, or relation to, the recovery of the original investment."

If the purpose of depreciation is solely to recover the original expenditure on fixed assets, without any regard to the replacement of such assets at the end of their useful life, then the amount so recouped each year is a recovery of portion of the original capital invested and, having played its part in the cycle of production, could be returned to the investors. But business must be considered as a continuous entity and except in the case of isolated special ventures, and mining companies in some cases, capital is not invested in fixed assets with the intention of winding up the business on expiration of the current life of those assets.

The divorce of the writing off of the asset from the replacement of the asset is also emphasised by S. Gilman in discussing the subject of depreciation funds, stating "it should be obvious that cost recovery is not related to the obligationto accumulate funds for replacement - when the time comes to replace a substantial asset there may not be sufficient cash on hand". (Ibid. p. 351). The present position regarding the use of cash obtained from depreciation is that such cash usually is not set aside in a special reserve to be used for the replacement of assets but, in most cases, is used for the purposes whatever within the business.

It should be noted that the mere debiting of depreciation against revenue does not secure the receipt of equivalent cash within the business. To the extent that depreciation included in costs is passed on to consumers in the selling price of goods, equivalent cash will be available within the business as the deductions are made from debtors: Montgomery's Auditing 7th Ed. p.285.

There should be no objection to the use of depreciation provisions within a business as working capital to finance an increase in current assets, or to purchase, additional fixed assets; until such time however, if the amounts provided for depreciation have been fully utilised by an expansion of the business, and cannot be released to finance the purchase of replacement assets, additional finance should be secured. In such a case, it should be recognised that depreciation provisions have enabled an expansion of the business to be carried out which, in their absence, would have required additional finance.

The third argument is that the use of original cost depreciation allowances will give a false picture of profits in times of rising prices. During a period of rising prices, depreciation calculated on the original cost will be insufficient. Profits will therefore appear to be greater than they really are, and capital consumption will take place. This danger is all the greater because of the accounting practice of taking the original cost of any asset and writing it off over the lifetime of the asset. The method is quite safe if prices

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are stable, that is, under conditions of equilibrium but neglect in replacement cost in a time of rising prices must mean that capital is being consumed.

From the preceding discussion there appears to be only two valid arguments against the replacement cost basis of depreciation - the first one being that such a basis would result in the exemption of accrued capital gains from taxation. This proposition is based on the assumptions that capital gains are made on account of the fact that the price of the old equipment would increase at the same rate with the new ones which are required to replace the old, and that such capital gains if they do exist at all, should be subject to taxation. The first assumption seems to have missed the concept of depreciation completely. To acquire capital gains from the increased price of the old equipment, that equipment must be sold before the actual expiration of its useful life. But upon such a sale the owner is immediately disallowed any further depreciation in so far as that particular equipment is concerned; and as to how the owner could make capital gains from this transaction is difficult to imagine as the proceeds of the sale in addition to the aggregate of depreciation allowed on that equipment would be used up to purchase the new replacement equipment. For this reason the second assumption must be invalid. Even if it is not, there does not appear to be any conceptual inconsistencies to extend depreciation to capital gains for after all depreciation deals with items of a capital nature.

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The second argument is that it is inequitable to the consumers of the firm's products in that a levy for the replacement of capital equipment is put on them. If the replacement cost basis of depreciation is not adopted then there are two things the firm could do. It could either increase the price of its products to a level that a fair margin of profits could be made in addition to an amount sufficient to replace its equipment - this would, no doubt, be much higher than where the replacement cost basis is allowed; or, if it could not increase the price of its products to the desired level, the business would most probably have to be closed down. In a freely competitive economy a choice between these two evils will have to be made. Theoretically, there is, of course, a third alternative, and, that is for the firm to increase the price of its products to the desired level after the capital equipment has been replaced. This, however, appears to be not feasible from the business point of view for three reasons. Firstly, the firm will have to raise extra funds to supplement the amounts it may recoup on the basis of original cost before it can replace its capital equipment. Secondly, that would mean that for the increase to its cash investment the firm must have a corresponding increase in its returns in order to make this extra investment worthwhile. To achieve such returns the firm now has not only to add to the price of its products a fair margin of profits and an amount sufficient to replace its capital equipment, but also an amount

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sufficient to replace the newly acquired capital equipment. Thirdly, increasing the price of its products to such an extent would probably result in a decrease in the demand for its products; in which event the firm must either decrease its price or the supply of its products. In either case it would mean a reduction in its returns and a resultant loss.

The writer is of opinion that in so far as the present discussion is concerned both the historic cost and replacement cost bases are important and neither should be pursued to the exclusion of the other. It is suggested that instead of regarding depreciation as an absorption into current costs of the expired outlay upon capital equipment as opposed to a provision for the replacement of fixed assets, the two points of view should be regarded, not as conflicting concepts, but as correlative, viewing the question of depreciation from two different sides. The original cost of fixed assets should be amortised and charged against revenue over the life of the assets, and, unless the business is to be wound up after a limited period, the fixed assets eventually should be replaced. Depreciation charges, therefore, should both write off the original cost of the fixed assets and when such assets have reached the end of their effective life (not necessarily corresponding with the time when they reach the stage of being fully depreciated) depreciation charges should assist their replacement.

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In conclusion it may be observed that the base figure for depreciation purposes has not, in practice, been confined to historic cost. "In some countries, departure from the historical cost basis has been made, either by means of a revaluation of fixed assets, as in Belgium in 1947, or by means of the application, as in France, of official coefficients of equivalent costs to assets acquired in earlier years" - Goldberg, Concept of Depreciation, 70. It may also be noted that the idea of allocation of cost has a wider application than the one of periodic charge of fixed asset cost. Units of activity other than that of a period may be and are frequently adopted. One might, for example, allocate the cost of a motor vehicle over the number of miles travelled or an item of equipment over units of output; and this could be done over its effective life. In practice, allocation of cost is frequently made by superimposing, so to speak, one unit of activity on another, and in this procedure systematic and rational bases are normally used. But however rational the criteria for allocation may be, it has to be borne in mind that they are nevertheless arbitrary, in the sense that each allocation represents a selection, determined in accordance with human judgment, out of several possible criteria, some of which may be regarded as having equal validity with the one selected.

XII DEPRECIATION AS AN INSTRUMENT OF GOVERNMENT ECONOMIC POLICY

"Government nowadays attempt to influence economic development and guide the allocation of

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resources into those fields of enterprise which are considered to contribute most to growth and welfare. In order to guide the allocation of resources, Governments make use of a wide range of policies and instruments. At one extreme the government can allocate resources directly by engaging in producing and trading activities .... At the other extreme, the government can allow market forces to influence the allocation of resources by encouraging the quest for profits by private enterprise. In between these extremes is a mixed area in which government relies on private enterprise spurred on by opportunities for profit, but alters the profitability of business ventures by controlling prices, granting subsidies, or giving tax concessions .... The essential characteristic of an incentive tax concession is the reduction in the amount of tax otherwise payable, subject to certain conditions being met by the taxpayers. The effect of such a concession is to increase the profit arising from the taxpayers' business ....

The basic approach adopted in the provision of those concessions through the income tax system is relatively simple. The income tax law distinguishes between capital expenditure and revenue expenditure. The respect of capital expenditure for which it is desired to provide an incentive concession the end is achieved in one of two ways:

- If the capital expenditure is, under the ordinary rules, recoverable by way of depreciation allowances, by the granting of increased or accelerated

allowances.

- If the capital expenditure is not in the above category, by the making of express provisions which permit full or partial deduction.

In respect of expenditure which is ordinarily deductible and relates to activities which it is desired to encourage, the end is achieved by granting an additional deduction (normally initial or special depreciation) related to the amount ordinarily deductible" - '<u>The Ross Taxation Review Committee Report</u>' (1967), paragraphs 558, 560 and 563.

Apart from manipulating the rates of depreciation allowances in achieving the desired allocation of resources, governments, in their taxation policy, should treat depreciation not only as a means of enabling investors to recoup their capital expenditure or fixed assets but more importantly, as a replacement investment in the case of ordinary depreciation, and an expansion investment with regard to special or initial depreciation.

A.J. Brown when discussing the aspects of the world economy in war and peace in his book <u>Applied Economics</u> poses this question "Since depression makes re-equipment and progress impossible, and if boom does not efficiently promote their realisation - what new factors are required to produce the changes on which the necessary expansion of British exports depends?" He suggests that the answer to the problem could be found in two parts - replacement investment and

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expansion investment.

The replacement of old plant at the end of its depreciated life would represent a large regular flow of work, year by year, for the capital goods industries, the effect of which would be multiplied in the consumption goods industries. If stability could be so obtained in the annual demand for replacement plant it would make much easier the task of achieving stability in total private investment, and constitute a step towards the maintenance of employment at a high and stable level.

"As far as replacement investment is concerned it is closely tied up with depreciation, and the influence of income taxation is so great that the treatment of depreciation by the taxation authorities largely governs the treatment of depreciation by individual business. It is suggested that the replacement element in private investment as far as concerns producers' plant, could be stabilised, in the main, if satisfactory depreciation rates with suitable conditions attached, were adopted for taxation purposes": G.T. Webb, _Depreciation of Fixed Assets_, page 260.

With regard to expansion investment, "it would not be so easy to stabilise expansion investment at a consistently high level, but definite methods appear to be available by which it could be attempted without exercising government control over the direction and extent of expansion investment. The amount of depreciation allowed for taxation

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purposes has an influence on the volume of new investment. The Canadian short term experiments in expanding private investment after the Second World War through special depreciation allowances were so successful that action had to be taken to reduce private investment by withholding special depreciation for taxation purposes": Ibid. pp.260-261.

The importance of replacement and expansion investments cannot be emphasised. Apart from the direct and secondary effects these investments have on employment there is the question of national defence. The geopolitical consequences of the "long-continued neglect of the physical facilities of production" in England and France are referred to in an American publication: "Machinery and Allied Products Institute", Technological stagnation in Great Britain, p. 1. which quotes a report of the President's Scientific Research Board on the military and political consequences for Great Britain: "Since the turn of the century The British have been paying, in terms of technological obsolescence, the penalty for their easy industrial leadership. Particularly in the basic industries, British facilities and technology were older and less efficient than their German counter-parts. The balance of power in Europe was upset primarily as a result of this fact. Today, one of the most serious long-term problems still facing the British Government is the modernisation of industrial facilities."

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A further very important secondary effect of replacement and expansion investments is the effect on the technical improvements in the building of machines for industries. This point was stressed in the "Lace" industry, and they pointed out that "the complete cessation since 1923 of purchases of new machinery is disturbing for a vicious circle is created. If new machines are not being bought then little or no research will be undertaken by machine builders into possible technical improvements. And without these improvements, the familiar arguments that the old machines are as good as the new must carry with it a substantial element of truth." "Lace", Working Party Report (1947) p. 40.

However, as replacement and expansion investments have an inflationary effect on a nation's economy such investments should be reduced to a bare minimum in times of inflation. Such investments should then be kept in reserve as a measure to induce investment in capital investment once the economy has slackened or if unemployment increases to any great extent.

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