24 T.C. 709 (1955)

When a taxpayer changes from retirement accounting to depreciation accounting, the tax basis for calculating gain or loss on the disposition of assets is not reduced by depreciation allegedly sustained prior to the change, absent an explicit agreement to the contrary.

Summary

The case concerns a railroad company that switched from retirement accounting to depreciation accounting. The IRS sought to reduce the railroad's basis in certain assets (a tunnel lining and a water tank) for the purposes of calculating gain or loss on fire damage, by the amount of "accrued depreciation" prior to the accounting method change. The Tax Court held that this reduction was improper because the agreement between the railroad and the IRS, which governed the change to depreciation accounting, did not explicitly address the calculation of gain or loss. The court found that the terms letter, which constituted the entire agreement, solely addressed depreciation and did not authorize the IRS to reduce the basis in this manner. The court also held that expenses incurred by the railroad to obtain bondholder consent for its merger with its parent company were capital expenditures, not deductible as ordinary business expenses.

Facts

The Denver & Salt Lake Railway Company (petitioner) used retirement accounting for its depreciable roadway property before 1943. This method did not involve depreciation deductions during an asset's life; instead, the full cost of a retired asset was expensed at the time of its retirement. The Interstate Commerce Commission (ICC) mandated that the petitioner switch to depreciation accounting effective January 1, 1943. Petitioner requested and received permission from the IRS to make the change for tax purposes. The IRS imposed conditions, including setting up a depreciation reserve based on a percentage of the total depreciable road accounts. The agreement, formalized in a "terms letter," did not explicitly address the basis for determining gain or loss. In 1943 and 1946, fire destroyed parts of the petitioner's property (a tunnel lining and a water tank), resulting in insurance recoveries. The IRS calculated gains on these casualties by reducing the assets' cost basis by amounts of

