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BASIS FOR DEPRECIATION IN INCOME TAXES

By W Lewis Roberts*

Increases in income tax rates in recent years have led taxpayers to more carefully consider allowable deductions to reduce their net incomes as much as possible. Depreciation allowances on property that wears out or becomes worthless in the course of time have not been overlooked as a means of accomplishing this end. As a result the subject of depreciation has given rise to much litigation in recent years. During the past two or three years several interesting decisions in this field have been handed down by the courts, especially in determining the basis or value of the property on which depreciation is allowed. It is the purpose of this article to examine these recent decisions and see what a taxpayer may expect from an examination of his deductions for depreciation if the commissioner disagrees with him and it is necessary to settle the matter in court.

Section 23 (e) of the Internal Revenue Code defines depreciation as "a reasonable allowance for the exhaustion, wear and tear (1) on property used in the trade or business, or (2) property held for the production of income." It may be of interest to see what the courts have considered in the past as "used in the trade or business" of the taxpayer or what property has been considered as "held for the production of income."

The phrases property "used in trade or business" and property held for the "production of income" seem so unambiguous that we might reasonably expect that their meaning would not come before the courts in litigation. Let us look at some of the problems that have been presented to the courts in recent years involving the meaning of these two phrases.

It has, of course, been made clear that depreciation cannot be deducted for ordinary wear and tear of property not used in a trade or business.¹ A taxpayer is not entitled to a deduction on the depreciation of his automobile which he uses in going to

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¹ Matheson v. Commissioner, 54 F 2d 537 (2d C., 1932).
and from his place of business. That is a personal use. Steel tugs and wooden barges, which were not in actual use for long periods but were kept ready and in seaworthy condition, were subject to depreciation deductions. Realty, managed and improved by testamentary trustees, was subject to an allowance as used in a trade or business. A mailing list of persons likely to contribute to charities was not subject to depreciation where the taxpayer was engaged in the business of soliciting funds for charities. Patents in the hands of an inventor are depreciable property as they are used in his business. A winery leased until 1922 and thereafter idle as the owner could neither lease nor operate it himself was not denied allowance for depreciation. A life insurance company is entitled to depreciation upon the furniture used in its investment department, but not upon that used in its underwriting department. A life tenant, who owned also a one-fourth interest in the fee of property used in the business of selling realty, was allowed deduction on his interest in the fee. A farmer may take a depreciation deduction on his farm buildings, other than his dwelling house; on his farm machinery and on his livestock bought for work, breeding or dairy purposes. In Frederick Victor and Achelis v Salt's Textile Manufacturing Co. a deduction was allowed for depreciation of the franc.

Still more varied is the list of situations where depreciation deductions have been disallowed. An instance is that of a German language newspaper that was denied a deduction on loss of anticipated renewals and subscriptions. A deduction for depreciation on patterns and dies where the taxpayer had charged the patterns and dies in his expense account was denied. No

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Harvey v. Comr., 171 F 2d 952 (9th C., 1949).
26 F 2d 249 (D., Conn., 1928).
Keener-Williams Stamping Co. v. United States, F Supp. 807 (Cl. Clams, 1940).
deduction was allowed on a long term lease renewable in perpetuity. Where a playwright gave an exclusive use of a copyrighted play to a picture producer the copyright was held to be not "property used in trade or business." A particular automobile model that had met with public favor was not subject to depreciation. Where the taxpayer acquired a plant in consolidation and did not use it, no deduction for depreciation was allowed. In one case no deduction was allowed by the collector where the taxpayer bought a ferry and later learned that a bridge was going to be built which would take his patronage away from him. Several cases arose upon the adoption of Prohibition. The courts held no deduction in such case should be allowed for obsolescence of good will. The United States Supreme Court was quoted as ruling that "when a business is extinguished as noxious under the Constitution the owners cannot demand compensation from the Government or a partial compensation in the form of an abatement in taxes otherwise due."

In a later case the same court did allow a brewing company a deduction for obsolescence of buildings due to Prohibition. Prior to this decision a circuit court had refused any allowance for loss of good will of a malting company—and the Supreme Court denied a writ of certiorari. To the same effect was the case of "Che G. Hupfeel Co. v. Anderson." Prior to an amendment of the revenue law in 1942 an individual owner of vessels which were not used in a trade or business was not allowed to take a deduction on them in computing his income tax, but after that date deductions for depreciation were allowed on property held in such a case for producing income. Finally, where the United States Industrial Alcohol Company acquired, among as-

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14 New York Central R. Co. v. Com'r., 79 F. 2d 247 (2d C., 1935).
15 Goldsmith v. Com'r., 143 F. 2d 466 (2d C., 1944).
16 Dodge Bros., Inc. v. United States, 33 F. Supp. 312 (D., Md., 1940).
17 Real Estate Land Title and Trust Co. v. United States, 309 U. S. 13 (1940).
18 Detroit and Windsor Ferry Co. v. Woodward, 115 F. 2d 795 (6th C., 1940).
19 Rockwood v. United States, 38 F. 2d 707 (Cl. Claims, 1930); Seneca Hotel Co. v. United States, 42 F. 2d 348 (Cl. Claims, 1930).
22 Red Wing Malting Co. v. Wilcuts, 15 F. 2d 626 (8th C., 1926).
24 51 F. 2d 115 (S. D., N. Y., 1931).
sets of a company it had taken over, contracts calling for deliveries before the end of the year, it was not allowed depreciation deductions on these contracts.\textsuperscript{26}

Of course, the person entitled to take a depreciation deduction on a piece of property is he who naturally bears the loss from wear and tear or obsolescence. That usually means the owner takes the deduction, but it is not always as simple as that. There are situations where the owner of property may not be entitled to a deduction of "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." An instance in point is that of a lessor. In the case of Grant Building, Inc. v Commissioner of Internal Revenue,\textsuperscript{27} a landowner leased land on which a building was erected by the lessee. The lessor made a contribution for the erection of the building. It was to receive an annual rental of six per cent of the cost. This did not give it an investment status in the building and it was not allowed to take a depreciation deduction on the same. The right of the lessor to take a depreciation deduction on the leased property depends upon the terms of the lease. Cases hold that a lessee's agreement to keep up repairs does not prevent the lessor from taking a deduction because of obsolescence.\textsuperscript{28}

A different holding has been reached where the lessee agrees to return the leased premises at the end of the lease in as good condition as when received, or where the lease is for a long period of time, 999 years or even 99 years with right to renewal forever. In such cases the burden of loss from wear and tear is placed on the lessee and it is only just that he should be the one entitled to take the deduction.\textsuperscript{29}

As between a life tenant and a remainderman, the latter is generally the one who bears the loss and should be given the

\textsuperscript{26}United States Industrial Alcohol Co. v. Helvering, 137 F 2d 511 (2d C., 1943).
\textsuperscript{27}169 F 2d 469 (3d C., 1948).
\textsuperscript{28}Alaska Realty Co. v. Commissioner, 141 F 2d 675 (8th C., 1944); St. Paul Union Depot Co. v. Commissioner, 123 F 2d 235 (8th C., 1941); and Helvering v. Terminal Railroad Assoc., 89 F 2d 739 (8th C., 1937).
\textsuperscript{29}Wiener v. Weiss, 27 F 2d 200 (6th C., 1929), appealed 279 U. S. 333 (1929), not questioned on the point; Frank & S. Co. v. Commissioner, 44 F 2d 147 (3d C., 1930); Cogar v. Commissioner, 44 F 2d 554 (6th C., 1930); re-argument denied in 51 F 2d 501 (6th C., 1931); and Bonwit Teller & Company v. Commissioner, 53 F 2d 381 (2d C., 1931).
deduction for depreciation.30 Where a trust instrument makes no provision as to who shall take the allowable deduction on the trust property, it is provided in the Code that it shall be apportioned among the beneficiaries according to their respective interests.31 This specific provision for depreciation deductions in the case of trusts first appeared in the Revenue Act of 1928.

In the Lazarus case,32 the taxpayer conveyed realty in trust to his bank and took a lease from the bank. The question arose as to whether he or the bank was entitled to take the deduction for depreciation. The Court of Appeals decided that he was, since the transaction was really a mortgage to secure a loan. In the Scott case,33 the taxpayer had a one-eighth interest in the distributed income under a trust. One-half the income went to charities and since charitable organizations were not taxable and therefore were not in a position to take advantage of any depreciation deduction, the taxpayer contended that the noncharitable beneficiaries were entitled to the whole deduction and that his share was one-fourth of the depreciation on the trust property. The Court of Claims disagreed with him and held he was entitled to only one-eighth. It is different when a trust suffers a deductible loss as in the Grey case.34 It was there held that the trust alone and not the beneficiaries were entitled to take the loss in computing income taxes. The beneficiaries were entitled to the net income of the trust as provided in the statute, and not the “taxable trust income.” As the Court pointed out, “Under the revenue acts, a trust is regarded as a taxable party separate and distinct from its beneficiaries.”35

Having considered thus far what property is “used in trade or business” or held for the “production of income,” and also who is allowed to take the deduction in computing his income tax, let us turn to the real problem under consideration and see

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30 Laflin v. Commissioner, 69 F 2d 460 (7th C., 1934).
31 I. R. C. Section 23 (b) (2). “In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income, allocable to each.”
34 Charles F. Grey v. Commissioner 118 F 2d 153 (7th C., 1941).
35 Id. at p. 154
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how the courts in the recent cases have settled the question of what value is to be given the property on which depreciation is allowed. In other words, what is the basis to be taken for depreciation purposes?

The United States Supreme Court laid down the proposition that the "adjusted basis," as shown by several sections of the Internal Revenue Code, "shall be the cost of the property." Mr. Justice Jackson, speaking for the Court, said.

"For the basis we are referred by Section 23 (n) to Section 114 of the Act which refers us again to Section 113 (b) thereof which provides an adjusted basis for gain or loss but which again refers us to Section 113 (a) for the basis upon which adjustment is to be made. The sum of these is that the basis of depreciation allowance shall be the cost of such property."

The question the Court had under consideration at the time was whether an electric power company could take a depreciation deduction on line extensions paid for by persons desiring to secure the services of the company. These extensions became the property of the company, which refunded in cases where the revenue was sufficient to warrant its so doing. The court concluded that Section 113 (a) means cost to the owner and that the payments by the customers were neither gifts nor contributions to the company and affirmed the holding of the Court of Appeals for the Sixth Circuit, to the effect that the utility company was not entitled to deductions for depreciation on the line extensions. Whether the court was right in its holding in this case, in view of very recent cases, will be considered later. In the Oxford Paper Co. case, it was said "cost" as used in Section 113 (b) normally means cost to the taxpayer. In the case of a taxpayers assuming liabilities in consideration of the property

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37 Id., p. 101. Section 114 (a) "Basis for Depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property."
received, the basis for depreciation of the property is the amount of the liabilities assumed. The fair market value of stock given for patent rights has been held to be the basis for depreciation of the patents for income tax purpose. Mr. Justice Roberts, in speaking for the court in Helverng v Owens, regarded Section 113 (b) (1) (B) as limiting the amount on which depreciation may be taken as not to exceed the cost. The various courts of appeal have also emphasized the fact that the total cost to the taxpayer is the basis for depreciation purposes as well as for computing loss and gain for income tax purposes.

Not infrequently cases arise where the taxpayer has purchased property at bankrupt sales and the question arises as to what shall be his basis in computing his income tax returns. Ordinarily it will be the cost of the assets to the taxpayer. Where the taxpayer, who was mortgagee, bid in the property at the mortgage sale, the actual market value of the property at the time of the sale was taken as the basis and not the amount of the bid. Where the bondholder's committee organized a new corporation to take over the assets of the bankrupt corporation and exchanged stock in the new corporation for the bonds of the old company, there was a tax-free reorganization and the new corporation was entitled to take the cost of the property to the old as a basis for computing depreciation. And in Briggs-Darby Construction Co. v Commissioner, the Fifth Circuit allowed a corporation, organized by the parent corporation to take over equipment on construction jobs, to take the price paid for equipment as the new cost basis and were not limited to the depreciation cost basis of the parent company.

Numerous cases involving the basis to be taken for comput-

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39 At p. 368.
41 305 U. S. 468 (1938).
44 Helverng v. New President Corporation, 122 F 2d 92 (8th C., 1941).
45 Pelham Hall Co. v. Hassett, Collector, 149 F 2d 63 (1st C., 1945).
46 119 F 2d 89 (5th C., 1941).
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In income taxes arise where there has been a tax free reorganization of a corporation under Sections 112 (b) and 112 (g). The usual result has been that the new corporation is allowed the basis of the old corporation since the property is still in the hands of those who controlled before the transfer was made.\(^{47}\)

Controversies have often arisen between the tax commissioner and persons who have acquired the property in question by devise or inheritance. Where an executor was paying the tax, the value of the estate at the decedent's death was taken and not the cost to the decedent in \textit{Hartley v. Commissioner}\(^{48}\). If the devisee receives the property subject to a mortgage, his basis is the value of the buildings and not the value of his equity in the same.\(^{49}\)

A question that recent cases in the Tax Court and Circuit Courts leave in an unsettled condition is whether the devisee or heir is entitled to depreciation on buildings erected by lessees on land held under long-term leases. Two circuit courts have denied the right\(^{50}\) and the Tax Court has allowed it.\(^{51}\)

In the case of gift of real property, it has been ruled that the donee should use the fair market value of the property on the date of conversion where he has converted rental property into income-bearing property.\(^{52}\) Also, where a parent corporation took over depreciated assets in liquidating a subsidiary, the basis was the fair market value of the assets on the date they were taken in exchange for stock and not the cost of the assets to the subsidiary;\(^{53}\) and in fixing the value of paper mill property for tax depreciation purposes the fair market value of the stock issued in payment was taken.\(^{54}\)


\(^{52}\) \textit{Moore v. Commissioner}, 15 T. C. 906 (1950).


\(^{54}\) \textit{Fox River Paper Corporation v. United States}, 65 F. Supp. 605 (E. D. Wis., 1946).
In adjusting depreciation allowances the courts are sometimes called upon to determine the length of time over which deductions are to be permitted. Since the object of allowing such deductions is to return to the taxpayer the amount of his investment in property that wears out or becomes obsolescent in the course of time, it becomes necessary to determine upon the period such property can be of use in the taxpayer's business. The Bureau has worked out the approximate lives and depreciation rates of such property to aid the taxpayer in making out his tax returns, but this table does not meet all possible situations. The court has said that the question of the useful economic life of a thirty-three-story office building, for instance, is one of fact to be determined from the evidence in the case. Where a hydroelectric plant had a useful life of 100 years and the life of the structure's improvements was of 60 years and the company's license from the Federal Power Commission ran for only 50 years, the company was required to make its depreciation deductions on the basis of 100 and 60 years respectively and not for the 50-year period of its license. In Bank of American National Trust & Savings Association v United States, the taxpayer was required to use the depreciation base as reduced by the amount allowable each year, whether a deduction was claimed or not. It will not allow the taxpayer to accumulate deductions for use in a year when the company's net returns are large. Where the taxpayer has made deductions in excess of the amount allowable in prior years, it will not prevent reducing the depreciation base in subsequent years by the lesser amount that was allowable. The policy of increasing the depreciation rate where the use of machinery is increased was denied a taxpayer in a recent case on a showing that repair bills were higher and offset the greater use being made of the machinery because of wartime conditions. In other words, the frequent repairs might offset the heavy usage.

The United States Supreme Court made it clear in the case of

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55 Bulletin "F" 511 CCH, par. 219.29.
57 Union Electric Co. v. Comr, 177 F 2d 269 (8th C., 1949).
58 69 F Supp. 932 (N. D., Cal., 1949), affirmed 168 F 2d 399 (9th C.).
59 Copifyer Lithograph, 12 T. C. 728 (1949).
Virginia Hotel Corporation v. Helvering\footnote{319 U. S. 523, 63 S. Ct. 1260, 87 L. Ed. 1561, 30 AFTR 1304 (1943).} that the base reduction under section 113 (b) (1) (B) of the Internal Revenue Code\footnote{Which read, "to the extent allowed (but not less than the amount allowable)."} included allowable deduction whether the taxpayer took the deduction or whether he was benefitted by an allowable deduction or not. In that case the taxpayer had taken deductions yearly on a straight line basis for several years. Then for three years it earned no taxable income. In readjusting the depreciation base, depreciation for these three years was taken into consideration although the taxpayer had received no benefit therefrom. The same year the District Court followed the Supreme Court’s decision in Goss & Deewu Mach. Co. v United States.\footnote{293 F 2d 853 (D. Conn., 1943).} Since that time, the ruling has been followed.\footnote{Corn r v. Saltsonstall, 124 F 2d 110 (1st C., 1941).}

Of course, where the amount of the total deductions for depreciation on a piece of property equals the cost or basis used, the taxpayer has a return of his capital investment and is entitled to no further deductions for depreciation on the property.\footnote{Reg. 111, Sec. 29.23 (1)-5 reads in part as follows: “If the cost of other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis.”} Section 29.23 (1)-5 of Regulation 111 expressly so states.\footnote{Supra, n. 36.}

With the principles derived from the decisions so far covered in mind, let us next turn to the way the courts have handled the problems arsing where the taxpayer has acquired the property on which it seeks to take a depreciation deduction as an inducement for locating one of its factories in a community or for extending its services therein.

In the Detroit Edison case\footnote{53 F Supp. 853 (D. Conn., 1943).} the taxpayer was not allowed to take depreciation on extension of its rural lines paid for by the persons who wanted the service. They took the view that these payments were neither gifts nor contributions to the company’s capital and that it was not entitled to take any depreciation de-
ductions, on such contributions, from its gross income in computing its income taxes.

The Fourth Circuit had the year before reached an opposite result in *Arundel-Brooks Concrete Corporation v Commissioner* where part of the money for an asset was donated to the corporation by an interested party. After the Supreme Court's decision in the *Detroit Edison* case, the same parties and the same question came before it and it held it was bound by the decision in the *Detroit Edison* case. The Concrete Corporation was not allowed depreciation on the half of the cost of its plant that had been contributed by the Maryland Slag Co. to induce the Concrete Corporation to build where it did.

The *Revere Land Co.* case presented a much more complicated situation. Three corporations were involved. The Revere Company was owner of lots on which it was proposed to erect a large office building. The Strasswill Company was the financing and promoting agency in securing the construction of the buildings, and the Grant Company was to be the owner of the building. To help finance the construction, the Revere Company contributed over a million dollars to the Grant Company and received an equivalent in preferred stock. Several years after the building was completed the Revere Company claimed the right to take a tax depreciation on the proportionate part of the structure represented by the amount of its contribution. The Grant Company intervened, claiming the entire depreciation allowance on the building. The Tax Court held the Revere Company was entitled to the deduction and that the Grant Company was not. In reversing this holding, Judge Kolodner, in speaking for the Third Circuit Court, said:

"Grant had an investment or ownership interest under the statute with respect to the entire cost of construction of the Grant building including Revere's contribution. Grant paid for the money of which Revere was the originating source with the issuance of preferred stock of Strasswill in an equal amount, just as it paid for

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67 129 F 2d 762 (4th C., 1942).
68 Com'r v. Arundel-Brooks Concrete Corporation, 152 F 2d 225 (4th C., 1945).
70 7 T. C. 1061 (1946).
the other funds used in the construction of the building by the issuance of additional preferred stock and mortgage leasehold bonds. Grant further paid Revere for the money in question by contracting to pay a rental of 6% annually under the terms of the August 16, 1927, lease.71

The same court the next year reached a similar result in *Commissioner v McKay Products Corporation*,72 where the company was given a building in consideration of moving its industry to a town. It was allowed deduction for depreciation based on the cost to the transferor. Judge Goodrich said: “We think that the transfer entitles the taxpayer to its donor's basis under Section 113 (a) (2)” He noted that they differed from the Fourth and Eighth Circuits on this problem. The Eighth Circuit held the same year that where a chamber of commerce had erected a building for the taxpayer for use as a factory, the latter was not entitled to a depreciation allowance on the building in making out its income tax return.73 The same court, the same year when it passed upon the *Brown Shoe* case, consistently held that “cost of property” under 26 U S. C. A., Section 114, “means cost to the taxpayer and does not include contributions from others made for business or community interests.”74 The court in so holding had reversed the Tax Court's decision that the taxpayer could take the deduction.75 The amount involved was large. Community contribution in several different states aggregated nearly a million dollars; and the Supreme Court granted a writ of certiorari. The Supreme Court was willing to accept Judge Goodrich's view as expressed in *Commissioner v McKay Products Corporation*,76 to the effect that the assets received and used by the taxpayer in its business wear out and must ultimately be replaced and they come within the provisions of the Internal Revenue Code. The taxpayer was held entitled to deductions for depreciation under Section 113 (a) (8) (B) and to include the contributions in equity-invested capital under Section 718 (a) (1) and (2) as well.77 Mr. Justice Clark in giving the

71 At p. 482.
72 178 F 2d 639 (3d C., 1948).
73 C. L. Downing Co. v. Comr, 172 F 2d 810 (8th C., 1949).
74 Brown Shoe Co., Inc. v. Comr, 175 F 2d 305 (8th C., 1949).
75 10 T. C. 291 (1948).
76 *Supra*, n. 72.
opinion of the Court sought to distinguish the decision in the 
_Detroit Edison Co._ case\textsuperscript{78} on the ground that the farmers and 
other customers had no intention of making contributions to the 
power company. This seems, however, unsatisfactory since if 
not donations, the payments must have been for anticipated 
services to be rendered by the company and therefore the ex-
tension lines became property of the company and subject to 
wear out with use just as any other assets of the company and 
should be included in the company's depreciation allowance. If 
the same facts were to come before the court again, it seems, to 
be consistent, it would have to decide the other way, that the 
power company would be allowed to include such rural extension 
lines in its depreciation account.

The _Brown Shoe Co._ case has settled an important problem 
and put an end to the different solutions reached in the circuit 
courts. The conclusion reached by the Supreme Court is logical 
and seems consistent with the majority of the decisions we have 
considered.

\textsuperscript{78} Supra, n. 36.