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## Taxation of Imaginary Profits under the Federal Income Tax Law of 1926

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## COMMENTS

### TAXATION OF IMAGINARY PROFITS UNDER THE FEDERAL INCOME TAX LAW OF 1926

The Revenue Act of 1926 is an undisputed benefit to the taxpayers as a whole but it was unfortunate that Congress did not take advantage of the opportunity to clarify that part of the Act which applies to profits from the sale of real estate. Let us see how the income tax operates as applied to the sales of real estate held by a trustee whose duty is to pay all the net income of his trust to a beneficiary. We will suppose that the trustee purchased an office building in 1913 as an investment for \$50,000, and sold it in 1923 for \$45,000. In making out the income tax return the trustee shows that all income is distributed to the beneficiary who must pay the tax. His books show a loss of \$5,000 on the sale, and consequently he assumes there is no tax for him to pay as trustee. Then comes the keen eyed Internal Revenue Agent and reports that the basis for determining gain and loss is not the purchase price in 1913, but that that price must be reduced by the amount of depreciation sustained during the trustee's ownership. He computes this at 2% per annum, making a total for the ten years of \$10,000, thereby reducing the basis to \$40,000 and showing a \$5,000 profit to the trust which must be taxed as income. The trustee protests that he has claimed no deduction for depreciation during all those years, as indeed he could not, for he had no taxable income from which to claim a deduction, all income having been taxed to the beneficiary.<sup>1</sup> The agent however is backed by *Regulations* 62, Article 1561. The depreciation has been an 'allowable deduction' during the years in question, and the fact that this gave no advantage to the trust was not to deprive the trust of the disadvantage of having the basis "adjusted" according to the Regulations.<sup>2</sup>

Is such an assessment justified under the Revenue Act of 1921? There has been no decision on this point as applicable to estates. As applied to individuals the regulation has been upheld by the Board of Tax Appeals,<sup>3</sup> and has been denounced by the U. S. Court of Claims

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<sup>1</sup> Revenue Act of 1921, Sec. 219.

<sup>2</sup> Not only is the trustee unable to get any advantage from the deduction where there is no income taxable to the trust, but he is also unable to pass the deduction along to the beneficiary. I. T. 2218; (1925) IV-43-2411. See also *Baltzell v. Mitchell* 3 Fed. (2d) 428.

<sup>3</sup> "What is true of a manufacturer is equally true of the owner of an office building. The instant taxpayer bought a building in 1909, rented offices in it until 1920, and then sold it. Presumably the value of the building was in part used up during that period, and the rents received were attributable, before the discovery of income, to the reimbursement of the owner for such capital exhaustion or loss. It is true that in many cases the loss in value is partially offset by repairs and replacements, but general experience has shown that wear and tear and obsolescence to reduce the

holding that the adjustment for depreciation was erroneous.<sup>4</sup> There seems to be nothing in the 1921 Act to call for such an adjustment, and as has been said by one learned author:—"The result of the ruling is to nullify the provision for annual deduction for depreciation and throw into one year's income the total of the amounts deducted as depreciation in several years."<sup>5</sup> In view of the doctrine that all doubts in tax laws are to be resolved in favor of the taxpayer<sup>6</sup> it is submitted that the trustee in the above supposed case ought not to have his loss turned into a gain and taxed, in the absence of express statutory authority.

Now let us suppose our trustee had sold the realty after the 1924 Act became operative. This would bring us in contact with a new provision contained in Section 202 (b) of that Act which reads as follows:

- (b) In computing the amount of gain or loss under sub-division (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property.

It looks as though Congress realized the injustice of the Regulations and used the words "previously allowed" to meet the situation we have been supposing. These words have been construed by the

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value of a building or any other tangible asset actively used in commerce, in excess of such offset. In the absence of affirmative proof to the contrary and in the light of the Commissioner's determination to that effect in it being incumbent upon it to submit proof to sustain any claim that the instant case—the taxpayer being the moving party in this appeal and Commissioner has been guilty of an error of fact—we must accept the finding of the Commissioner, which was necessary to his determination, that such an exhaustion or loss of value did occur.

But, says the taxpayer, the *depreciation* of the building was more than offset by *appreciation* in value during the period of ownership, as is evidenced by the excess of the sale price over the cost. There is no evidence before us to show that this appreciation was in the building rather than in the land which was bought and sold with the building. However, even if it were shown that the land had not appreciated one cent in value, we do not think that would change the result." Even Realty Co. 1 B. T. A. 365 at 360.

See also Esther Firestone. 2 B. T. A. 309.

<sup>4</sup>*Ludey v. United States*, decided May 11, 1925.

<sup>5</sup>Geo. E. Holmes:—Federal Income Tax, Sec. 361 (6th Ed. 1925). This seems to be unfair to the taxpayer because it makes his income reach a higher sur-tax level than would otherwise be the case in the year of the sale. It would be preferable to abolish the deduction for depreciation altogether.

<sup>6</sup>"If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer. *Gould v Gould*, 245 U. S. 151, 153. The rule is stated by Lord Cairns in *Partington v. Attorney-General*, L. R. 4 H. L. 100, 122:

"I am not at all sure that, in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal

Solicitor of Internal Revenue to mean in substance "granted as a deduction in computing tax liability for previous years."<sup>7</sup> Thus construed the 1924 Act does no harm to our imaginary trustee, and it is to be hoped that the Solicitor's opinion will prevail.

Now we come to the Revenue Act of 1926, and find that Section 202 (b) has been changed so as to read in part as follows:

- (2) The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws;.....

What shall we say is the effect of this on our problem? No doubt the depreciation of the building has been an "allowable deduction" during the period of the trustee's ownership, and hence he must diminish his "basis" by this amount. The old inequitable rule has been restored by Congress probably without realizing what it was doing.<sup>8</sup>

The backward step might give cause for despair of ever getting a reasonable method of computing real estate profits, if it were not for the fact that a new Joint Congressional Committee on Internal Revenue has been created by Section 1203 of the 1926 Act, with the duty to investigate the operation and the administration of our Federal Tax System and to recommend to Congress any changes that may be deemed advisable. This new committee ought, it is submitted, to consider seriously the question whether it would not be more equitable to bring the law into conformity with the principle laid down in *Ludey vs. U. S.* namely that depreciation is not a matter to be considered in determining the cost or sale value of property.<sup>9</sup> Such a change as applied to the taxation of estates in trust would prevent the glaring injustice that has been considered above. As applied to individuals it would merely mean that annual depreciation was a real deduction instead of a temporary deduction, to be added back again in the year when a sale is made.

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legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand if the Crown, seeking to recover the tax, cannot bring the subject within the letter of law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be." *U. S. v. Merriam* 263 U. S. 179, 188.

<sup>7</sup> Cum. Bull. 1925, IV-43-2408; S. M. 4349.

<sup>8</sup> See Report of the Committee on Ways and Means on the Revenue Bill of 1926 (69th Congress—Report No. 1, p. 5) and Report of the Senate Committee on Finance concerning the same bill (Report No. 52 p. 161.

*Ludey v U. S.*, decided by the U. S. Court of Claims, May 11, 1925.