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THE REINVESTMENT DEPRECIATION PROPOSAL*

By FRED W. PEEL, Attorney, Washington, D. C.

The purpose of this article is to outline a proposed change in the method of computing depreciation deductions for income tax purposes which will recognize the problem of maintaining business investment in real terms in periods of rapidly rising costs.

In measuring income in the past it has generally been assumed that the dollar was a constant and unchanging measure of value. As we all know, however, the facts are quite to the contrary. The dollar is not a constant and unchanging measure of value. Instead, the dollar has been shrinking steadily in value as costs have been increasing.

As a result, conventional accounting statements, while suitable for the measurement of income in terms of a constant unit of value, have grossly overstated actual profits in informing stockholders and creditors, in determining income taxes, or for any other purpose for which it is necessary to know how much a business is making or losing over a period of time.

In the midst of rapidly rising costs in recent years, many businessmen struggling to meet them must have felt like Alice in *Through The Looking Glass.*

> "Alice looked round her in great surprise. 'Why, I do believe we've been under this tree all the time! Everything's just as it was.'
>
> 'Of course it is', said the Queen: 'what would you have it?'
>
> 'Well, in our country,' said Alice, still panting a little, 'you'd generally get to somewhere else—if you ran very fast for a long time, as we've been doing.'
>
> 'A slow sort of country!' said the Queen. 'Now, *here*, you see, it takes all the running *you* can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!' "

The Queen would have been understating the case had she been describing the plight of a businessman trying to "keep even" in our present economy.

The consequences of failure to take account of the declining value of the dollar would be serious if they merely involved misleading management into making wrong operating and investment decisions. But they are even worse since business has been required to pay income taxes on amounts which must be reinvested to maintain the existing level of the business. To the extent that corporate profits are overstated, our present Federal income tax system exacts a tax of 52% of the amount of this overstatement. The effect of overstating partnership or sole proprietorship profits may be a tax on the mistake of from 20% to 91%.

Because it is usually weaker financially and finds it more difficult to obtain financing from outside sources, small business is particularly vulnerable to the squeeze created by taxing "profits" which must be retained to maintain existing levels of investment. The problem of the small business is further complicated by the fact it is also hard pressed to keep up with the rapid rate of technological changes in the products it markets and in methods of production. While this is an additional problem which does not arise from inflated replacement costs, its existence should be borne in mind as increasing the urgency of finding a way to give small business depreciation adequate to maintain, at least, existing investments.

The problem of recovering the cost of assets varies in importance as the amount of the depreciation charge increases in relation to the gross income of the business. For income tax purposes inadequate depreciation charges result in actual effective income tax rates in excess of those ostensibly imposed by law, with the additional tax burden increasing as depreciation costs increase in proportion to gross income.

Where a business derives its earnings principally from the use of depreciable assets, the variance between the income tax rates ostensibly imposed and those actually paid is staggering in a period of steadily increasing costs. A corporation with a large investment in depreciable property in relation to its gross income may actually be

*This proposal was presented by Mr. Peel to the Ways and Means Committee of the House of Representatives at its Tax Revision Hearings on January 15, 1958.

paying taxes at the rate of 70% or 80% of its real income—although the stated maximum corporate income tax rate is 52%.

Replacement-cost depreciation proposals which have been made in the past were subject to the objection, from the standpoint of the income tax system, that they provided no assurance that the additions to the depreciation reserves in excess of those which would be made under the historical cost method, would, in fact, be reinvested. There is a possibility that costs might decline, at least over the short run, so that the additional depreciation reserves will not be needed to maintain existing investment when the time comes to reinvest in new plant and equipment. Also, a businessman might simply terminate his business or reduce it in size and not reinvest an amount equal to the depreciation reserves based on replacement-cost computations. While this latter point would not matter for ordinary accounting purposes, it would be a serious defect from the point of view of the tax system, since it would permit a diversion by some taxpayers of tax-free allowances into non-investment channels. This would be a remote possibility with established corporate business concerns, but it might be a more serious problem with individuals.

A further difficulty with some replacement-cost depreciation proposals has been that they contemplated calculating replacement-cost depreciation allowances on the basis of the current replacement costs of the specific assets being depreciated. This would be a laborious and difficult process. In many instances technological improvements and changes in marketing patterns make the replacement cost of a particular asset a meaningless concept. Furthermore, it misses the point that it is the continuation of investment in general (although costs have increased) which is the proper goal of reform in historical cost depreciation—not allowance of the replacement cost of specific assets.

"Reinvestment depreciation" is not subject to these objections which have blocked replacement-cost depreciation proposals in the past. This proposal is called "reinvestment depreciation" because it is measured by the cost of the reinvestment necessary to maintain the size of the taxpayer's investment in real terms and because it is limited by the dollar amount actually reinvested. Reinvestment depreciation takes account of the decline in the value of the dollar for purposes of measuring depreciation when actual transactions have occurred which establish the fact of this decline.

This solution — reinvestment depreciation — is for all practical purposes an adaptation of LIFO applied to long-lived properties. LIFO has for several decades been recognized as sound business accounting for business enterprises with inventories, and the same principle is equally sound as applied to capital equipment.

Industry is continually spending money for buildings, machinery, and equipment. At the same time industry is continually selling, scrapping, or disposing of the same sort of property when it wears out or when it is no longer economical to operate it. Just as in the LIFO method for inventories, under the reinvestment depreciation proposal the original property would be recorded on the books of the enterprise at its original cost. When such property is used up and replaced, if the taxpayer merely reinvests enough to "keep even", the properties acquired would be recorded at this original cost and the additional cost due to the decline in the value of the dollar would be charged off immediately. The effect is to allow depreciation sufficient for the taxpayer to maintain his investment in real terms (not merely in price-inflated dollars).

The additional cost in current dollars of reinvesting is simply the difference between the original cost of the property disposed of and the equivalent number of dollars which would have to be reinvested today to buy the same amount of property, as determined by using a price index constructed or chosen by the Government. The basic steps in the reinvestment depreciation proposal are as follows:

1. To maintain the base investment, the deficiency in depreciation in terms of current dollars is made up (but only when the extent of the deficiency is known).
2. The measure of the extent of the deficiency is the difference between the cost of the original property and its equivalent in current dollars, determined by applying an appropriate price index when the property is disposed of.
3. The deficiency is made up only when the property represented by the original investment is disposed of and the equivalent in current dollars is spent for other property—or reinvested.

4. The basis for tax purposes of the newly-acquired property is its cost, minus the amount of the reinvestment depreciation allowance deducted—so that total depreciation deductions will never exceed actual dollar cost.

In determining the amount of the reinvestment depreciation deduction the first step is to determine the cost, in terms of current dollars, of the assets sold or dismantled during the taxable year. To arrive at this figure the original, or historical, cost of such assets which were acquired in a given year in the past is increased or decreased by the percentage change in the appropriate price index between the year of acquisition and the year in which the assets are sold or dismantled.

The aggregate of the costs of all of the assets sold or dismantled during the year, converted to current dollars, is the amount of reinvestment to which the taxpayer should be entitled without tax penalty. To the extent of the additions which the taxpayer has previously made to depreciation reserves with respect to the assets sold or dismantled during the year, the taxpayer has already received a deduction in computing taxable income. The amount which the taxpayer realizes as salvage through the sale of the assets is offset against the remaining tax basis in the assets. If the assets are disposed of for salvage in an amount less than their remaining tax basis or if they are dismantled while they still have tax basis remaining, the taxpayer is entitled to a reduction for a loss in this amount. However, the total of the foregoing amounts will only equal the cost basis of the assets figured in terms of historical dollars in the years the assets were acquired. With rising costs this falls short of the total cost, in terms of current dollars, of the assets sold or dismantled. It is this deficiency which is the measure of the proposed reinvestment depreciation deduction.

The reinvestment depreciation deduction will be limited, however, to the amount by which actual reinvestment during the year exceeds the unadjusted or cost basis. In order for a taxpayer to obtain a reinvestment depreciation deduction he must reinvest, in current dollars, an amount greater than the total of the dollar amounts already taken into account in computing taxable income with respect to the assets sold or dismantled—that is, the amounts previously added to depreciation reserves, the recovery on salvage, and the loss on sale or dismantlement. For assets which were acquired in years before the reinvestment depreciation provision becomes operative for the taxpayer the unadjusted basis of the assets sold or dismantled, for purposes of this determination, will be their original historical dollar cost. For assets which are acquired after the reinvestment depreciation provision becomes operative with respect to the taxpayer, their basis for this computation will be their cost reduced by the reinvestment depreciation deduction attributable to their own acquisition.

The effect of limiting the reinvestment depreciation deduction to the amount by which actual reinvestment in the year exceeds the cost basis of the assets sold or dismantled is to guarantee that the amount of the deduction which will be allowed to compensate for the increased cost of reinvestment represents actual reinvestment.

The assets to which the proposal applies are tangible, physical assets which are subject to an allowance for depreciation. To be eligible, assets must be either used in the taxpayer's trade or business or used by him for the production of income. Inventory and items held for sale in the course of the taxpayer's trade or business would not be eligible.

In order to take account of the fact that reinvestment may not exactly coincide with sale and dismantlement of old assets from year to year, the proposal provides for a two-year carryforward of the unused, or "unreinvested", deficiency between the original cost of the assets sold or dismantled during a year and the equivalent reinvestment cost in current dollars.

The following examples illustrate the operation of the reinvestment depreciation proposal.

Example 1. Suppose that in 1958 a taxpayer dismantles a machine purchased in 1938 for $50,000 and fully depreciated since that time. Assume that the cost index shows an increase in costs of 130% from 1938 to 1958. The taxpayer may elect to deduct in 1958, as a reinvestment depreciation allowance, the cost of tangible, depreciable property purchased in 1958 to the extent that its cost exceeds $50,000 (the original, historical cost of the property dismantled during the year) but does not exceed $115,000 (230% x $50,000). The maximum deduction taken to place the taxpayer on a current-cost basis in this example is $65,000, or the equivalent of the 130% cost increase.

Example 2. Suppose that, in Example 1, new investment is only $60,000 in 1958,

but that additional investments amounting to $200,000 are made in 1959. In this case the taxpayer will take reinvestment depreciation deductions of $10,000 in 1958 and $55,000 in 1959, the total of $65,000 of deductions for the two years being equal to the 130% price index increase multiplied by the $50,000 original cost.

The reinvestment depreciation proposal has the great advantage that it does not require a departure from the basic principles on which the tax basis of assets is computed under our income tax system. It will not result in a taxpayer recovering an aggregate amount through depreciation deductions which exceeds his actual investment.

This proposal is designed to help an operating business maintain its investments. It is not planned with the idea of aiding taxpayers to obtain deductions from ordinary income which are later offset by capital gain. Consequently, under the proposal, if a taxpayer elects to use reinvestment depreciation, subsequent gain on the sale or other disposition of assets, to the extent attributable to reinvestment depreciation deductions previously allowed, will be treated as ordinary income ineligible for capital gain or section 1231 gain treatment.

Because the impact of inflation is greater on small business, and also in order to simplify record-keeping, it is suggested that a minimum reinvestment depreciation allowance be established to cover a flat amount of capital expenditures per taxpayer each year in excess of depreciation reserves and salvage allowances for retired assets, but in no event more than the taxpayer's taxable income during the year from the trade or business in which the investment is employed.

Foreign countries—particularly those in which costs started to rise earlier and have risen more rapidly than in the United States—have already adopted various measures designed to counteract the effect of cost increases in distorting proper depreciation in the measurement of taxable income.

France uses a system of indices as a basis for allowing depreciation on a base in excess of original cost. These indices take into account price increases over three different periods.

Canada has set up an optional system of rapid depreciation for 14 separate classes of depreciable assets. Britain allows a rapid write-off of an arbitrary percentage of cost. Argentina, Brazil, and Belgium have all permitted revaluation of assets for depreciation purposes in order to take into account inflationary price increases.

In the United States we have heretofore taken no measures in our income tax system aimed directly at the inadequacy of depreciation allowances because of cost increases. Emergency, or 60-month, amortization has served to postpone the impact of inadequate depreciation allowances on some parts of our economy. However, 60-month amortization deductions are rapidly running out and new certifications have been sharply reduced. In any event, 60-month amortization does not represent an attempt to solve the inflationary problem, being based on a totally different concept and designed to serve a totally different purpose. Furthermore, it has affected only some sectors of our economy.

The liberalized depreciation deductions under the declining balance or sum-of-the-years-digits methods instituted in the 1954 Internal Revenue Code were also directed at a different problem. The allowance of more rapid depreciation deductions in the early years of the lives of new assets will not remedy the fact that inadequate depreciation reserves have been accumulated on assets acquired previously at lower cost levels.

To summarize, a change in the conventional method of determining taxable income to take account of the declining value of the dollar through use of the "reinvestment depreciation" concept is vitally needed, particularly for small business; it is required if income is to be measured properly; and it is important if we are to prevent our income tax system from stifling the source of funds for the maintenance of our present level of business investment (leaving aside any question of encouraging additional investment).

THE PROPOSED EQUAL RIGHTS AMENDMENT TO THE UNITED STATES CONSTITUTION (PART I)

By SARAH JANE M. CUNNINGHAM, Lincoln, Nebraska

"Equality of rights under the law shall not be denied or abridged by the United States or by any state on account of sex. Congress and the several States shall have power within their respective jurisdiction, to enforce this article by appropriate legislation. Sec. 2. This article shall be inoperative unless it shall have been ratified as an Amendment to the Constitution by the Legislatures of three-fourths of the several States. Sec. 3. This Amendment shall take effect one year after the date of ratification."[2]

This is the proposed Equal Rights Amendment to the United States Constitution. What is taken away by these words? Absolutely nothing of course. All it does is to bring the Constitution up to date by adding the word "sex" to the original "race, creed, or color" that appear elsewhere in *our* much vaunted laws against discrimination.

Senator Estes Kefauver, from the Committee on the Judiciary of the United States Senate, in making the favorable report of the committee on the amendment said:
"The purpose of the proposed legislation is to submit an amendment to the State Legislatures which, if adopted, would insure equal rights for men and women.

"This is a well-known proposal, designed to assure equal rights for men and women. Similar legislation has been introduced in the Congress since 1923 following the adoption of the equal-suffrage amendment to the United States Constitution. The equal-suffrage amendment prohibits inequality in voting rights on account of sex. The proposed amendment would prohibit inequalities under the law on account of sex and thereby complete the movement for equality for women begun by the adoption of the equal-suffrage amendment.

"The language of the amendment parallels the language of the 19th Amendment. Like the 14th and 15th amendments, its prohibitions are directed against the acts of Government and its agents and agencies. It does not apply to acts of individuals unless such acts are undertaken in concert with officials of Government. It is designed to establish equality of treatment, particularly in matters of employment.

"The United Nations Charter, to which the United States is a signatory, states in the preamble, as one of its objectives, the reaffirmation of faith in the equal rights of men and women. As a signatory to this charter, the United States has subscribed to its principles, including those expressed in the preamble. However, as pointed out by supporters of this amendment, this Nation has not kept pace with other nations, notably Egypt, Burma, Greece, Japan, Western Germany, and Pakistan, all of whom have given constitutional equality to women.

"The Committee on the Judiciary believes that this proposed amendment throughout the years has received thorough consideration. Consequently, in accordance with its previous recommendations on prior proposals to achieve the same objective, the committee is recommending that the legislation be favorably reported in order that the matter may be submitted to the Senate for its consideration."[3]

It would seem obvious from this report that after thorough study and consideration of this proposed legislation over a period of many years, the members of the Senate Judiciary Committee have assured themselves that such legislation is a matter of equity and justice for this nation.

But many people say, "Why a Constitutional Amendment?" "Aren't there other ways that this problem can be solved?" It would seem that there are adequate answers to such questions but before we delve into those perhaps it would be fitting here to take a brief look at the historical background of this proposed amendment for in so doing some of the answers to these questions will seem obvious.

In the summer of 1848, the first Woman's Rights Convention was called at Seneca Falls, New York. Among the leaders at the beginning of the organized fight for woman suffrage and equality under the law were

1. Susan B. Anthony in her magazine THE REVOLUTION.

2. S. J. Res. 80, 85th Congress, 1st Session (Report N. 1150).

3. Senator Estes Kefauver, from the Committee on the Judiciary, submitted the Report to accompany S. J. Res. 80, 85th Congress, 1st Session.

Lucretia Mott, Martha Wright, Elizabeth Cady Stanton, and Mary Ann McClintock. Thirty years later, the Suffrage Amendment in the form in which it was finally ratified was introduced in the Congress. Other suffrage proposals had reached the Congress as early as 1869. By 1913, when the National Woman's Party was formed by Alice Paul, six states had authorized suffrage for women. In June of 1919, the Congress passed the Suffrage Amendment and sent it to the States, eleven of which had already granted suffrage to women. By 1920, the requisite number of States had ratified the amendment and it became operative.

In 1923 the first Equal Rights Amendment was introduced in Congress by Senator Charles Curtis and Representative Daniel Anthony, both Republicans from Kansas. The proposal has been reintroduced in every Congress since that time. Numerous hearings have been held by Senate and House Judiciary subcommittees. Three subcommittees reported the proposal favorably to the full committee between 1924 and 1938. On April 25, 1938, the proposed amendment was reported to the Senate without recommendation. It was recommitted to the Judiciary Committee on May 5, 1938. In 1942, the amendment was reported to the Senate without amendment. The following year, May 23, 1943, the proposal was reported to the Senate with amendments. Up until this time, the proposed amendment had read:

> "Men and women shall have equal rights throughout the United States and every place subject to its jurisdiction. Congress shall have the power to enforce this article by appropriate legislation."

The Senate Judiciary subcommittee altered the language to read:

> "Equality of rights under the law shall not be denied or abridged by the United States or by any State on account of sex. The Congress and the several States shall have power, within their respective jurisdictions, to enforce this article by appropriate legislation."

In 1945, the amendment was reported to the House for the first time, but no action was taken by that body. In 1946, the Senate considered the amendment and defeated it by a vote of 35 to 23 on July 19, 1946. The proposal was reported in the House again in the 80th Congress (June 4, 1948) but no further action was taken in that Congress. On January 25, 1950, the Senate by a vote of 63 to 19 passed Senate Joint Resolution 25 of the 81st Congress which proposed an equal rights amendment to the Constitution.

In the 82nd Congress the Equal Rights Amendment was again introduced by a number of Members of Congress. The only such bill to receive action was S. J. Res. 3, which was reported to the Senate on May 23, 1951 (Senate Report 356). No further action was taken with respect to any of these bills in the 82nd Congress. No hearings were held in the 83rd Congress; although a number of such bills were again introduced, S. J. Res. 49 was reported on May 4, 1953 (Senate Report 221). The Senate Judiciary Committee did not hold hearings on this resolution. It was passed as amended (the Hayden amendment) on the floor of the Senate on July 16, 1953. The Hayden amendment to the Equal Rights Amendment was approved by a vote of 58 to 25. The amendment offered by Senator Carl Hayden of Arizona had also been attached to the Equal Rights Amendment passed by the Senate in the 81st Congress. The resolution as finally passed by the Senate reads:

> "Equality of rights under the law shall not be denied or abridged by the United States or by any State on account of sex.
>
> *The provisions of this article shall not be construed to impair any rights, benefits, or exemptions now or hereafter conferred by law upon persons of the female sex.*
>
> The Congress and the several States shall have power, within their respective jurisdictions, to enforce this article by appropriate legislation.
>
> This article shall take effect one year after the date of its ratification. This article shall be inoperative unless it shall have been ratified as an amendment to the Constitution by the legislatures of three-fourths of the several States, as provided in the Constitution, within seven years from the date of its submission to the States by the Congress."

The resolution as amended was referred to the House Judiciary Committee on July 17, 1953. The amended version of the amendment was received with mixed reactions by both proponents and opponents. Both sides claimed a victory, opponents of the measure expressing themselves as "much gratified" that special labor and other legis-

lation had been safeguarded by the Hayden amendment.[4]

In the 85th Congress, 1st Session S. J. Res. 80 was reported favorably to the Senate without amendment.

The women who attended the Seneca Falls meeting issued a momentous declaration of independence. 'We hold these truths to be self-evident: that all men and women are created equal,' they intoned; 'and we insist that women have immediate admission to all the rights and privileges which belong to them as citizens of the United States.' American men at that time scoffed, ridiculed, and angrily rejected this claim to equality. They called it 'feminism' and grimly classified it with atheism and socialism. But today it has provoked what one writer has called the greatest American revolution: The emergence of the American wife from the status of "charwoman" and "maternity machine" to that of an independent human being with the heady power of freedom.

In 1848, when the first National Woman's Rights Convention made its declaration of independence, there were, beyond all argument, serious defects in the status of women, particularly married women, in the United States. A single woman had most of the male's legal rights. But under the English tradition of common law, which the United States inherited, a married woman was "legally dead." She had no identity in the eyes of the law: She could not make a legal contract, she could not sue or be sued. She lost the title to all property in her possession, even though it had been acquired before marriage. Even such personal property as clothing, jewelry, and household furnishings could be taken and sold to pay the husband's debts or destroyed by him without her consent. Her salary, if she worked, belonged absolutely to her husband. Finally, and most outrageously, she had no control over the destiny of her own children. Not only was the father their sole guardian during his life, but in his will he could appoint an outsider as guardian with authority superseding the mother's.

If this was the legal status of women, one could hardly expect their social status in the community to be an improvement. Nor was it. Women did not have the right to vote, their education was inferior to that of men both in quality and duration, they were prevented from enjoying most of the healthful physical exercise in which men engaged. Wives were advised by the moralists of the period as follows: "Seem always to obtain information from him, especially if before company, though you may thereby appear a simpleton. Never forget that a wife owes all her importance to that of her husband. Leave him master of his actions to go or come whenever he thinks fit." [5]

With the historical background which has been here pictured is there really any need to discuss. "Why a Constitutional Amendment"? But even so there are those who desire more of an answer and it can be given. Following a survey of various fields of law it was shown that, despite the great progress that has been made toward narrowing the common-law gap between the sexes, there is no full legal equality for women in present-day America. The magnitude of this remaining differentiation has led to the introduction in Congress of this Equal Rights Amendment. Some militant women's organizations have become dissatisfied with the slow process of whittling away at discriminatory legislation statute by statute, and now seek to achieve absolute legal equality for their sex in one constitutional stroke.

The Honorable Katherine St. George, sponsor of the amendment in the House of Representatives in speaking before that body on the amendment said: "In looking over the life of Susan B. Anthony we find that *The Revolution,* her magazine, had as its motto these words:

> *"Men, their rights and nothing more;*
> *Women, their rights and nothing less."*

We always find any philosophy best stated briefly and the more talk and verbiage we get the less we understand and the less, to be brutally frank, we know what we are talking about.

In these very simple words Susan B. Anthony and her friends epitomized what the so-called equal-rights amendment would do, and also answered the objections of those who claim it would take away necessary protection and special legislation needed by women.

First she speaks of the rights of men and women. That is exactly what the

(Continued on page 12)

4. *Congressional Digest,* Dec. 1946, pp. 290, 298, 301; Bruton, Margaret Perry, "Present-Day Thinking on the Woman Question," *Annal of the American Academy of Political and Social Science*, May 1947, p. 11; Kennerly, Edwin B., "Equal Rights: Proposed Constitutional Amendment," Fed. 11, 1948, Legislative Reference Service, Library of Congress, 4 p., typescript.
Congressional Record. January 25, 1950, p. 903.
New York Times, January 26, 1950, p. 1; January 27, p. 19; July 17, 1953, p. 10; July 19, p. 9E.

5. *Cosmopolitan Magazine,* January 1958, pp. 20 et seq., James T. F., "The American Wife".

TAX ASPECTS OF RENTAL PROPERTY

By VERA COULTER, Los Angeles Chapter, ASWA

Rental income, of course, must be reported for income tax purposes. The interesting questions are when must it be reported and what deductions can be taken against it.

Let us first consider the question of when rental income should be reported. If a taxpayer is on a cash basis, rental income is reported as received. If a taxpayer is on an accrual basis, it must be reported as it accrues unless collection is not expected. Even on an accrual basis, rental income received in advance must be reported in the year in which received. If property is leased and the taxpayer receives two year's rent in advance, the entire amount must be reported as income in the year in which it was received. If, on the other hand, a taxpayer receives a deposit to secure performance under the lease, he would not receive taxable income even though he has temporary use of the money.

A landlord need not report as income any improvements made by a lessee either at the time the improvements are made or at the termination of the lease unless the improvements are in lieu of rent. If a lessor rents a piece of land and receives yearly rentals and in addition the tenant builds a building which will belong to the lessor in fifty years at the termination of the lease, the lessor reports only the yearly rent as income. There will be no profit from the building improvements until the building is sold. But should the lessor say "Don't pay me any rent, but build a building which will be mine at the end of a certain time", he is in a different position. In this case the lessor must report as ordinary income the entire fair market value of the building in the year it is completed.

Now let us turn to the question of deductions, a subject which seems to have universal appeal. All of the expenses directly connected with the rented property are deductible and are deductible directly from the income of the property. To be technical, the expenses are deductible from gross income to arrive at adjusted gross income. This is important if a taxpayer wishes to use the standard deduction in lieu of itemizing his deductions on his return, inasmuch as he may deduct these expenses from gross income and also take the standard deduction. Depreciation, repairs and other expenses are deducted to arrive at net rental income. It is interesting to consider what some of the other expenses may include. Among them are:

Travel expense incurred in looking after income producing property.

Attorney's or accountant's fees paid for services rendered in obtaining adjustment of local real estate tax on business property.

Expenses paid or incurred by the taxpayer in connection with the determination, collection, or refund of any tax related to business property.

Fees for keeping books of income producing property.

Suppose a taxpayer owns an apartment building, lives in one unit and rents the three other units. What deductions can he take? He may deduct all expenses pertaining directly to the rented units plus three fourths of any general expenses applying to all units. Thus if he is renting furnished apartments, he may deduct in full the depreciation on the furniture in the apartments rented, but may deduct only three fourths of the depreciation on the building. Such items as interest and taxes are deductible whether they are business expenses or personal expenses, but only the business portion of these expenses may be deducted from the rental income. The personal portion is deductible only if deductions are itemized. Should the taxpayer sell the apartment house, he must split the sales price and expenses connected with the sale into business (three fourths) and personal (one fourth). The cost of the property would then be computed separately with depreciation on the building being deducted only from that portion allocated to business. It is possible to end up with a profit on the business portion and a loss on the personal portion of the sale.

Getting back to expenses, if insurance premiums are paid in advance for more than one year, the Tax Court has always held that only a pro rata part is deductible in each year whether the taxpayer is on a cash or an accrual basis. However in a

recent case, Waldheim Realty and Investment Company v. Commissioner of Internal Revenue,[1] the Court of Appeals reversed the decision of the Tax Court. In so doing the Court ruled:

"We do not believe that any substantial distortion of the taxpayer's income resulted from the method in which it handled its deductions for insurance expense. Taxpayer deducted the insurance premium in the year paid. This is the usual and ordinary way for a cash basis taxpayer to handle business expenses. To require the taxpayer to treat insurance payments upon an accrual basis would, as the Supreme Court states in Security Flour Mills Co. v. Commissioner, 321 U.S. 281 create 'a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system'."

Depreciation is a subject in itself, but a few items may be of special interest in connection with rental property. A lessor should be careful not to include a phrase which states that the property must be returned to him in as good a condition as when rented as such a statement may cause disallowance of the depreciation allowance. When a taxpayer purchases property which he plans to rent, he must have a basis for allocating the cost between land and buildings since only the buildings may be depreciated. An appraisal report or property tax bills may be used for this purpose. The purchaser may want to consider the possibility of using accelerated depreciation. This subject is too involved to take up here, but it should be considered.

The question arises as to whether an item should be capitalized and recovered through depreciation or whether it should be taken as a current expense. Expenditures should be capitalized if any of the following conditions are met:

1—The expenditure improves the asset beyond its original condition.

2—The expenditure fits the asset for some new use.

3—The expenditure will prolong the life of the asset beyond its original life.

In addition, the replacement of major parts of a building must be capitalized. If a roof is replaced, the cost must be capitalized and recovered through depreciation. If the roof is simply repaired the expenditure may be deducted as repair expense.

If a taxpayer decides to rent a house in which he previously lived, expenses may be deductible from the time he puts the house up for rent, even though he does not succeed in renting the house and eventually sells it. The basis for depreciation of a house previously used as a residence is the adjusted basis of the house at date of conversion or the fair market value at the date of conversion whichever is lower. For example, suppose a taxpayer owned a house which cost $15,000 (excluding the value of the land). After ten years he converted it to rental property at a time when the fair market value of the house was $12,000. The house had an estimated life of 20 years when converted. Depreciation on cost would be $750 per year, but on the fair market value would be $600 per year. The amount of depreciation allowable would be $600. If the house had cost $10,000, depreciation on cost would be $500 annually and since this is the lower figure, $500 would be the amount of allowable depreciation.

If after converting the house into business property, taxpayer decides to sell, any gain is taxable. Value of the property at date of conversion has no effect upon the amount of the gain. However, should the property be sold at a loss, the loss is limited to that which occurred after the property was converted to business property.

Since the adjusted cost is the basis for gain and the adjusted cost or the adjusted fair market value at date of conversion, whichever is the lower, is the basis for loss, it is possible to have neither gain nor loss when selling rental property which was converted from a residence. In the example on page 12, had the selling price been $21,000, there would have been neither loss nor gain since the basis for gain would be $23,200 and that for loss $20,200.

Rental property is a Section 1231 asset since it is property used in trade or business. It is therefore subject to the provisions applicable to Section 1231 assets, which in general allows gains to be treated as capital gains and losses as ordinary losses.

The law permits the deduction of losses which arise from fire, storm, shipwreck or other casualty. This deduction is allowed whether the property is personal

[1]Waldheim Realty and Investment Company, Petitioner v., Commissioner of Internal Revenue, Respondent. CA-8-No. 15,651, 6/4/57 (rev'g. and rem'g. TC-25TC 1216; Dec. 21,617) 245 Fed. (2d) 823. (57-2 USTC #9717, CCH)

or business property. There is a difference in the treatment of business property, however. Since a casualty is an event due to some sudden, unexpected or unusual cause, damages by termites to a residence would be disallowed (unless the termites were unusually fast eaters), but damages to business property by termites is allowed.

If a residence burns down, and there is no insurance coverage, the casualty loss will be limited to the fair market value of the house at the time of the fire, if this basis is lower than the adjusted cost. But if rental property is completely destroyed by fire, the owner will be entitled to deduct the adjusted basis of the property, less salvage value and less insurance received.

If only part of the property is destroyed and the remaining property is not discarded, the following formula may be used for computing the deductible loss:

$$\text{Adjusted basis} \times \frac{\text{Actual value before loss} - \text{Actual value after loss}}{\text{Actual value before loss}} = \text{Loss}$$

Rental income and expenses pertaining thereto are reported on Schedule G.-Income from Rents and Royalties, Form 1040—U.S. Individual Income Tax Return. Depreciation of rental property is to be explained on Schedule I.-Explanation of Deduction for Depreciation Claimed in Schedule G and repairs and other expenses should be itemized on an attached list. The net rental income is combined with other income and is included in adjusted gross income by being reported on Page 1 of Form 1040.

Accountants should impress upon their clients the importance of good records in support of deductions claimed for rental properties. The taxpayer should be encouraged to preserve appraisals, invoices for expenditures, cancelled checks, and any other pertinent memoranda. Oftentime property owners conclude a sale or disposition of properties without adequate knowledge of proper accounting for such transactions because they fail to consult an accountant. An accountant can render more effective service to the client when consulted prior to the consummation of such transactions, and is in a better position to advise tax treatment of the transaction most favorable to the taxpayer rather than after the event has occurred.

Example:

Cost—		
Land	$10,000	
Bldg.	15,000	$25,000
Depreciation, 3 yrs. @ $600 per year		1,800
		$23,200
Selling price		16,000
Loss		$7,200

Fair Market Value at Conversion—		
Land	$10,000	
Bldg.	12,000	$22,000
Depreciation, 3 yrs. @ $600 per year		1,800
		$20,200
Selling price		16,000
Deductible Loss		$4,200

(Continued from page 9)

amendment does. The title of the resolution reads:

> "Proposing an amendment to the Constitution of the United States relative to equal rights for men and women."

Next, she wants both sexes to have their rights, nothing more and nothing less. These rights we spell out as being equality under the Constitution, nothing more or nothing less.

Although both AWSCPA and ASWA are on record as supporting Equal Rights legislation, which is introduced in each session of Congress, many members are quite vague as to what the broad problems are. This information is being published in a series of articles so that members of the two societies may become better informed.

Mary F. Hall, Legislative Chairman, AWSCPA

IDEA EXCHANGE

By LUCILLE PERELMAN, C.P.A., Charleston, West Virginia

RECORDING OF SUBMITTAL DATA REQUIRED ON GOVERNMENT PURCHASE ORDERS

As a subcontractor dealing with the U.S. Corps of Engineers on the Missile Project for the U.S. Army through a general contractor, we are required to have at our fingertips dates on submittals of purchase orders to the vendors and other pertinent information necessary to the expediting of government controlled materials.

We save time in submitting the information by recording on a reproduced ditto form opposite the purchase order in the file the proper facts. After listing the purchase order, number and date, along with the vendor's name, address and telephone number, across the page we record:

1) Date purchase order forwarded to general contractor
2) Date acceptance form from vendor, manufacturer, supplier forwarded to general contractor
3) Date submittal data, working drawings, descriptive literature, etc., forwarded to general contractor
4) Date approvals from U.S. Corps of Engineers received
5) Date approvals forwarded to supplier
6) Date of resubmittals, in case of rejections

Dixie E. Maffett, Atlanta

MANUFACTURERS' EXCISE TAX

Several of the customers of automobile manufacturers ship service (replacement) stock, which is actually purchased for domestic usage, to foreign countries. All service orders that do not bear a tax exemption certificate are subject to the manufacturers' excise tax, and in order to file claim for refund of the tax which was billed to them on foreign shipments, the shippers are required to submit evidence of payment of the tax by the manufacturer. Consequently, the automotive customers submit forms to the manufacturers to complete, listing the dates and numbers of the invoices for which they will file claim with the Internal Revenue Service.

Considerable time by the manufacturers has been saved from looking up the dates on which the taxes were paid by preparing a chart listing the exact date of payment of each month's tax. Using at least a six-column sheet on which six consecutive years' dates are recorded across the top, the months of the year have been entered vertically. Each month when paying the tax for the prior month, the date of the payment is posted to the chart. For example the date of the payment in February, 1958 of the January tax is posted opposite the listing of January in the column headed 1958.

Alice B. Walsh, Grand Rapids

COST RECORDS AND GRAPHS

In engineering, as in many other professions, one project may last for a period of months, and even years. Particularly is this true of system studies made of Electric Distribution Systems. In addition to the regular cost records kept, graphs covering operations for a period of years will tell at a glance the complete record of total expenses, total billing and total time spent on each project. In total time spent, further charting may show the total time spent by registered engineers and total time spent by others, including surveyors, draftsmen and engineers-in-training. When service is the only product, time spent on a project is of prime importance.

Mary Burson, Atlanta

EDITOR'S NOTE:

Let us have your experience with, or reaction to, the articles which appear on these pages, or to these "ideas". We shall gladly print your views or further suggestions to points covered, and may evaluate some to be worthy of "award points".

WELCOME TO NEW CHAPTERS

A warm welcome to our newest chapters: Erie, No. 63, Mrs. Elva Louise Beverly, president, 4648 Station Road, Erie, Pa. Dallas, No. 64, Mrs. Doris H. Neeley, president, c/o W. B. Hinton, 2900 Mercantile Building, Dallas, Texas.

TIPS FOR BUSY READERS

By S. MADONNA KABBES, C.P.A., Chicago, Illinois

Max D. Richards and William A. Nielander, *Readings in Management* (Cincinnati, Ohio: South-Western Publishing Company, 1958, pp. 882)

Although this book contains ninety-one selections it is so arranged that the reader can easily refer to the phase of the subject that interests him.

The authors explain in the preface that in dividing the book into six sections, they have followed the general outline of several basic texts in management. The first section covers the elements that are fundamental to all management functions. Sections following are devoted to the functions of planning, direction, control, organizing and staffing. Each section is subdivided into three or more chapters and selected readings are arranged under each title. A bibliography is given at the end of each chapter.

The editorial comments preceding each chapter give the reader a brief introduction to the contents of the selections included. Some of the articles present the results of comprehensive scientific research, others outline the experiences of various individuals and companies and a third group offers possible solutions to various problems in administration.

The book has been so planned as to be helpful to both practitioners and scholars. Since the arrangement follows that of a basic text, the student should find the articles very helpful as additional reading. The manager in business can easily turn to the phase of the subject with which he is concerned and find the opinions of management specialists as expressed in the articles.

An objective viewpoint has been adopted in choosing the material. In controversial areas one will find expressions by advocates who hold opposite viewpoints. Writings of consultants, educators and practitioners in various phases of management are included.

Gordon Shillinglaw, LEASING AND FINANCIAL STATEMENTS, (Accounting Review-Vol. XXXIII-No. 4, October, 1958-p. 581).

The ever increasing number of lease arrangements as a means of providing plant and equipment for corporate requirements makes this discussion a very timely one.

The writer maintains that part of the annual rental under a lease arrangement is financial expense and hence should not be charged as an actual cost of the facilities so acquired.

This dual nature of the rental cost under a lease suggests two questions which the accountant should consider in preparing financial statements. First, should the financial expense contained in the rental cost be segregated from the amortization portion? Second, should the balance sheet disclose the company's liability for future payments under the lease?

The article includes possible variations in amortization procedures which may be involved when leases have cancellation or renewal clauses, or when rental payments require a certain minimum payment plus a percentage of revenues.

A Critical Look at Generally Accepted Auditing Standards, by R. K. Mautz. Illinois Certified Public Accountant, Vol. XXI, No. 1, Autumn, 1958.

(This article is adapted from a paper presented at the 20th Annual Institute on Accounting held at Ohio State University, Columbus, Ohio, May, 1958.)

The author states the purpose of his paper is "to subject the ten generally accepted auditing standards to the critical study which they have long merited but have not as yet received."

His analysis of the various standards leads him to conclude that most of the statements are too indefinite to adequately guide the practicing accountant, outsiders called upon to evaluate the work of auditors, or those in educational work who are training students to enter the profession.

He urges the present standards be strengthened and expanded and suggests possible supplementary standards to achieve this purpose. He invites practicing accountants to offer their suggestions on how best to clarify and expand the present standards in order to raise the level of professional performance.

(Continued on page 15)

TAX NEWS

By LOUISE A. SALLMANN, CPA, Oakland Chapter

Any news in the tax field after the 1958 Code Revisions and the Small Businessman's Tax Act of 1958 seems to be rather anticlimactic. But there have been a few refinements since the enactment in September, 1958. That is, temporary regulations have been issued to guide the taxpayer in making certain elections and to advise him in the reporting procedure to take advantage of some of the provisions of the 1958 amendments.

The first year additional depreciation allowance deduction will require full disclosure. A statement must be included with the return giving a description of the property to which it is applied, the acquisition date, its estimated useful life (not less than six years), total cost of each item, and the portion of cost of each item to be included in the write-off.

In order to take advantage of the increased limitations on medical deductions, over-sixty-five-year-olds will be required to disclose the nature of their disabilities as well as including a statement from their attending physicians. The determination as to whether a taxpayer qualifies for the increased medical deduction will depend upon the extent of the disability. Certain tests are described in the temporary rules, such as, loss of two limbs; progressive diseases, such as diabetes, multiple sclerosis or Buerger's disease; major loss of heart or lung reserve; cancer; damage to the brain or brain abnormality; mental disease; loss of vision incorrectible in nature; total loss of speech or hearing.

A taxpayer may now elect in the event of a condemnation of his residence to treat the non-recognition of gain as if there had been a sale. If he wishes to do so, he must attach a statement to his return indicating his basis, date of disposition, proceeds, and cost of replacement.

One of the elections which has been fully discussed in a previous edition of this magazine, taxing of corporate income to its shareholders, is probably the most spectacular of those included in the 1958 amendments. Procedures have been much publicized. However, there have been some ideas tossed about which may make the election more attractive to some taxpayers. Where the stockholders of the electing corporation have an operating loss of which they would like to take advantage but are precluded from so doing because of the limited basis of their stock, consider the following. A stockholder may deduct an operating loss not only to the extent of his stock basis but also up to the amount to which the corporation is indebted to him. Thus, if the stockholder loans additional monies to the corporation he may take advantage of such losses. These losses are of course ordinary by classification whereas any future gain created by this reduction of basis of stock or loans will be capital.

1958 returns with all their possible elections and requirements for full disclosure promise full files for the Internal Revenue Service and longer hours for those of us who prepare them. Each year the gap between the possibility of examination and acceptance narrows.

(Continued from page 14)

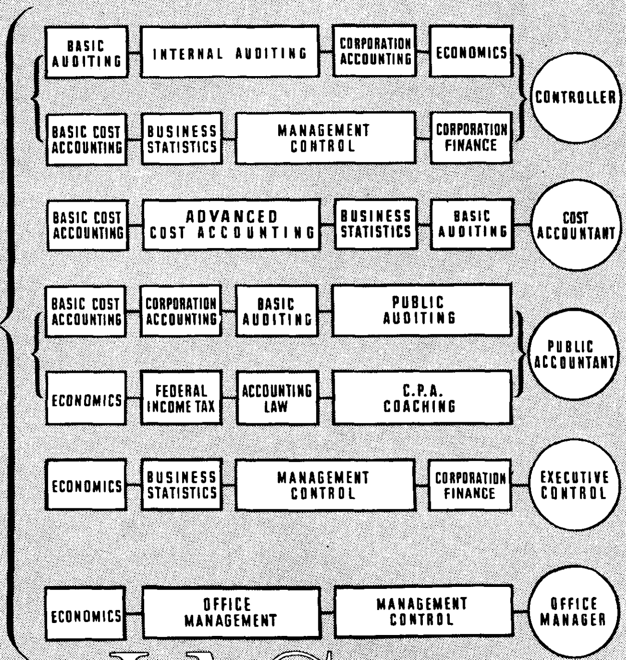
Travel and Entertainment Expenses — by Richard S. Helstein, C.P.A.—The New York Certified Public Accountant, Vol. XXVIII-No. 11-Nov., 1958

This article presents a straightforward discussion of the basic issues involved in this area which continues to be very controversial.

Mr. Helstein states in the past four years the Internal Revenue Service has changed from what might be characterized as an "easy-going live and let live" policy to the present "get tough" policy.

The article emphasizes that the law itself has not changed, but only the method of its enforcement. As tax laws become more complex, and abuses in this area more unreasonable, it was only logical that the Service should attempt to plug loopholes which favored one taxpayer as against another.

In his conclusion the author states most of the disallowed business expenses in past litigation have turned on "substantiation". He urges the best way to protect deductions is to provide proof. If this can be done the question of whether they are ordinary, necessary or reasonable will seldom be raised, unless they are very obviously personal in nature.



AT THIS POINT A SERIES OF ELECTIVES, COVERING THE ADDITIONAL SUBJECTS, IS TO BE CHOSEN. THE MOST LOGICAL COMBINATIONS FOR SPECIFIC GOALS ARE SHOWN ON THIS CHART

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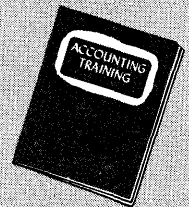

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