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Correspondence: An Answer Explained

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Correspondence

AN ANSWER EXPLAINED

Editor, The Journal of Accountancy:

SIR: I have received from you several letters criticising my answer to question 13 of the May, 1925, examination. That answer was published in the August issue of THE JOURNAL OF ACCOUNTANCY. These criticisms show careful consideration of the question by the persons who make them, and I think it is therefore advisable for me to say something further about this question.

The question was as follows:

> "No. 13. A purchased an apartment house in 1921. A never received any income from the property; in fact, it never produced sufficient revenue to pay for the cost of running it. He sold the property in 1924 at a price lower than that he paid for it. You are called upon to prepare A's income-tax return for 1924. Upon examining his returns for prior years, you find that no depreciation was ever deducted by A in regard to the apartment house property, A explaining that as there was no income from the property to serve as the basis of a reserve fund for depreciation, he had never taken any. How would you compute A's loss on the sale and should any action be taken with reference to the returns for prior years?"

My answer was as follows:

> "No. 13. Depreciation does not depend on income. Amended returns should be made for prior years taking depreciation as a deduction. In computing the loss the purchase price should first be reduced by depreciation from 1921 to 1924."

The critics of the answer call attention to the fact that while my answer was probably correct under earlier laws, the revenue act of 1924 provided in section 202 (b):

> "In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for . . . any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property."

Referring to the question, they believe that since the depreciation in question was not taken by the taxpayer, and therefore obviously was not allowed by the bureau previous to the sale in 1924, it should not be considered in computing the gain or loss.

They say that regulations 62, article 1561, contemplated proper adjustment for "any depreciation or depletion sustained and allowable as a deduction", and that the use of the word "allowed" in the act of 1924 indicated an intent to change the prior construction of the bureau.

It is my belief that the words "previously allowed" in the revenue act of 1924 will be construed to mean previously allowed by law and not simply previously allowed by the commissioner, as is assumed by the critics of the answer. My reasons for this are as follows:

1. It seems to me improbable that the law will be construed to allow a taxpayer not to take depreciation and thus create or increase a loss in a year when he may desire to have a loss. A construction which brought about such a result certainly would not be favored by the courts.

2. The construction limiting the adjustments to depreciation actually allowed by the bureau would eliminate depreciation for all previous years where the returns had not in fact been audited and settled. As the bureau usually is necessarily several years late in auditing returns, this would, in the ordinary case, exclude a large amount of depreciation, which would appear to be an unreasonable construction of the act. There is nothing in the act which indicates that there might be any middle ground of taking into consideration depreciation to the extent that it had been allowed in auditing the returns and to the extent that it had been claimed in unaudited returns.

3. The provision contained in section 202 (b) was not to be found in the revenue act of 1921. Before 1924, it was simply a matter of regulation. It is very clear in regulations 62, article 1561, already quoted, that any depreciation sustained and *allowable* was to be taken into consideration in determining gain and loss (the critics of the answer agree as to this). Unless, therefore, there is some indication that the revenue act of 1924 was intended to change the previous ruling of the bureau, the answer is correct.

4. No suggestion has been given of any reason why section 203 (b) of the revenue act of 1924 should be considered to change the prior ruling, except that new words, to wit, "previously allowed", have been used. I believe that a construction of these words as meaning previously allowed by the law is just as reasonable as to construe them to mean previously allowed by the bureau.

5. On the other hand, it appears that there was no intention on the part of congress to change the construction of the bureau under the revenue act of 1921 and earlier acts. It is true that the bill as originally introduced in the house of representatives contained the words "properly chargeable" instead of "previously allowed," and the bill as submitted by the committee on ways and means continued to use the words "properly chargeable." The report of the committee, however, was as follows (68th congress, first session, *H. R. Report No. 179*, page 12):

> "(2) There is no provision in the existing law which corresponds to subdivision (b), but the rule laid down therein is substantially the same as the construction placed upon the existing law by the treasury department. It provides that in computing gain or loss from the sale or other disposition of property the cost or other basis of the property (and in the appropriate case the fair market value as of March 1, 1913) shall be increased by the amount of items *properly chargeable* to capital account and decreased by the depreciation and similar deductions allowed with respect to the property. Under this provision capital charges, such as improvements, and betterments, and carrying charges, such as taxes on unproductive property, are to be added to the cost of the property in determining the gain or loss from its subsequent sale, and items such as depreciation and obsolescence *previously allowed* with respect to the property are to be subtracted from the cost of the property in determining the gain or loss from its subsequent sale."

It should be noted that the committee report uses the words "properly chargeable" and "previously allowed" interchangeably. The bill passed the house with the words "properly chargeable." By senate amendment, these words were changed to "previously allowed." The senate report, however, 68th congress, first session, *Senate Report No. 398*, page 13, did not contain any language which indicated that there was an intention to change the prior construction of the bureau or the meaning of the language used by the house as

interpreted by the house committee. Apparently, the senate committee believed that "previously allowed" was a clearer expression than "properly chargeable". The report in part was as follows:

> "(2) There is no provision in the existing law which corresponds to subdivision (b). It provides that in computing gain or loss from the sale or other disposition of property the cost or other basis of the property shall be increased by the cost of capital improvements and betterments made to the property since acquisition and decreased by the depreciation and similar deductions previously allowed with respect to this property. To remove a possible ambiguity in the house bill, the deductions are limited to those 'previously allowed' rather than those 'properly chargeable.'"

6. The report does not say what this "possible ambiguity" was, but it is easy to find an ambiguity in the words "properly chargeable." "Loss, exhaustion, wear and tear, obsolescence, amortization and depletion" were all words which had a statutory meaning as deductions allowed, but many of these words had also a broader meaning in accountancy. Particularly under the earlier statutes there were instances of losses and depletion, which would be "properly chargeable" under good accounting practice, but which would not be "allowed" by the revenue laws. The provision for deductions which were "previously allowed" rather than those which were "properly chargeable" seems to tie up the section to the other provisions of the revenue acts rather than to accounting principles generally.

7. Since it must be admitted that the earlier construction of the bureau took into consideration depreciation which was allowable, and since apparently congress had no intention to change this construction, it seems to follow that under the revenue act of 1924 depreciation which is allowable by the bureau, or allowed by law, should be taken into consideration in determining gain or loss.

8. Now, looking at the question from another point of view, there is nothing in it that says that the taxpayer's returns for 1921–1923 have been audited and finally settled. It would seem to me that as soon as the bureau became aware of the whole story from 1921 to 1924, it would of its own motion allow the taxpayer depreciation up to the sale and would reduce the loss by the depreciation so allowed thus effecting the same result.

Yours truly,

SPENCER GORDON.

Washington, D. C., September 14, 1925.