

## St. John's Law Review

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Volume 6  
Number 1 *Volume 6, December 1931, Number 1*

Article 33

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June 2014

### Income Taxation--Deduction for Obsolescence--Goodwill

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#### Recommended Citation

Wecker, Theodore S. (1931) "Income Taxation--Deduction for Obsolescence--Goodwill," *St. John's Law Review*. Vol. 6 : No. 1 , Article 33.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol6/iss1/33>

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maturing within that period, to be in violation of the equal protection clause and hence unconstitutional.<sup>26</sup>

It is evident from the foregoing cases that the Supreme Court would uphold the license tax on Chain Stores only if it found that there was a very substantial and significant difference between the business and operation of the two kinds of stores. The Court found<sup>27</sup> that the Chain differed from the individual store in many respects. Quantity buying, buying for cash and thus obtaining the advantages of a cash discount, distribution from a single warehouse, a greater turnover, a different sales and pricing policy, cheaper and better advertising, superior management, special accounting methods, and standardization of store management and sales policies are some of the advantages and distinguishing features between the two. In upholding<sup>28</sup> the Indiana statute, the Court concluded as a fact that the Chain Store was a distinctly different enterprise from the individual store and hence presented a different taxable entity.

What will be the effect of this decision? Chain Store systems are here to stay.<sup>29</sup> What the effect of a tax upon them will be is conjecture. It is a certainty that it will not put an end to the growth and development of the system. Let us bear in mind that in certain lines and in some communities the Chain Store has reached the limit of its growth.<sup>30</sup> A "Chain Menace" does not exist, it is merely a fiction originated by the competing independent, so as to enlist the aid of the public in his struggle with the more competent Chain Store.

From the standpoint of the public, the question in this Independent-Chain Store controversy is which system can provide the desired goods and the proper service at the lowest price. Everything else is subsidiary to this. Legislatures should be wary lest a prohibitive tax on the Chain Store be too easily shifted to the consumer.<sup>31</sup>

PHILIP ADELMAN.

INCOME TAXATION—DEDUCTION FOR OBSOLESCENCE—GOODWILL.—Section 234 (a) (7) of the Revenue Act of 1918,<sup>1</sup> and

<sup>26</sup> *Quaker City Cab Company v. Commonwealth of Pennsylvania*, *supra* note 15; *Louisville Gas and Electric Company v. Coleman*, 277 U. S. 32, 48 Sup. Ct. 423 (1928).

<sup>27</sup> *State Board of Tax Commissioners of the State of Indiana v. Lafayette A. Jackson*, 283 U. S. 527, 51 Sup. Ct. 540 (1931).

<sup>28</sup> *Supra* note 27.

<sup>29</sup> *Supra* note 1, p. 21.

<sup>30</sup> NYSTROM, *ECONOMICS OF RETAILING* (1930) p. 213.

<sup>31</sup> Address of Robert M. Haig before the 1930 Convention of the National Chain Stores Association on Business Taxation.

<sup>1</sup> REV. ACT OF 1918, c. 18, 40 stat. 1077, 1078.

identical provisions of later Acts,<sup>2</sup> permit "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence" in the computation of net income.<sup>3</sup> These sections have been generally, if not uniformly, held to apply to obsolescence of tangible property, whatever its cause, where the amount fairly attributable to the tax year has been shown;<sup>4</sup> the rule including such intangible property<sup>5</sup> as patents,<sup>5a</sup> leases,<sup>5b</sup> and contracts.<sup>5c</sup> It has been held, but only in

<sup>2</sup> Sec. 214 (a) (8) 1921, 1924 and 1926 Acts, relating to individuals; §234 (a) (7) relating to corporations.

<sup>3</sup> THE REV. ACT OF 1918, *supra* note 1, provides in part as follows: "Sec. 234 (a). That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

\* \* \* (7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade of business, including a reasonable allowance for obsolescence \* \* \*."

<sup>4</sup> National Ind. Alcohol Co. v. Commissioner, 38 F. (2d) 718 (Ct. of App. D. C. 1930), *aff'd*, 282 U. S. 646, 51 Sup. Ct. 265 (1931); Dean v. Hoffheimer, 29 F. (2d) 668 (C. C. A. 6th, 1928); Kansas City Title & Trust Co. v. Crooks, 35 F. (2d) 351 (W. D. Mo., 1929), *aff'd*, 46 F. (2d) 928 (C. C. A. 8th, 1931); Milwaukee Wausheka Brewing Co., 15 B. T. A. 579 (1929).

These cases are authority for the proposition that where the period of *economic* usefulness of property is shortened, even though its *physical life* may not be otherwise than normally affected, a reasonable deduction should be granted. Illustrations are to be found in the effect of construction of more modern hotels and of more modern office buildings; of changes in surrounding conditions, caused by shifting of industry and commerce to new locations; of property becoming inadequate to the growing needs of the expanding trade or business; of decreased usefulness or total destruction of property caused by legislation.

<sup>5</sup> See Art. 163, Regs. 45 (1919), REV. ACT OF 1918; Art. 163, Regs. 62 (1922), REV. ACT OF 1921; Art. 163, Regs. 65 (1924), REV. ACT OF 1924; Art. 203, Regs. 74 (1929), REV. ACT OF 1928.

Art. 163, Regs. 45 (1920 ed.) provides in part:

*Depreciation of intangible property*—

"Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. \* \* \* If \* \* \* an intangible is an asset acquired through capital outlay, \* \* \* such intangible asset may be the subject of a depreciation allowance."

(a) *As to patents*, see Perfect Window Regulator Co. v. U. S., 66 Ct. Cl. 147 (1928); Van Kammel Revolving Door Co. v. Commissioner, 11 B. T. A. 1209 (1928).

(b) *As to leases*, see Lynch v. Alworth-Stephens Co., 267 U. S. 364, 45 Sup. Ct. 274 (1925); Kaufman Strauss Co. v. Lucas, 12 F. (2d) 774 (C. C. A. 6th, 1926); Phillip Henri v. Reinecke, 3 F. (2d) 34 (N. D. 111, 1924); but *cf.* Weiss v. Weiner, 279 U. S. 333, 49 Sup. Ct. 337 (1929); Appeal of Secor Hotel Co., 7 B. T. A. 158 (1927).

(c) *As to contracts*, see Lassen Lumber & Box Co. v. Blair, 27 F. (2d) 17 (C. C. A. 9th, 1928); International Curtis Marine Turbine Co. v. United States, 63 Ct. Cl. 597 (1927); Tobacco Products Co. v. Lucas, 5 F. (2d) 723 (W. D. Ky., 1925).

Consequently, if good will is to be distinguished from other intangibles in this respect, some reason must be found for this distinction.

the lower courts, that because the obsolescence allowance, as specified in the statute, is limited to property subject to depreciation allowance, no loss that is claimed for diminution in the value of intangible goodwill, trade marks or trade names is deductible under the statute.<sup>6</sup> The question of obsolescence of goodwill *per se* has not been disposed of in the Supreme Court. However, in *Clarke v. Haberle Brewing Co.*,<sup>7</sup> the Supreme Court denied a deduction for obsolescence of the brewery's goodwill on the startling ground that Congress did not intend through taxation to compensate partially for the loss resulting from the destruction of a business which is "noxious under the Constitution."

In *Loewers Gambrinus Brewery Co. v. Anderson*,<sup>8</sup> decided February 24, 1931, Butler, J., delivered an opinion of the Supreme Court, in the light of which a comparison may be made with the *Haberle* decision, and the soundness of the latter may be considered. In the *Gambrinus* case, plaintiff Brewing Company was engaged from 1879 until 1919 in the business of manufacturing and selling beers, ales and porter, and for that purpose, erected and installed suitable buildings and equipment. The buildings were not commercially adapted to any other use. January 31, 1918, it had become common knowledge and was known to plaintiff that prohibition would become effective, and that as a result plaintiff would suffer obsolescence in the value of its capital assets. The Court found prohibition became effective on January 16, 1920, and thereafter plaintiff's buildings had no salvage value. The case came to the Supreme Court on a writ of *certiorari*, limited to the question whether plaintiff was entitled under Section 234 (a) (7) of the Revenue Act of 1918 to any deduction for obsolescence of its tangible property. *Held*, that the Brewery was entitled to a deduction in computing 1918 and 1919 taxes on account of the depreciated value of the tangibles due to the imminence of prohibition. A comparison between the *Haberle* case and the *Gambrinus* case is facilitated in that the former case was the chief reliance of the defendant in the latter case. Justice Holmes in denying the claim of the *Haberle* Brewing Company said:

"It seems to us plain without help from *Mugler v. Kansas*,<sup>9</sup> 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 of taxes otherwise due. It seems to us no less plain that Congress cannot be taken to have

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<sup>6</sup> *Red Wing Malting Co. v. Willcuts*, 8 F. (2d) 180 (3rd Div. Minn., 1925, *aff'd*, 15 F. (2d) 626 (C. C. A. 8th, 1926) *certiorari* denied 273 U. S. 763, 47 Sup. Ct. 476 (1926).

<sup>7</sup> 280 U. S. 384, 50 Sup. Ct. 155 (1930); *Renzienhausen v. Lucas*, 280 U. S. 383, 50 Sup. Ct. 156 (1930), following the *Clarke* case.

<sup>8</sup> 282 U. S. 638, 51 Sup. Ct. 34 (1931).

<sup>9</sup> 123 U. S. 623, 8 Sup. Ct. 273 (1887).

intended such a partial compensation to be provided for by the words 'exhaustion' or 'obsolescence.' Neither word is apt to describe termination by law as an evil of a business otherwise flourishing, and neither becomes more applicable because the death is lingering rather than instantaneous."<sup>10</sup>

It is significant that the Circuit Court of Appeals<sup>11</sup> in the *Gambrinus* case in denying the deduction asked for, said:

"In view of the decision of the Supreme Court in *Clarke v. Haberle Brewing Co.*, a deduction in the value of the buildings may not be made. *We can see no difference between tangible and intangible property within the principle case.*"<sup>12</sup> (Italics ours.)

The Supreme Court, however, as seen above, granted the deduction for the buildings, and restricted the *Haberle* case to obsolescence of goodwill. It is difficult to imagine why the Supreme Court should regard the element of "noxiousness under the Constitution" as controlling in the case of intangibles, and immaterial in the case of tangibles. It is submitted that the two positions taken by the Supreme Court are irreconcilable; it is clear that one or the other must fall. This conclusion is further substantiated when it is considered that the basic logic of Justice Holmes in the *Haberle* case and the fundamental reasoning of the Supreme Court in the *Gambrinus* case are entirely contradictory. Compare the quotation above presented from Justice Holmes' opinion in the *Haberle* case with the following excerpt from the opinion in the *Gambrinus* case:

"None of the acts made any classification on the causes from which obsolescence results. And as the sole purpose is to arrive at the net income subject to taxation, it is clear that such a discrimination could not reasonably or justly be made. \* \* \* *There is nothing in the language of the statute or the circumstances of its enactment to suggest that Congress intended that the taxable income of brewers should not be arrived at according to the rules that govern taxable incomes of others.*"<sup>13</sup> (Italics ours.)

If we accept this theory, then we must unalterably take the position that the reasoning in the *Haberle* case is unsound.

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<sup>10</sup> *Clarke v. Haberle Brewing Co.*, *supra* note 7 at 386, 387, 50 Sup. Ct. at 157.

<sup>11</sup> *Lowers, Gambrinus Brewing Co. v. Anderson*, 42 F. (2d) 216 (C. C. A. 2d, 1930).

<sup>12</sup> *Supra* note 11 at 217.

<sup>13</sup> *Supra* note 8 at 644, 51 Sup. Ct. at 39.

It is significant that the highest Court has not to date disposed of the question of goodwill *per se*. The Bureau of Internal Revenue had allowed such deductions,<sup>14</sup> but later, based mainly on the case of *Red Wing Malting Co. v. Willcuts*,<sup>15</sup> the Bureau reversed its attitude and ceased allowing them.<sup>16</sup> However, the *Red Wing* decision has been severely criticized.<sup>17</sup> Indeed, the Circuit Court of Appeals in the *Haberle* case,<sup>18</sup> in a decision written by Swan, J., was of the opinion that the *Red Wing* case was unsound, stating:

"\* \* \* legislation which cuts short the use of tangibles in the business necessarily limits also the goodwill. Every consideration which justifies allowance for the obsolescence of the tangibles because of compulsory future discontinuance of the business, ought to create a similar allowance for the goodwill."<sup>19</sup>

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<sup>14</sup> T. B. R. 44, 1 C. B. 133 (1919) provided that distillers and dealers in liquor are entitled to a deduction for obsolescence of goodwill and other intangibles, such deductions being limited to assignable assets, the value of which has been destroyed by prohibition legislation. T. D. 2929 (1919) to the same effect. In O. D. 298, 1 C. B. 138 (1919) a like ruling was made applying to brewers. A. R. M. 34, 2 C. B. 31 (1920) provides a method for computing the March 1, 1913 value of goodwill, and makes special mention of obsolescence deductions due to prohibition. For a complete summary of Bureau rulings on this subject, see Mr. Trammel's dissenting opinion in *Manhattan Brewing Co.*, 6 B. T. A. 696 (1926). The presumption is, of course, that the long-continued uniform construction of the statute by the Treasury, the Board of Tax Appeals, etc., is correct. *Edwards v. Darby*, 12 Wheat. 206 (U. S. 1827); *Robertson v. Doming*, 127 U. S. 607, 8 Sup. Ct. 1328 (1888); *United States v. Healy*, 160 U. S. 136, 16 Sup. Ct. 247 (1895); *United States v. Falk*, 204 U. S. 143, 27 Sup. Ct. 191 (1907); *National Lead Co. v. United States*, 252 U. S. 140, 40 Sup. Ct. 237 (1920).

<sup>15</sup> *Supra* note 6.

<sup>16</sup> *Landsberger v. McLaughlin*, 26 F. (2d) 77 (C. C. A. 9th, 1928).

<sup>17</sup> See KLEIN, *FEDERAL INCOME TAXATION* (1929) at p. 658: "The author feels free to assert that prior to this decision (*Red Wing* decision, ed. note), there existed little doubt that \* \* \* a deduction for the obsolescence of goodwill would have been permitted."

HOLMES, *FEDERAL INCOME TAX* (1925) at p. 1095: "Obsolescence is not ordinarily applicable in the case of goodwill, but should be allowed in exceptional cases, \* \* \* where the cost of the goodwill, or its value as of March 1, 1913, if acquired prior to that date, or other method provided by statute, can be definitely shown, and the period of obsolescence determined with reasonable accuracy."

See also, MONTGOMERY, *INCOME TAX PROCEDURE* (1929) at pp. 321 *et seq.*; BELL, *AUDITING* (1925) at pp. 244 *et seq.*; 2 FINNEY, *PRINCIPLES OF ACCOUNTING* (1927) at pp. 1 *et seq.*; COLE, *FUNDAMENTALS OF ACCOUNTING*, at pp. 370 *et seq.* Rolnick, *The Probable Life of Goodwill as a Basis for Depreciation*, *TAX MAGAZINE*, issue of July 1931, at p. 248: "In the *Red Wing Malting* Decision the Circuit Court quoted a number of accounting authorities whose writings sustained the opinion of the court that goodwill is not subject to depreciation, but the court did not point out that there are other accountants who believe the contrary."

For a complete note on the subject of losses, see A. L. R. 500.

<sup>18</sup> 30 F. (2d) 219 (C. C. A. 2d, 1929).

<sup>19</sup> *Supra* note 18 at 222.

The Court in the *Red Wing* case, in denying an allowance for obsolescence of goodwill, placed special emphasis on the meaning of the word "including," basing its decision on the wording of the statute. "Including" was interpreted as used in the sense of restricting the "obsolescence" allowance to that which is capable of "exhaustion, wear and tear." It may fairly be implied from that opinion that had the statute read, "a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business," the Court would have allowed the deduction. It is important to note that the denial of a writ of *certiorari* by the Supreme Court in that case constituted no expression on the merits.<sup>20</sup> Indeed, it is also significant to note that Justice Holmes in the *Haberle* case, which was exactly parallel with the *Red Wing* case, had an opportunity to affirm or disaffirm the theory of the *Red Wing* case; the facts of the two cases being similar, if the *Red Wing* case were sound the *Haberle* case might have been disposed of on the same theory. Instead, the issue was avoided, all discussion on the wording of the statute or the nature of property was omitted, and the decision founded solely on the "cause of the loss" which was "legislation" branding as "noxious" an occupation theretofore permitted by law. May we then imply that if the "cause" was not of such character, but simply progress of science and of the arts, that the deduction would have been allowed? May we also infer that the failure of Justice Holmes to use the theory of the *Red Wing* case, in disposing of a case with which it was identical, was a rejection of that theory? If this is so, then we may conclude, in the light of the *Gambrinus* case, that we have been furnished by the Court with no plausible grounds to deny obsolescence of goodwill.

It is submitted that the inclusion in the statute of "obsolescence," "exhaustion, wear and tear" has no tendency to show that the allowance is restricted to the obsolescence of tangible property.<sup>21</sup> To exclude goodwill from the statute is to incorporate into the statute a distinction and limitation which is not in accord with the intent of the unrestricted language thereof. Such restrictive interpretation represents an endeavor to read into the statute limitations which it does not contain or provide for. It has been recognized that "the plain, obvious and rational meaning of a statute is

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<sup>20</sup> *United States v. Carver*, 260 U. S. 482, 43 Sup. Ct. 181 (1923). Holmes, J., at 490: "The denial of a writ of *certiorari* imports no expression of opinion on the merits of the case, as the bar has been told many times."

<sup>21</sup> (a) The history of the statute indicates that "there is obviously no limitation on the kind of property to which the allowance attaches—personal, real and mixed; tangible and intangible."—KLEIN, *op. cit. supra* note 17 at p. 652.

(b) The term "exhaustion" is not confined to physical consumption, lessening or diminution of tangible property, but includes the *exhaustion of value or usefulness* of intangible property having a limited useful life (*supra* note 4).

always to be preferred to any curious, narrow, hidden sense."<sup>22</sup> In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used.<sup>23</sup> In case of doubt, they are construed most strongly against the government and in favor of the taxpayer.<sup>24</sup>

It is further submitted that the allowance for obsolescence is as necessary for the computation of net income in the case of goodwill property as in the case of tangible property,<sup>25</sup> and therefore the former should merge equally with the latter within the comprehension of the unrestricted language of the statute. The term "property" in the act under consideration is not used in a restricted sense.<sup>26</sup> Goodwill is property of an intangible nature, and the term "property" includes goodwill, the importance of goodwill property having been universally recognized in recent years.<sup>27</sup> Goodwill property is clearly used in the business just as other intangibles are.<sup>28</sup> It may be bought and sold therewith and as an incident thereof.<sup>29</sup> There is no doubt that the goodwill property of the brewing companies was rendered obsolete by the adoption of prohibition. Where the goodwill represents money, labor, and time invested in building up the business, it should be considered a capital asset, indistinguishable from other property for which the deduction is allowed.

That there is much confusion in the courts dealing with this subject has been shown. Further clarification by the Supreme Court is of the utmost importance. If the deduction allowance for goodwill is economically justified, the Supreme Court should make it legally so.

THEODORE S. WECKER.

<sup>22</sup> *Lynch v. Alworth Stevens*, 267 U. S. 364, 45 Sup. Ct. 274 (1925).

<sup>23</sup> *Gould v. Gould*, 245 U. S. 151, 38 Sup. Ct. 53 (1917); *United States v. Field*, 255 U. S. 257, 41 Sup. Ct. 256 (1920); *Schwab v. Doyle*, 258 U. S. 529, 42 Sup. Ct. 391 (1922); *United States v. Merriam*, 263 U. S. 179, 44 Sup. Ct. 69 (1923).

<sup>24</sup> *Crocker v. Malley*, 249 U. S. 223, 39 Sup. Ct. 270 (1918); *Smietanka v. First Trust & Savings Bank*, 257 U. S. 602, 42 Sup. Ct. 223 (1922); *Hecht v. Malley*, 265 U. S. 144, 44 Sup. Ct. 462 (1923); *Reinecke v. Northern Trust Co.*, 278 U. S. 339, 49 Sup. Ct. 123 (1928).

<sup>25</sup> *Doyle v. Mitchel Bros.*, 247 U. S. 179, 38 Sup. Ct. 467 (1918); *United States v. Ludley*, 274 U. S. 295, 47 Sup. Ct. 608 (1927).

<sup>26</sup> *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U. S. 436, 13 Sup. Ct. 944 (1893); *Washburn v. National Wall Paper Co.*, *et al.*, 81 Fed. 17 (C. C. A. 2d, 1897); *Coca Cola Bottling Co. v. Coca Cola Co.*, 269 Fed. 796 (D. C. Del., 1920).

<sup>27</sup> *Kaufman Straus Co. v. Lucas*, 12 F. (2d) 774 (C. C. A. 6th, 1926); *Phillip Henrici Co. v. Reinecke*, 3 F. (2d) 34 (D. C. N. D. 111, 1924).

<sup>28</sup> *Camden v. Hunt*, 144 U. S. 104, 12 Sup. Ct. 586 (1892); *Sawilowsky v. Sawilowsky*, 288 Fed. 533 (C. C. A. 5th, 1923); *Coca Cola Bottling Co. v. Coca Cola Co.*, *supra* note 26 at p. 805.

<sup>29</sup> *Supra* note 26.