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Income Tax--Acceleration of Depreciation on a Racehorse

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and agent. In many of these cases public policy and social justice would dictate liability. But, at the common law, the principal-agent relationship must necessarily be established before the rule of respondeat superior is applicable.

Such a result is exemplified by a recent decision handed down by a United States District Court of North Carolina.[9] In that case a son was using an automobile with the express consent of his mother when an accident occurred. There was no express consent by his father, but there was evidence that the father knew the son did occasionally drive the car. The court held this evidence insufficient to establish that use by the son was permissive or in pursuit of a purpose for which the parent provided the car. Therefore the son was not acting within the implied scope of agency necessary for invoking the Family Purpose Doctrine. This court further stated:

> The legal reasoning behind the rule is that when one provides and maintains a car for the use, convenience and pleasure of a member of his family, he constitutes that member his agent, and when the member so uses it he is acting within the scope of such agency.[10]

This reasoning forced the North Carolina District Court to reach a result believed by the writer to be contrary to general public policy. In contrast, recognition of public policy as the true legal basis of the Family Purpose Doctrine has enabled the Kentucky Court to take a more liberal view in applying the doctrine to impose liability. As the Kentucky Court said in the *Turner* case, "The purpose of this doctrine would be destroyed entirely if a father could relieve himself of responsibility by specific instructions known only to himself and his son."[11]

Charles E. English

INCOME TAX—ACCELERATION OF DEPRECIATION ON A RACEHORSE—Petitioner purchased a racehorse, "Baby Jeanne," in August 1948 for $9,000. In 1949 she partially bowed a tendon and was placed on a farm in Kentucky from April to October, 1949. During 1950 "Baby Jeanne" raced 19 times and placed twice. On October 14, 1950, she bowed a tendon completely and, *as a racehorse,* had no value. The petitioner sold "Baby Jeanne" for $1,000 in December, 1950. Using the straight line method, the petitioner had taken depreciation of $1,500 ($375 in 1948 and $1,125 in 1949). In 1950 the petitioner claimed depreciation of $6,500 (cost of $9,000 less depreciation

[9] Cronenberg v. United States, 123 F. Supp. 693, 704 (E.D.N.C. 1954).
[10] Ibid.
[11] Turner v. Hall's Adm'x., 252 S.W.2d 30, 32 (Ky. 1952).

previously claimed of $1,500 and the sale price of $1,000). The Commissioner allowed depreciation on the horse in 1948, 1949 and 1950 in the amounts of $500, $1,500 and $1,500 respectively. The Commissioner allowed the difference between the depreciated cost ($5,500) and the sale price ($1,000)-or $4,500-as a long term capital loss. The Tax Court[1] upheld the Commissioner and the taxpayer petitioned for a review of the decision. *Held:* affirmed.[2] There was no showing that the injury could be attributed to excessive use or added wear and tear. Such showing is essential to entitle a taxpayer to an allowance for accelerated depreciation. *Whitaker v. Commissioner*, 259 F.2d 379 (5th Cir. 1958).

This seems to have been a case of first impression. There were no similar cases to follow nor conflicting opinions to settle. Even analogies to machinery are somewhat superficial. Therefore, this is basically a question of whether the statutes were properly interpreted and applied.

The court reasoned that accelerated depreciation depends upon the showing that the effective life of the subject matter (noting that a racehorse may be like a delicate piece of machinery) was shortened by excessive use, added wear and tear.[3] It may be conceded that accelerated depreciation with regard to machinery has been held to depend on the showing of some relationship between the excssive use and the decreased usefulness. This requirement, however, seems to conceive of depreciable property growing useless at a rate which can be determined by the amount of use as the steadily operating cause. Regardless of the reasonableness of such a concept when it concerns machinery, etc., where replacement parts can be used to keep the growing uselessness at a steady rate, it is not completely satisfactory when animals are concerned. The physical incapacity of the racehorse in this case was not physical deterioration[4] which might have been anticipated or foreseen by the taxpayer. Termination of the horse's

[1] B. F. Whitaker, 27 T.C. 399 (1956).

[2] The court also affirmed the part of the decision holding that where under verbal agreements the owner of a mare paid entire stud fee to owner of stud when mare owner determined his mare was in foal and no part of such fee was withheld pending birth of a live foal, although, if a foal was not born alive, stud fee was to be refunded, stud fees received under such agreements were income in the year they were received rather than in the following year when the foal was born, and refunds in case of still born foals constituted deductions in the year paid. Whitaker v. Commissioner, 259 F.2d 379 (5th Cir. 1958).

[3] Id. at 385, citing Commissioner v. H. E. Harman Coal Corp., 200 F.2d 415, 419 (4th Cir. 1952) *affirming* H. E. Harman Coal Corp., 16 T.C. 787, 802 (1951) and cases cited; Copifer Lithograph Corporation, 12 T.C. 728 (1949).

[4] Webster's New Int'l Dictionary 711 (2d Ed. 1939), defines "deterioration" as: 1. "Act or process of deteriorating, or state of having deteriorated; gradual impairment . . ." thus "deterioration" in common usage (the courts not having defined it) seems to connote a progressive process of becoming inferior.

useful life as a racehorse was sudden and unforeseeable and could have been the result of any one of several possible causes.[5] The Tax Court stated, "The practical question is whether the petitioner can deduct his loss in full or in part. The method used by the petitioner would deduct it in full."[6] Even conceding that disallowance of the total loss as a deduction for accelerated depreciation was justifiable under the authorities, perhaps the loss in value should have been fully deductible for other reasons.

It was agreed that bowing a tendon was similar to an "accident" or the "sudden malfunctioning" of a piece of machinery.[7] It may be inferred from these words that the court was thinking of a casualty loss. "Casualty" is defined in the dictionary as "[c]hance; accident; contingency; also, that which comes without design or without being foreseen; an accident."[8] The word may, for purposes of the Internal Revenue Code, have a slightly more restricted meaning. For purposes of the Code a "casualty" has been defined as an event due to some sudden, unexpected or unusual cause.[9] The word "denotes an accident, a mishap, some sudden invasion by a hostile agency."[10] Thus, even using the words of the court, this loss would apparently be deductible as a casualty loss.

Horse racing, in the *Whitaker* case, was one of the businesses of the taxpayer.[11] By asserting that the loss resulted from the casualty and not from the sale,[12] and that the sale only substantiated the salvage value of the horse, it seems that the loss would have been deductible under section 23 (e) (1) of the Internal Revenue Code of 1939.[13]

[5] U.S. Dept. of Agriculture, "Miscellaneous Diseases of Equines", Agricultural Yearbook of 1942, at 417, 433-434. "Horses used in such sports as hunting, racing, and polo are frequently injured in this way (sprains) as a result of overweighting, fast work on a wet track or field or in rough country, improperly balanced shoes, and the sudden stresses which are frequently encountered in competition." "Bowed tendon" is an abnormality resulting from this strain. *Accord:* Lacroix, Lameness of the Horse, 135-142.

[6] 27 T.C. at 406.

[7] Whitaker v. Commissioner, supra note 2, at 385, where the court asserted, "It seems to us, as it seemed to the Commissioner and the Tax Court, that bowing of a tendon is similar to an accident or the sudden malfunctioning of a piece of machinery."

[8] Webster's New Int'l Dictionary 419 (2d ed. 1939).

[9] Matheson v. Commissioner, 54 F.2d 537, 539 (2d Cir. 1931), interpreting § 214 (a) (6), Revenue Act of 1921; also annot. 41 A.L.R.2d 691, 696 (1955).

[10] Fay v. Commissioner, 120 F.2d 253 (2d Cir. 1941).

[11] Whitaker v. Commissioner, supra note 2, at 381.

[12] *Accord:* Industrial Cotton Mills Co., Inc., 43 B.T.A. 107 (1940), where because of changes in business conditions petitioner discarded certain machinery and equipment and recovered the salvage value thereof in the taxable year the court held that the loss sustained did not result from a sale of capital assets, but instead resulted from a loss of useful value of capital assets and that the loss was deductible in full. S.S. White Dental Mfg. Co. v. United States, 102 Ct. Cl. 115, 55 F. Supp. 117 (1944) gave same effect on abandonment of branch factory sold for salvage in the same year.

[13] 53 Stat. 12 [now Int. Rev. Code 1954, § 165 (e) (1)].

The Tax Court in the *Whitaker* case held[14] that the petitioner's loss was a capital loss deductible as provided for in Int. Rev. Code of 1939, section 117 (j).[15] Normally this section would not seem to decrease the percentage of the loss deductible in this situation. Section 117 (j) (2) of the Int. Rev. Code of 1939 was the same in wording as section 1231 (a)(1) and (2) of the Int. Rev. Code of 1954. In effect, if the section 1231 losses exceed the section 1231 gains, all the section 1231 gains are treated as ordinary income, and all the section 1231 losses are treated as ordinary losses.[16] Thus a net loss from the involuntary conversion of a section 1231 asset held for more than 6 months[17] is treated as an ordinary loss[18] and is not subject to the limitation on capital losses in section 1211.[19]

Full deductibility of these losses has been recognized by the courts on two occasions as to sales of land.[20] On another occasion the courts recognized the full deductibility of losses on the sale of race horses under section 117 (j)(2) of the Int. Rev. Code of 1939.[21] Int. Rev. Code of 1939, section 117 (j)(2) (B)[22] provided that "[l]osses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion." Can the taxpayer in the *Whitaker* case classify his sale as an involntary conversion under this definition?

In the *Sullivan* case the Tax Court went even further in interpret-this section of the Code. The Commissioner had, in order to "consider" the losses on the sale of horses as losses from sales "of capital assets held for more than 6 months" within the meaning of Int. Rev. Code of 1939, section 117 (j)(2), offset against those losses all of the gains

14 B. F. Whitaker, supra note 1, at 406.

15 Added by ch. 619, 56 Stat. 844-847 (1942) (now Int. Rev. Code of 1954, § 1231).

16 Treas. Reg. § 1.1231-1 (1957); 1 P-H 1959 Fed. Taxes ¶¶ 5221 and 5226.

17 Int. Rev. Code of 1954, § 1231 (b) (3) requires livestock to be held 12 months or more for this section to apply.

18 Treas. Reg., § 1.1231-1 (b) (2) (1957); P-H 1959 Fed. Taxes ¶ 5226 at 4983.

19 Int. Rev. Code of 1954, § 1211, limits net capital losses from sale or exchanges of capital assets to $1,000 in excess of capital gains from such sales or exchanges.

20 Losses from sale of land upon which taxpayer had erected office building to make it readily resalable but which he had used for twenty years in his business of owning and renting office space were governed by Int. Rev. Code of 1939, § 117 (j), 53 Stat. 50 (now Int. Rev. Code 1954 § 1231), and deductible in full in determining taxable net income. Jay Burns, 21 T.C. 857 (1954), *rev'd on other grounds*, 219 F.2d 128 (5th Cir. 1955). Losses sustained on sales of acreage were deductible in full under Int. Rev. Code of 1939, § 117 (j), 53 Stat 50 (now Int. Rev. Code 1954 § 1231). Graves Bros. Co., 17 T.C. 1499 (1952).

21 John L. Sullivan, 17 T.C. 1420 (1952), *aff'd* 210 F.2d 607 (5th Cir. 1954) without discussion of this point.

22 Now Int. Rev. Code of 1954, § 1231 (a) (2).

from sales of capital assets held for more than 6 months.[23] The Tax Court, however, held that:

> A proper interpretation is that not all gains on capital assets held for more than 6 months are to be considered for the purposes of section 117(j)(2) but *only* the *recognized gains from the compulsory or involuntary conversion of capital assets* held for more than 6 months into other property or money.[24] (Emphasis added)

Although the court did not discuss what type of casualty was involved in the sale of the two horses in that case, the losses were noted to be casualty losses.[25] Thus the taxpayer in the *Whitaker* case could, it seems, have claimed full deductibility on his losses as an involuntary conversion even under the section of the Code which the Commissioner and the courts held applicable to this situation. This, however, leaves one question unanswered. Did the petitioner in the *Whitaker* case have recognized gains from *compulsory or involuntary conversion* of capital assets held more than 6 months to offset this loss? The answer to this question cannot be ascertained from the reports of the Tax Court nor the report of the Circuit Court.

For taxable years beginning after December 31, 1957, Int. Rev. Code of 1954, section 1231(a) is inapplicable to uninsured casualty and theft losses.[26] Such losses will always be treated as ordinary losses and will not offset gains which might otherwise be treated as capital gains under section 1231.[27] No such amendment, however, has been added to exclude casualty losses from the special provisions governing reinvestment after an involuntary conversion under section 1033.[28] A taxpayer would be reasonably safe in assuming that a casualty like that in the *Whitaker* case would satisfy the "destruction in whole or in part" requisite for the operation of section 1033, thus permitting him to elect not to recognize any gain from the involuntary conversion of his property.[29]

[23] John L. Sullivan, 17 T.C. 1420, 1425 (1952).

[24] Id. at 1426.

[25] Id. at 1423. In that case the Commissioner disallowed the casualty loss as an ordinary deduction. This point was not discussed by the Tax Court apparently because the court decided that the losses were nevertheless fully deductible under § 117 (j) (2) of the Int. Rev. Code of 1939 where the Commissioner had put them in attempting to offset the losses against capital gains.

[26] Int. Rev. Code of 1954, § 1231 (a), as amended, 72 Stat. 1642 (1958).

[27] 4 CCH 1959 Stand. Fed. Tax Rep., ¶ 4729.012.

[28] Int. Rev. Code of 1954, § 1033, provides that if property as a result of its destruction in whole or in part is compulsorily or involuntarily converted, no gain shall be recognized to the extent that the taxpayer uses, within a specified period, money received upon such conversion when he purchases other property similar or related in service or use to the property so converted.

[29] Similar casualty losses already treated as involuntary conversions under this section are livestock destroyed by disease [§ 1033 (f), as amended, ch. 464, § 5 (a), 70 Stat. 407 (1956)]. A very close analogy it seems could be drawn between bowing a tendon and these casualties.

Conclusion

It seems very probable that the taxpayer had a sound basis for claiming a deduction for his loss in *Whitaker*. It is submitted, however, that there are more reasonable theories than the accelerated depreciation argument upon which he proceeded. The loss would seem to be fully deductible either as a casualty loss or as a section 117(j)[30] loss, except for the possibility, not discernible from the statement of facts in the particular case, that taxpayer may have had gains from similar involuntary conversion transactions against which he would have been required to offset the loss.

Thomas L. Jones

TORT—NEGLIGENCE-MANUFACTURER'S LIABILITY—TERMINATION OF RISK—The plaintiff, a four-year old boy, fell from a moving automobile when the door came open. The plaintiff's mother had recently purchased the automobile new from defendant dealer. The door from which the plaintiff fell was known to have a tendency to "bind" and it was often necessary to slam it several times to latch it. Two other doors had previously come open and the purchaser had taken the automobile to the dealer for repair, but on neither occasion did she mention the "bind" in the door from which the plaintiff fell. An action was brought against the manufacturer and dealer alleging that the automobile was defective and that the defendants were negligent in its manufacture and sale. Evidence proved the automobile had been constructed with a warped frame and defective locks. The jury returned a verdict for the plaintiff and from judgment entered thereon the defendants appealed on grounds that they were entitled to a directed verdict. *Held:* reversed. The purchaser, in continuing to operate the automobile daily with knowledge that the doors could not be depended upon to function properly, was negligent as a matter of law. This was an intervening cause of the accident which relieved the defendants from liability. *Ford Motor Company v. Atcher*, 310 S.W.2d 510 (Ky. 1957).

The Court of Appeals was faced with a problem of risk termination. Risk termination is the extent to which the risk of harm caused by the actor's negligence will render him liable for injuries caused thereby. Specifically, the question before the court was whether the duty owed to the plaintiff by the defendants was terminated by the negligence of the purchaser in continuing to operate the automobile with knowledge

[30] Now Int. Rev. Code of 1954, § 1231.