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Income Tax Department

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Income Tax Department

EDITED BY JOHN B. NIVEN, C.P.A.

The most hopeful forecast that has been received regarding the passage of the revenue bill is that it may be reported by the conferees and passed by both houses ready for the signature of the president by February 1, 1919.

Supreme court decisions have been quoted in which the right of congress to impose a tax measured by the income of the previous year is affirmed, thus setting at rest the doubts that have been circulated as to the constitutionality of an income tax law retroactive in its effect and even if enacted in a year subsequent to that to which it relates.

The only new ruling available, bearing on income taxes, is T. D. 2773. It relates to the 1909 corporation excise tax law, but is of interest because of its distinction, as made by the court, between maintenance and depreciation. Maintenance, "the upkeep or preserving of the condition of the property includes the cost of ordinary repairs necessary and proper from time to time for that purpose." But "depreciation is not to be confused with ordinary repairs," and is "intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property in spite of ordinary current repairs." Hence repairs were deductible as an "expense," and depreciation also, because specifically mentioned in the act.

The 1917 act contains substantially the same wording in dealing with the same subject, which is further explained in article 159 of regulations 33. Depreciation is there described as the loss "from wear and tear due to the use to which the property is put and which loss has not been made good through expenditures for renewals, replacements and repairs deducted under the heading of expense for maintenance and operation."

TREASURY RULING

(T. D. 2773, November 8, 1918.)

Special excise tax on corporations—Decision of court.

A steamship company is entitled to deduct from gross income in annual tax returns required by section 38 of the act of August 5, 1909 (36 Stat., 112), amounts paid out for ordinary and necessary repairs in the maintenance and operation of its business and property and in addition a reasonable allowance for depreciation of property, if any.

IN THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DIVISION OF THE NORTHERN DISTRICT OF CALIFORNIA, SECOND DIVISION. No. 15782.

The San Francisco & Portland Steamship Co., plaintiff, v. John J. Scott, collector of internal revenue, etc., and August F. Muentzer, defendants.

Income Tax Department

[Memorandum by BEAN, district judge (sitting by special assignment).]

This action is to recover certain amounts paid by the plaintiff under protest as excise taxes levied under the act of congress of August 5, 1909, section 38 (36 Stat. L., 112) for the years 1910 and 1912.

In its returns plaintiff included in its deductions for ordinary and necessary expenses paid out for the maintenance and operation of its business and property, for the year 1910, \$17,088.77 and for the year 1912 \$25,371.40, being amounts expended in each of such years for making "ordinary and necessary" repairs to the deck department, engine department, and commissary department of its steamers, and also \$59,642.11 for 1910 and \$79,350.96 for 1912 for depreciation of such steamers, being 5 per cent. of the book value thereof.

It is admitted that the deductions for depreciation are reasonable and should be allowed, but the commissioner ruled that the cost of making *ordinary and necessary* repairs was not a proper item to be included in the operation and maintenance expenses but was covered by the deductions for depreciation and required plaintiff to pay taxes thereon, which it did under protest and hence this suit.

The question thus raised does not seem to have been directly decided in any reported case to which my attention has been called or which I have been able to find, although the cost of repairs and upkeep was assumed in *Grand Rapids & Indiana Railway v. Doyle* (245 Fed., 792) to be an item properly included in operating and maintenance expense.

Under the law the tax is to be laid on net income and such net income is to be ascertained by deducting from the gross income (1) all the ordinary and necessary expenses actually paid within the year out of income in the "maintenance and operation" of the business and property; (2) losses actually suffered not covered by insurance, including a reasonable allowance for depreciation, if any. * * *

It will thus be seen that the deductions allowed are to include not only ordinary and necessary amounts actually paid out in the operations of the property but also the amounts paid out in the maintenance thereof, and in addition a reasonable sum for depreciation, if any. Now, the operation of a business or property includes payment for labor and materials which go into the actual operation thereof, while maintenance means the upkeep or preserving the condition of the property to be operated and therefore, in my judgment, includes the cost of ordinary repairs necessary and proper from time to time for that purpose. Depreciation as used in the statute is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property in spite of ordinary current repairs. It follows that the tax complained of was illegally exacted and the plaintiff is entitled to judgment for its recovery. Findings may be prepared accordingly.