Calendar No. 1091

82D CONGRESS
2d Session

SENATE

REPORT
No. 1160

ADJUSTMENTS TO BASIS ON ACCOUNT OF EXCESSIVE DEPRECIATION

FEBRUARY 6 (legislative day, JANUARY 10), 1952.—Ordered to be printed

Mr. GEORGE, from the Committee on Finance, submitted the following

REPORT

[To accompany H. R. 3168]

The Committee on Finance, to whom was referred the bill (H. R. 3168) to amend section 113 (b) (1) (B) of the Internal Revenue Code with respect to the adjustment of the basis of property for depreciation, obsolescence, amortization, and depletion, having considered the same, report favorably thereon with an amendment and recommend that the bill, as amended, do pass.

GENERAL STATEMENT

H. R. 3168 amends section 113 (b) (1) (B) of the Internal Revenue Code (relating to the adjustment of the basis of property for depreciation, obsolescence, amortization, and depletion) to provide, in general, that the basis of property shall be adjusted by the amount of depreciation previously allowable, or by depreciation previously allowed, if that was more than the amount allowable, but only to the extent that the deduction of the excess amount reduced income or excess profits taxes for any year.

This amendment is intended to correct the situation created by the decision of the Supreme Court in *Virginian Hotel Corp.* v. *Helvering* (319 U. S. 523 (1943)), which has been followed by three court of appeals decisions in which certiorari was denied by the Supreme Court.[1] The rule in the Virginian Hotel case construed those provisions of the Revenue Act of 1932 which are equivalent to what is now section 113 (b) (1) (B) of the Internal Revenue Code.

The law prior to the Revenue Act of 1932 provided that the basis of property should be reduced by the depreciation allowable over the previous life of the property. The law was amended in 1932 to add another provision requiring that, where depreciation in excess of

[1] *Commerce Company* v. *United States* (171 F. 2d 189, certiorari denied 336 U. S. 972); *Piedmont Cotton Mills* v. *Commissioner* (177 F. 2d 148, certiorari denied 339 U. S. 919); and *Blackhawk-Perry Corp.* v. *Commissioner* (182 F. 2d 319, certiorari denied 340 U. S. 875).

that allowable had been actually allowed, the excess allowed over that properly allowable should also reduce the basis of the property. The purpose of that amendment was to provide that, where taxes had been reduced by excessive depreciation erroneously claimed and the statute of limitations had barred the collection of the correct tax, the taxpayer could not then claim that he could restore to basis the amount of the excess depreciation. If this latter result had been permitted, the taxpayer in effect would have been allowed a double deduction.

In the Virginian Hotel case the Supreme Court construed the 1932 amendment to mean that, where a taxpayer had claimed excessive amounts for depreciation in his returns for earlier years now closed, such excessive amounts were properly deductible from cost in readjusting the basis of the property in question, even though in those years the taxpayer had received no tax benefit from the depreciation deduction. Thus, the taxpayer would be penalized because of his error in claiming excessive depreciation in an earlier year, even though for that year he had a net loss (not capable of being offset against income of a preceding or succeeding year) even without the deduction of the excessive depreciation. Under those conditions the excess depreciation claimed by the taxpayer could have resulted in no tax advantage to him and in no tax prejudice to the Government. Mr. Chief Justice Stone, in his dissent to the Virginian Hotel decision in which he was joined by three other members of the Court, termed the above rule an "incongruous" result which was contrary to the statute. This legislation is intended to correct the inequitable tax effects which resulted, or which would in the future result, from the application of the rule of the Virginian Hotel decision.

The bill as passed by the House would have corrected the effects of the Virginian Hotel decision only with respect to the computation of tax liabilities for taxable years beginning after December 31, 1947.

Your committee has amended the bill so as to provide that the amendment may be applicable to taxable years beginning after December 31, 1931, rather than December 31, 1947, as the House version provides. This will reinstate the intent of Congress with respect to section 113 (b) (1) (B) of the Revenue Acts of 1932, 1934, 1936, and 1938 and the Internal Revenue Code. Since the principle embodied in the bill has been endorsed by the House and by this committee, it seemed desirable to extend that principle to all open years to which it is applicable. Retroactive application to these years will remedy the injustice of the Virginian Hotel decision as fully as is possible without lifting the bar of the statute of limitations. If the amendment were made applicable in all cases for all taxable years ending after December 31, 1931, however, the effect might have been to reduce the excess profits credits of certain taxpayers without providing for a proportionate reduction of their excess profits net income; and in other cases the effect might have been to prevent taxpayers from taking advantage of some of the relief provisions of the present excess profits tax law, without affording them corresponding advantages. For those reasons the application of the amendment to periods before January 1, 1952, is made elective, so that no taxpayer need be hurt by retroactive legislation.

The Treasury Department has now concluded that the additional revenue loss resulting from making the amendment applicable to taxable years beginning prior to January 1, 1948, will be in the neighbor-

hood of $7 million. The staff of the Joint Committee on Internal Revenue Taxation agrees. The revenue loss resulting from the application of the bill only to tax liabilities for 1948 and subsequent years, as in the House bill, is now estimated to be in the neighborhood of $56 million. Thus the total revenue loss resulting from your committee's bill (excluding interest of approximately $7 million) is estimated as about $63 million.

Technical Analysis

As passed by the House, H. R. 3168 amended section 113 (b) (1) (B) of the Code to provide that the unadjusted basis of property shall be reduced by depreciation, etc., to the extent allowed "as deductions in computing net income and resulting in a reduction of the taxpayer's taxes," but not less than the amount allowable, under chapter 1 of the Internal Revenue Code or prior income-tax laws.

Your committee has amended H. R. 3168 to provide in greater detail certain rules for determining the amount of the excessive deduction for depreciation, etc., which may be ignored in the adjustment to the basis of property, and to provide that the disregard of depreciation, etc., allowed by reason of this bill shall be elective for periods prior to January 1, 1952. Under your committee's amendment, the rules for determining adjustments to basis where deductions have been allowed are set forth in two new clauses, (i) and (ii), added to section 113 (b) (1) (B) of the code.

Under clause (i), the basis of property shall be reduced to the extent of the amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code or under prior income-tax laws. Clause (ii) provides that the basis shall be so reduced, however, only to the extent the deductions so allowed resulted in a reduction for any taxable year of the taxpayer's taxes under chapter 1 of the Code (other than subchapter E thereof, relating to self-employment taxes), subchapter E of chapter 2 (the World War II excess-profits tax), or under prior income, war-profits, or excess-profits tax laws. The determination under clause (ii) of whether a deduction resulted in a tax benefit for any taxable year shall be made by ascertaining whether the tax for such year would have been greater but for such deduction having been allowed. In making such determination any reduction in tax for the taxable year for which the deduction was allowed and also any reduction in tax for a preceding or succeeding taxable year (for example, by reason of any carry-over or carry-back of net operating loss or unused excess-profits credit) must be taken into account.

Your committee continues the provisions of existing law, also included in the House bill, which require that the basis of property shall be reduced in any case by amounts allowable whether or not any tax benefit is derived therefrom.

The tax-benefit rule set forth in clause (ii) of section 113 (b) (1) (B) shall apply in respect of depreciation, etc., for all periods after December 31, 1951. However, in respect of the depreciation, etc., for any period after February 28, 1913, and before January 1, 1952, the requirement of clause (ii) that the deduction shall operate to reduce taxes (as distinguished from the requirement of clause (i) that the deduction be allowed) shall be applicable only if an election has been

made under new subsection (d) added to section 113 of the code by your committee. If the election is not made, the bill does not change the rule under existing law with respect to the adjustment to basis for depreciation, etc., for the period before January 1, 1952.

The new subsection (d) provides that any person may elect to have clause (ii) of section 113 (b) (1) (B) apply and that such election shall apply with respect to all periods after February 28, 1913, and before January 1, 1952, with the period during which such person held the property and the period, if any, for which adjustments must be made as provided in section 113 (b) (2) of the code, relating to substituted basis. The election must be made on or before December 31, 1952, shall be irrevocable, and shall be made in such manner as the Secretary may prescribe by regulations. An election may not be made with respect to a particular property but shall apply to all properties held by the person making the election at any time on or before the date of such election. In the case of a partnership or trust, an election as to property held by such partnership or trust shall be made by the partnership or trust rather than by the individual partners or beneficiaries.

Subsection (d) further provides that an election by a transferor, donor, or grantor after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. Where a transferor, donor, or grantor makes an election on or before the date of the transfer of the property, proper adjustments under section 113 (b) (2) giving effect to the election shall be made to the basis of the property in the hands of the transferee, donee, or grantee in respect of the period during which the property was held by the transferor, donor, or grantor. If the transferee, donee, or grantee makes the election on or after the date of the transfer, gift, or grant, the election is applicable in making the adjustment to the basis of property in respect of the period during which such property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor made an election under section 113 (d). An election by a transferee, donee, or grantee will not affect the tax liability of the transferor, donor, or grantor

The determination of the amount of depreciation, etc., which is allowable in any taxable year to which section 113 (b) (1) (B) (ii) is applicable shall be made in a manner consistent with such section. If prior to the enactment of this bill there was a final decision of a court determining the amount of depreciation allowable for a particular taxable year, the determination (but only for the purposes of this amendment) of the amount allowable for that year, or for subsequent taxable years, by reason of the application of section 113 (b) (1) (B) (ii) must be adjusted to reflect this change in the law.

A taxpayer seeking to limit his adjustment of basis with respect to excessive deductions for depreciation, etc., must establish that such excessive deductions did not produce a tax benefit. Certain taxpayers may not have available adequate records to establish such lack of tax benefit. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction for the taxable years 1946 and 1947 of excessive depreciation, but may not have available adequate records with respect to the deduction of excessive depreciation for a prior period during which the property was held by its transferor. In such case, the corporate transferee

shall not be denied the right to apply section 113 (b) (1) (B) (ii) with respect to the excessive depreciation for the period for which adequate proof is available.

Your committee contemplates that the Secretary shall prescribe regulations setting forth rules for the determination of tax benefit in cases involving depreciation, etc., with respect to more than one property in the same taxable year; in cases involving priority between the tax-benefit rule of section 113 (b) (1) (B) and other sections, such as section 22 (b) (12) or section 127; in cases involving partnerships or trusts (in which cases the tax benefit of the partners and the beneficiaries must be taken into account); and in cases involving adjustments required under section 113 (b) (2) (in which cases the tax benefit of the transferor, donor, or grantor must be taken into account, as well as any tax benefit attributable to a carry-over from such persons, as under Public Law 189, 80th Cong., approved July 15, 1947).

The bill as passed by the House provided that the amendment made to section 113 (b) (1) (B) of the code shall be applicable to taxable years beginning after December 31, 1947. Your committee has provided that the amendments to the code shall apply in respect of taxable years beginning after December 31, 1938 (that is, the taxable years to which the code is applicable), and that provisions having the effect of such amendments shall be deemed to have been included in the revenue laws respectively applicable to taxable years ending after December 31, 1931, and beginning before January 1, 1939. However, this retroactive amendment does not open for refund or credit, or assessment of a deficiency, any taxable year for which such refund or credit, or such assessment, is barred by any law or rule of law.

CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, H. R. 3168, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

* * * * * * *

(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General rule.—Proper adjustment in respect of the property shall in all cases be made—

(A) * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent [allowed (but not less than the amount allowable) under this chapter or prior income tax laws] *of the amount—*

(i) allowed as deductions in computing net income under this chapter or prior income tax laws, and

(ii) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this chapter (other than subchapter E), subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this chapter or prior income tax laws. Clause (ii) of this subparagraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under subsection (d). Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

* * * * * * *

(d) Election in Respect of Depreciation, Etc., Allowed Before 1952.—Any person may elect to have clause (ii) of subsection (b) (1) (B) apply in respect of periods since February 28, 1913, and before January 1, 1952. Such an election shall be made in such manner as the Secretary may by regulations prescribe, shall be irrevocable, and shall apply in respect of all property held by the person making the election at any time on or before the date on which the election was made and in respect of all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under subsection (b) (2). An election by a transferor, donor, or grantor, made after the date of the transfer, gift, or grant of property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. No such election may be made after December 31, 1952.

○