Denver Law Review

Volume 32 | Issue 3 Article 2

January 1955

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BUSINESS DEDUCTIONS UNDER THE 1954 INTERNAL REVENUE CODE

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The Internal Revenue Code of 1954 continues all the deductions that were available to businessmen under the 1939 code, but liberalizes some of them, and even does a little tightening up here and there.

In discussing the changes in the business deduction provisions, it is my purpose to be as sketchy as possible in describing the provisions and to emphasize the value of these changes to your clients. The most liberal laws in the world are of no benefit to you unless you make them work for you. I'll tell you what the changes are, but I'm more anxious to tell you how to make them work.

The deduction change with the broadest application and the best features for immediate tax savings is that relating to depreciation.

The 1954 code permits the use of any method that could be used under the 1939 code. It also permits you to depreciate new equipment according to any of the following methods:

(1) Declining balance at double the straight-line rate;

(2) The sum-of-the-years' digits; and

(3) Any other reasonable method in which the aggregate amount of depreciation taken in any year during the first two-thirds of the life of the facility does not exceed the amount that would have been permitted under the new declining balance method.

(4) As a fourth alternative, you may enter into a formal agreement with the Commissioner, setting forth the estimated useful life of the facility and thus the rate of depreciation you can take on it. This agreement may not be changed by either party unless evidence is brought out that was not available to the parties at the time the agreement was made.

We weren't sure how the sum-of-the-years' digits method would work in relation to property purchased or acquired during the year, but the proposed regulation would provide for apportioning the deduction. Thus, if you acquire a ten-year facility on October 1 of the first year you are using this method, instead of taking 10/55 of the value in the first year, you would take 3/12 of 10/55 in the first year, 9/12 of 10/55 and 3/12 of 9/55 in the second year, and so on.

It is important to note that the accelerated depreciation methods apply only to new equipment that has not heretofore been subject to depreciation. It does not apply to secondhand property, even though it has never been depreciated before; thus, if you turn your residence into a factory, you may not use the new methods.

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The new methods apply only to facilities acquired, constructed or re-constructed after 1953. If the construction or reconstruction was begun in 1953 and finished in 1954, the new methods apply only to the portion finished in 1954.

The new methods do not apply to any asset with an estimated useful life of less than three years.

Once you qualify for any of the new methods, you may use any combination of them for different assets or different classes of assets. By "classes" we mean any classification into which you put the assets, rather than a functional grouping.

In order to use any of the new methods all you do is compute your depreciation under the new method for the first taxable year after 1953 in which you have property eligible for the new method. You don't have to make an election.

Now what are the tax advantages involved in the use of the stepped-up depreciation methods?

(1) They enable you to buy new equipment, rather than secondhand equipment, and at the end of the first year the difference in cost will be negligible because of the high first-year write-off.

(2) You will be able to buy new equipment whether or not you have the cash for it.

(a) Banks which heretofore gave you the brush-off will be glad to make loans on productive facilities, because they know that the accelerated depreciation will enable you to pay off the loan while the facility still has value as collateral.

(b) You can afford it because the short-term financing will be less expensive than the long-term.

(3) You can use the new methods to convert ordinary income into capital gain. For example, assume an asset worth \$10,000 with a ten-year life. Under the declining balance method you could depreciate such asset \$4,880 in the first three years. But your facility is still worth \$7,000 and you sell it for that. You have a capital gain of \$1,880 (the difference between the \$7,000 you received and the \$5,120 to which you had depreciated the facility), but the same \$1,880 was the difference between the new and the old depreciation deductions which was taken against ordinary income. Thus, ordinary income is reduced to capital gains.

Depletion is a deduction in which there wasn't much change made, but what there was is a liberalization.

Cost depletion is continued as under the 1939 code, except that the new code provides for apportionment in estates. The depletion deduction is apportioned between the estate and the heirs, legatees and devisees on the basis of the estate income allocable to each.

Discovery depletion is eliminated because all wasting materials are now subject to percentage depletion.

Percentage depletion has been extended to include all wasting minerals under a catch-all clause which allows "all other minerals" (but those specifically named) 15 per cent depletion, unless the mineral is used for rip rap, ballast, road material rubble, concrete aggregates, etc., when the rate is 5 per cent. This use test applies only to the mine owner or operator and not to subsequent users.

The new law includes uranium at 23 per cent and creates a new group of strategic and critical minerals, most of which were heretofore depletable at 15 per cent, but are now allowed 23 per cent if produced from domestic sources. It applies also to waste or residue, such as mine tailings.

We get some breaks in the treatment of losses and loss carry-overs and carry-backs.

Before we get into a discussion of the carry-over and carry-back provisions, let's just mention in passing two benefits we derive from the new treatment of losses:

(1) Theft losses will now be deductible only in the year in which discovered, rather than in the year the loss was incurred as under the old law. No doubling.

(2) As under the old law, losses on stocks, bonds or other securities of an affiliated corporation are ordinary losses and not capital losses. However, the new law liberalizes the provision in that one of the requirements of the old law was that at least 90 per cent of the aggregates of the subsidiary's gross income be from business operations. Under the new law "gross income" is changed to "gross receipts," so that the test for business income is 95 per cent of gross receipts. But, gross receipts from the sale of stock or securities are defined by law as only the gain from such sales. Therefore, the gain from the sale of securities becomes a smaller proportion of the affiliate's gross receipts, and to that extent the provision is liberalized.

The net operating loss deduction has been liberalized in several ways:

(1) An operating loss for a tax year ending after 1953 can now be carried back two years, instead of one. Thus, a taxpayer with heavy Korean War profits in 1952 could recover some of the taxes paid then, if he had an operating loss in 1954. However, you can't use the new provision to recover excess profits taxes. Thus, a 1954 net operating loss could recover only income taxes in 1952 and income and excess profits taxes in 1953.

(2) An individual in business now gets the same break that corporations always had. That is, they can carry-back or forward losses realized on sales of machinery, buildings, etc. This includes losses on sale of the whole business.

This right to carry-back losses on the sale of business assets, plus the two-year carry-back, puts a premium on careful timing of a sale of all or part of your business at a loss. If you had a poor year in 1952 and a good one in 1953, the sale at a loss ought to be postponed until 1955. On the other hand, if 1952 was your big year, it would be a mistake to hold off selling this year in order to get a better price in 1955. For example, suppose you had income of $25,000 in 1952, no income in 1953. In 1954 you will break even in your business operations but contemplate selling some machinery at a loss of $15,000. Should you wait until 1955, looking for a better price, you would lose a recovery of the tax paid in 1952 on the top $15,000 of your income.

(3) The adjustments that under the old law limited the carry-back or carry-over are materially reduced in number. The old law required us to make these adjustments in order to make sure that only an economic loss was carried over or back, and not a loss that was a loss only for tax purposes. The new law provides, generally, that a taxpayer should be treated the same in a loss year as he is treated in any other year.

Thus, whereas under the old law you had to adjust for depletion allowances, tax-free interest, loss carry-overs and carry-backs, capital gains and losses and nonbusiness deductions, under the new law the adjustments for depletion and tax-free interest are entirely eliminated, and the nonbusiness deduction adjustment is of course liberalized in the manner we discussed relating to the sale of business property.

Moreover, the 85 per cent dividend-received credit has become a deduction instead of a credit and now may be included as part of the loss which may be carried over or back. In fact we get an even better break here, because in the loss year the 85 per cent dividend deduction is computed without the over-all limitation of 85 per cent of taxable income. Thus, taxpayers in a loss year get a better break than those in a profit year if the amount of dividends received is greater than the amount of other income.

The new code premits amortization of corporate organization expenses. The old law required that they be capitalized, and there was no way of deducting them before the corporation was liquidated. That was because there was no useful life. But the new code provides a useful life. It is at least five years. You can elect any period that is not shorter than five years, but the election must be made by the time the return has to be filed (including extensions of time for filing) for the year for which it is to apply. It won't apply to any expenses paid or incurred prior to August 16, 1954.

Expenses that may be amortized include those which are directly incident to creating the corporation, such as legal fees, state incorporation fees, expenses of temporary directors, cost of minute-book, etc. But the expenses of issuing stock are not included.

The period amortization is fixed at the time of the election and can't be changed thereafter. If you wait and elect to start to amortize organization expenses in a year after the year the corporation was organized, you lose part of the deduction.

The old confusion as to whether to expense or capitalize research and experimental expenses has been removed, not by a clear definition of what is a "capital expenditure" or what a "deductible expense," but by the simple method of letting the taxpayer elect to do it either way.

With the exception of exploration costs and the cost of acquiring or improving real property or buildings, you may elect to deduct any research or development expense whether or not it is a normally deductible item. It does not matter whether or not the expenditure results in depreciable property.

If the expenses are really capital expenses you have to elect to deduct them. The election may be made without permission in the first year in which such expenses are paid or incurred, and which begins after 1953 and ends after August 16, 1954. Election in any year after the first requires the Commissioner's permission. Election without consent requires that a statement be attached to the return, specifying the amount and type of each expenditure and giving a detailed description.

In case you don't want to deduct such expenses in the year paid or incurred, the new code gives you another election in respect to costs which are properly capital in nature. These may be amortized like corporate organization expenditures over a period of the taxpayer's choosing, but not less than sixty months.

This latter election is not available for expenses of research and experiments which result in depreciable or depletable property. If they are capital items, they must be expensed under the first election or amortized over the life of the item (not over the five-year or optional period).

For example, suppose the research results in a patent and you spend $15,000 for capital items. You elect to amortize over a sixty-month period, starting in August, 1954, when you put the new process into effect. In 1954 you can deduct $1,250 (five months at $250). In 1955, 1956, 1957 and 1958 you can deduct $3,000 a year, and in 1959 the remaining $1,750. Without the election, the patent would have been amortizable over a seventeen-year period.

This is also an election but does not have to be made in the first year. It can be made by the due date of the return (including extensions) in any year.

The new elections will permit smaller corporations without established research and development programs to start them.

It can provide a worthwhile deduction in a high corporate income year.

On the other hand, new corporations expecting slim earnings in the early years will probably want to defer the expenses to deduct from expected higher earnings later on.

The new code permits considerably liberalized deductions for charitable contributions. You will probably hear from another speaker on the increase in the limit an individual may give and, also, the reduction in the holding period on unlimited contributions.

I want to confine my remarks to two features as they affect strictly business people:

(1) Corporations are given a two-year carry-over of contributions in excess of the 5 per cent limit in any year. However, the carry-over, plus the contributions in the year to which it is carried over, may not exceed 5 per cent of the corporate net income for that year. The law is written a little peculiarly, and, while I

think you may not get away with it, the law says that each carry-over plus the charitable deduction for the year may not exceed the 5 per cent limit. It doesn't seem to preclude having two carry-overs, and having one plus the current year's deduction equal one 5 per cent, and the other plus the current year's deduction equal another 5 per cent.

(2) The net operating loss carry-back which under prior law could reduce or wipe out a charitable contribution deduction in the year to which carried back because it would reduce or wipe out the taxable income of which the charitable contribution was a percentage has been changed. Now carry-backs do not affect the percentages, and no adjustment need be made for loss carry-backs. This is not true of carry-overs. The charitable contribution limit is still figured on income reduced by the carry-over.

The big break given to farmers under the new code is the election to deduct expenses for soil and water conservation and for the prevention of land erosion. Prior to this code, farmers had to capitalize any expenditures for improvement to the land, and because land can't be depreciated they had to wait until they sold it to get back their improvement costs.

But under the new law the farmer may elect to expense, rather than capitalize, such expenses as levelling; grading; terracing; contour furrowing; construction, control and protection of diversion channels and drainage ditches, earthen dams, water courses, outlets and ponds; eradication of brush and planting of windbreaks.

The new election does not apply unless the expenditure is made on land used in farming either before or after the expenditure was made.

It does not apply to depreciable property, which must still be capitalized and depreciated over its useful life. Included in this list are items made of concrete, tile, metal or wood, such as tanks, reservoirs, pipes, conduits, canals, dams (other than earthen dams), wells and pumps.

It does *not* apply, and note this carefully, to expenditures that would be deductible even without the election. You can still deduct them and they aren't subject to the 25 per cent limitation. Thus, items found deductible in the *Collingwood* case[1] are deductible in full without any election and without any limitation.

Which brings us to the limitation. The total deduction may not exceed 25 per cent of the taxpayer's total income from farming for the year in which the deduction is made. Now there are two modifications of this:

(1) Any amount not usable in one year may be carried over indefinitely but cannot be used in a succeeding year to an extent that would make the deduction exceed 25 per cent of the income from farming in that year.

(2) Income from farming means all farming done by the

[1]Collingwood v. Commissioner, 20 T.C. No. 132.

taxpayer and is not limited to the farm on which the expenditures are made.

No deduction may be taken in a year in which there is no income from farming.

The amount not deducted because of the 25 per cent limitation does not become part of the taxpayer's basis in the farm. In fact if he sells that particular farm, the farmer can continue to carry-over any unused deduction against any subsequent farm income he may have. However, if he dies, or sells the farm and doesn't have any farm income thereafter, any unused deduction is lost.

You have to make the election. If made in the first year starting after 1953 and ending after August 16, 1954, you don't need consent of the Commissioner. You just attach a statement to your return specifying the amount of each type of expenditure and explaining it in detail. Once the election is made, you have to keep on expensing such items in subsequent years unless you get permission to change.

Any election made in a year subsequent to the first year in which you have such expenditures requires permission.

This is another provision in the law which permits the taxpayer to turn ordinary income into capital gain. Suppose you are a farmer and your average income from farming is $20,000 a year. You buy a piece of farm land that needs development or is run down. You use it in connection with your farm operations and spend $5,000 grading and levelling it. The following year you sell it at a $5,000 profit. You have a $5,000 capital gain on which you have to pay capital gains tax, but you also have a $5,000 deduction right off the top of your $20,000 farm income.

Hobby losses are somewhat liberalized. Under the old law if you sustained a loss of more than $50,000 in a business for each of five consecutive years, you had to recompute your taxes for each of the five years and limit the loss deductions to $50,000 in each year.

The new code continues this, but it gives the taxpayer some additional breaks in the computation of the $50,000 loss.

Under the old law you didn't count tax and interest deductions in determining whether your losses were over $50,000. You could deduct both, in addition to the $50,000 loss.

You still can, but now you have some more exceptions. Casualty and abandonment losses, losses and expenses of farming attributable to drought, and expenditures which you can elect to deduct or capitalize are not included in computing the $50,000 loss and are deductible in addition to the $50,000. Net operating loss carry-backs and carry-overs are not included in the computation of the $50,000 but are not deductible in addition to it.

These new "rules" of application may apply to prior years if they are included in a group of five consecutive years which ends with a year subject to the new law.

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