IN THE

United States Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Mary C. Young, *Petitioner,* vs. Commissioner of Internal Revenue, *Respondent.*	Docket No. 39825.
and	
Mary Young Moore, *Petitioner,* vs. Commissioner of Internal Revenue, *Respondent.*	Docket No. 39824.

APPELLANTS' OPENING BRIEF.

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STATEMENT OF THE CASE.

This is an appeal from a decision of the United States Board of Tax Appeals. The appeals of Mary C. Young and Mary Young Moore were consolidated before the Board of Tax Appeals, and are consolidated for the purpose of this appeal. The issues in the two cases are identical although there is a slight variation in the amount of tax.

STATEMENT OF FACTS.

The appellants are mother and daughter. They reside in Los Angeles. For many years they have been the joint owners of valuable lots located at the corner of

Seventh and Figueroa streets, Los Angeles, California. During 1917 they erected brick buildings on these lots at a cost of $50,000. The buildings were rented until 1924 when a lease was entered into for the period of 99 years. This lease was made with the Sun Realty Company in behalf of Barker Brothers and provided that the brick buildings then standing on the lots should be demolished and new buildings be erected by the lessee. This lease was obtained for the appellants by a real estate agent who charged as his commission therefor the sum of $50,500, which was paid during the years 1924 and 1925.

Each of the petitioners file their income tax returns on cash receipts and disbursements basis. Each of the petitioners actually paid to the real estate agent as commission in the year 1924 the sum of $10,750 and in the year 1925 the sum of $14,500. They deducted these amounts as expense on their income tax returns for the years 1924 and 1925. The Board of Tax Appeals disallowed the deduction of the amounts as expenses and treated them as capital expenditures to be amortized over the 99-year period of the lease. The petitioners assign this as error.

Likewise and for the same purpose the petitioners were required to pay and actually did pay in 1924 $5,500 in attorneys fees in procuring said lease, and $4,502.85 for obtaining certificate of title in connection with said lease. Each petitioner in her income tax return for 1924 claimed a deduction in the amount of $2,750, being one-half of the attorneys fees, and a deduction in the amount of $2,251.43, being one-half of the cost of obtaining certificate of title. These deductions were likewise disallowed by the Board of Tax Appeals and treated as capital expenditures to be amortized over the period of the lease. The petitioners assign this as error.

In the year 1924 in accordance with the terms of the lease the brick buildings, erected by the petitioners in 1917, were demolished. Depreciation sustained on the brick buildings from the date of their erection to the time of demolition was $7,785, which left an undepreciated cost thereof to the petitioners at the time of demolition of $42,215. Each of the petitioners in her income tax return for the year 1924 claimed a deduction of $21,107.50, representing her one-half of the undepreciated cost of these buildings, on the ground that the same was a realized loss in the year 1924. These deductions were disallowed by the Board of Tax Appeals, and the sum of $21,107.50 added back to the income of each of the petitioners to be amortized over the 99-year period of the lease. The petitioners assign this as error.

As a result of the decision the petitioners have each been allowed a deduction of $513.59 per year instead of the amounts claimed.

ARGUMENT.

I.

The Commissions Paid to Real Estate Agent, the Fees Paid the Attorney, and the Premium Paid on Title Insurance Should Be Allowed as Deductions in the Years in Which Paid.

This question has been the subject of several conflicting decisions by the Board of Tax Appeals. In the early decision of Crompton Building Corporation, found in 2 B. T. A. 1056, the Board made a holding with respect to a 5-year lease which would be contrary to the contentions of the taxpayer in this case. In the case of Robert McNeill, found in 16 B. T. A. 479, the Board reconsidered the precise question which arises in this appeal and decided squarely in favor of the taxpayers contentions, and expressly reversed its earlier decision. In its opinion in the McNeill case the Board spoke as follows:

> "Petitioner testified that the lease of his Maryland land to the Government was for a term of two years, at an annual rental of $25,000, and that he paid certain agents the amount of $3,000 for services in procuring said lease. We have frequently and consistently held that expenses incurred by a *lessee* in connection with the acquisition of a leasehold or other capital asset, such as bonds having a definite income-producing life, are capital expenditures and that for each taxable year ending within such term the lessee is entitled to deduct a ratable part of such expenditures from his gross income. D. N. and E. Walter & Co., 4 B. T. A. 142; Lincoln L. McCandless, 5 B. T. A. 1114; C. M. Nusbaum, 10 B. T. A. 664; Marjorie Post Hutton, 12 B. T. A. 265. In these and similar cases the *lessee* or the purchaser was the moving party claiming the right to deduct such expenditures from income as ordinary and necessary expenses. The disallowance in each instance was based on the theory *that the expense was incurred in the acquisition of assets* that became fused into the capital structure of the petitioner for income-producing purposes through a term of years and should be pro-rated against the income realized in each year of such term.
>
> "It appears, however, that in at least one case, Crompton Building Corporation, 2 B. T. A. 1056, we have held that brokers' commissions paid for procuring or selling leases to property owned by the taxpayer are capital expenditures which should be spread over the term of the lease. In our opinion in that proceeding we said:

'The leases were to run for a period of five years, and amounts paid out in acquiring them are just as much capital expenditures to be returned over the life of the leases as if they had been paid out by the tenant in acquiring a leasehold estate. The lease of property running for a period of years is just as much property in the hands of the owner as a leasehold is property in the hands of a tenant. As such the acquisition thereof by the owner of the property is capital.'

"If the Crompton decision is sound law, it follows that it is immaterial whether expense in connection with the creation of a leasehold interest in property is incurred by the lessor or the lessee and that case and those above cited establish a principle that makes it impossible for us to allow the deduction here claimed as an ordinary and necessary expense incurred or paid in the taxable year and requires us to find that the amount in question is a capital expenditure amortizable over the term of the lease.

"*After careful consideration, however, we are convinced that there is a readily distinguishable difference between the situations of the lessor and lessee in connection with expenses incident to the creation of a leasehold. The lessor acquires nothing that can be taken into his accounts as a capital asset. On the contrary he parts with something when he severs the lessor or leasehold interest from the greater or fee interest of the estate. In effect he sells the right to use his property for a limited term and the commission which he pays may very properly be regarded as expense incident thereto.* On the other hand the lessee acquires something which he can take into his asset accounts. He has more than he owned before the transaction and the fee owner has less. In exchange for income, all of which may be taxable, the lessor has parted with the right to use a certain part of his capital. *The lessee* has acquired a capital asset at a cost which he is entitled to recover free from tax within the period of its useful life to him, which is the term of the lease. *The lessor merely makes a sale*

> *and has no capital investment to recover.* If he incurs any cost in the creation of the leasehold estate, he may be entitled to deduct the amount thereof from his gross income, but *certainly not ratably over the term of the lease, since such expense is for a service in connection with a transaction which is closed when the leasehold is created. The lessor is, therefore, in the situation of one who pays a commission for a service rendered and in this case is within the rule established in Olinger Corporation,* 9 B. T. A. 170, *which is based on American National Co. v. United States,* 274 U. S. 99. We conclude, therefore that this petitioner is entitled to deduct the amount of $3,000 from his gross income for 1922 as commission for services rendered to him in that year and that in view of the conclusion here reached and of our opinion in the Olinger proceeding, *supra,* it is necessary to reverse our opinion in Crompton Building Corporation, *supra.*" (Italics added.)

In the case of *Bonwit Teller and Company v. Commissioner,* 17 B. T. A. 1019, the Board refused to allow as a deduction a brokerage fee paid by a lessee to secure a sub-tenant from whom it received a substantially larger rental. We see nothing in this holding inconsistent with the Board's holding in the McNeill case. In the McNeill case the Board had already distinguished between the position of lessor and lessee. Likewise, the case of *Evelena M. Howard,* 19 B. T. A. 865 (cited by the Board) is a case of a lessee obtaining a sub-tenant at a substantially higher rental.

In the case of *Julius Stowe Lovejoy v. Commissioner,* 18 B. T. A. 1179, (cited by the Board) the taxpayer had paid a commission for obtaining a loan which was to run over a long period of years, the loan to be used in the construction of a building. The Board refused to permit the deduction in the year in which the commission was paid. That case is clearly distinguishable from the instant case for in the Lovejoy case the petitioner did obtain the use of capital over a period of years. However, in the Lovejoy case a strong dissenting opinion was written in which four members of the Board joined. The dissenting opinion is set out below:

> "The petitioner made her income-tax returns upon the basis of cash receipts and disbursements. In such returns she could deduct from gross income as ordinary and necessary expenses only amounts actually paid out. In Olinger Corporation, 9 B. T. A. 170, we held that a note given for securing a loan was deductible as an expense in the year given where the petitioner was on the accrual basis. In Robert H. McNeill, 16 B. T. A. 479, involving the same point as is involved in this proceeding, we held that amounts paid out in obtaining leases are deductible expenses of the year in which paid. The decision in the McNeill case was followed by the United States District Court, Southern District of New York, in Daly v. Anderson, decided January 29, 1930, in which the court held that a commission paid in 1923 to a broker for obtaining a 21-year lease on the taxpayer's property to begin in 1931 was deductible in 1923 by the taxpayer where on a cash receipts and disbursements basis. *Those decisions are, I think, in line with American National Co. v. United States*, 274 U. S. 99, and *United States v. Anderson*, 269 U. S. 422. *It is not to be presumed that Congress contemplated the spread of an expense of the nature of that paid out by the petitioner in 1924 over a series of years. Such a method of charging off the expense is entirely foreign to the petitioner's method of keeping her books of account and making her tax returns.* It needlessly complicates the administration of the income-tax law. *If the petitioner were on an accrual basis it might be proper to treat the amount as a deferred expense and then to spread the charge. But*

> *the petitioner was not on an accrual basis. The income tax is levied not on economic income but on net income to be determined in the manner prescribed by the taxing statutes. In years subsequent to 1924, the petitioner is not entitled to deduct any part of the amount expended by her in 1924 in securing the money borrowed.* The expense paid in 1924 is a legal deduction from income of 1924." (Italics added.)

The Board's decision in *Central Bank Block Association,* 19 B. T. A. 1183 (also cited in Board's opinion), is based on its holding in *Bonwit Teller and Company, supra,* and *Julius Stowe Lovejoy,* both of which we have discussed above and distinguished from the instant appeal.

The only Board decisions that we find in point with the instant appeal where the Board has discussed the reasons for its opinion are the McNeill case, and the appeal of *James M. Butler,* 19 B. T. A. 730. The reasoning in the McNeill case has been set out above. To our minds it is both thorough and convincing. We believe it correctly states the law. Below we set out the reasoning in the Butler case holding *contra*:

> "The petitioner relies upon Robert H. McNeill, 16 B. T. A. 479, in which we held that the cost, to the lessor, of securing a lease is deductible from the gross income to the lessor in the year in which the expenditure is made. However, the principle laid down in Robert H. McNeil, *supra,* has been overruled in two recent Board decisions. Donwit Teller & Co., 17 B. T. A. 1019, and Julia Stowe Lovejoy, 18 B. T. A. 1179.
>
> In the instant proceeding the $980 which petitioner expended to secure the lease was not an ordinary and necessary expense. The expenditure in question resulted in the *securing of an asset from which income was to be derived for 99 years.* Such an expenditure is, beyond a doubt, of a capital nature and may be

> allowed as a deduction only as the benefit is realized. The respondent has allowed petitioner a deduction from income of 1923 calculated in accordance with our decision and upon the basis of a larger expenditure than petitioner has here shown. In this circumstance the holding of the respondent will be approved."

The only material statement in the Butler opinion is the one italicized. The Board's own opinions, the decision of the courts, and common reason all deny the truth and accuracy of the statement. The lease was not a *new asset purchased* by the taxpayers nor was it *the income producer.*

This whole question was squarely presented to the District Court in the Southern District of New York in the case of *Daly v. Anderson*, 37 Fed. (2nd) 728. In that case the owner of land paid in the year 1923 a commission of $8,500 to his broker for obtaining a 21-year lease, whose term was to commence to run in 1931. Having kept his books on the cash basis the petitioner claimed the $8,500 as a deduction in the year 1923. The court held that the taxpayer was entitled to the deduction in the year 1923, and spoke as follows:

> "I think that the first question must be answered in the negative. *The taxpayer did not invest in anything when he paid the real estate broker for services in securing a lease for him. What he did was to pay some one for services in connection with the use to which was lawfully putting his land.* Cf. McNeill v. Commissioner of Internal Revenue, 16 B. T. A. 479; Evalena M. Howard v. Commissioner of Internal Revenue, decided by the Board of Tax Appeals on November 30, 1929, Docket No. 25,749, and not yet reported.

> The taxpayer when the transaction was over had his estate in his land, minus the leasehold estate. It is true that ultimately he was to be paid rent, but that would be merely a periodic recognition by his tenant of the surrender the taxpayer has made by carving the lease out of his freehold, and would be taxable as income to the taxpayer in the year when paid." (Italics added.)

The court further in its opinion emphasizes the fact that the taxpayer is on the cash basis and that, therefore, the *only* years in which the taxpayer is entitled to the deductions under the law are those in which the payments were actually made.

The Board's theory is that when the taxpayers leased their land they *bought* something, and that this something they bought is the *income-producing factor.* To the contrary, and in line with the court's decision in *Daly v. Anderson* and the Board's decision in the McNeill case, we say the taxpayers bought nothing when they leased their land, but, in fact, they sold, or at least parted with something, namely, the right to use their land. As the Board states in the McNeill case, the fees and commissions were expenses incident to the sale, or, as the court puts it, they were amounts paid by the petitioners for services rendered in connection with the use to which they were lawfully putting their land. As either they are deductible expenses in the year in which paid.

The Board's decision assumes that the *lease* is the income producing factor. We deny this. *The land itself is the income producing factor.* The lease is merely the agreement through which income from the land is fixed and realized. Presumably the bargain made in 1924 was a fair one, and that being so, then the lease within itself at the date made had no value. It was only the land that was valuable. The terms of the lease represent the fair market rental value of the land on a 99-year basis. The only way the lease could take on value within itself would be because of changing conditions and changing values so that the payments stipulated under the lease would be in excess of the fair rental value of the land. Instead of the lease proving to be an asset it might just as easily and frequently does prove to be a loss; that is, the land in a few years after the execution of the lease might have a rental value substantially higher than the payments provided for in the lease.

II.

The Undepreciated Cost of the Old Building Amounting to $42,215 Should Be Allowed as a Deductible Loss in the Year 1924.

It is agreed that the undepreciated cost of the old buildings is $42,215 and that, if there is a loss and it is deductible it is deductible in this amount.

The Commissioner of Internal Revenue has frequently disallowed a loss from the demolition of buildings by reason of the provisions of article 142 of Treasury Department regulations. That article reads as follows:

> "Voluntary removal of buildings. Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements will be deductible from gross income. *When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another*

> *building,* it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and buildings plus the cost of removing the useless building."

We think it very clear that this article means that when a person buys real estate on which is located a building with the intent and purpose *at the time he buys* of demolishing the old building and erecting a new one that he shall not be entitled to any loss, but that such unextinguished cost of the old building shall become part of the cost of the new building. The words *"which he proceeds to raze"* clearly indicate this. If this be the correct interpretation then the article has no application to the present case where the petitioners had owned the land for many years, erected the brick buildings in 1917 and rented them continuously until 1924, when not the owners themselves but others erected a new building.

The Board of Tax Appeals denied the loss in the instant case on the ground that the issue was controlled by the Board's decision in the appeal of *Charles N. Manning,* 7 B. T. A. 286. The facts in that case are that the petitioners invested in certain real estate having buildings upon it in the year 1920 and in the year 1921 executed a 99-year lease which provided for the erection of new buildings and the consequent demolition of the old buildings. The Board held that the case did not come within the scope of article 142 set out above, but quoted section 214 (a) (5) of the Revenue Act of 1921, which provides for the deduction of the following losses:

> "Losses sustained during taxable year and not compensated for by insurance, or otherwise, if incurred in any transaction entered into for profit though not connected with the trade or business."

The Board admitted the loss but held that the petitioners had received compensation for the loss. Following is the most pertinent portion of the Board's opinion.

> "Prior to the execution of the lease the petitioners had land and buildings from which they were deriving income in the form of rent, and also land. After the execution of the lease, they had only the land and were lessors under a more advantageous lease than they formerly had. Did they part with the buildings, without receiving compensation therefor, *quid pro quo?* That the lease in question was a favorable one is admitted by the petitioners and that they improved their position thereby is shown by the fact that their rentals were substantially greater under the new lease than those being received prior to October 31, 1921, from the old buildings. But the petitioners say that they could not have been compensated in 1921 under the lease for the loss since they did not begin to receive rentals thereunder until 1922. We are not impressed by the logic of this argument. The acquisition of something from which income will be derived *in futuro* has a value in money's worth in the same sense as something which will produce income *in praesenti.* The value may differ on this account, but this does not alter the fact that each has a compensating value which may be recognized as having money's worth.
>
> "*Taken by itself, the petitioners undoubtedly would be said to have sustained a loss* in the demolition of their buildings, but when considered in connection with the entire transaction entered into on October 31, 1921, the Board is of the opinion that the removal of the buildings was *fully compensated* for in the rights acquired under the lease and that the cost of the buildings, less sustained depreciation, is properly allocable to the cost of securing the lease. In other words, there was in this instance what amounted to

> *a substitution of assets; instead of an asset in the form of buildings, the petitioners now have another asset, viz., a lease,* the giving up or voluntary destruction of the buildings being a necessary incident to the acquisition of the lease.
>
> "Since, however, the lease acquired had a definite life of 99 years, cost of the buildings, less sustained depreciation, which entered into securing the lease, are properly amortizable over the life of the lease, and a deduction from gross income should be allowed under the provisions of section 214 (a) (8) of the Revenue Act of 1918, for the exhaustion of this asset over a 99-year period from the date the lease was signed. Appeal of Grosvenor Atterbury, 1 B. T. A. 169 (1925 C. C. H., B. T. A. 2117).

It will be seen from the above that the theory of the Board is that although the demolition of the buildings represents within itself a loss yet the rental money to be obtained from the lease must be regarded as compensation for such loss. We believe this theory to be entirely erroneous. On what ground and for what reason does the Board say that a portion of the rent must be allocated to compensation for the old buildings which the lessee never used? Is it reasonable to infer that the lessee paid *more than the fair rental value of the land* on account of buildings which it couldn't use? Why should the Board say that the lessee paid more than the land was worth in order to compensate for old buildings rather than to say that the owners, two women, were willing to take a loss on the buildings in order to place their land on a definite income paying basis for 99 years and relieve them of cares and responsibilities. If the land had been clear of buildings in 1924, there is no reason to think the lessee would not have entered into the same lease on the same terms. The lessee was only interested in what it was *getting* for its money. The lease names the monthly income as *rent,* not compensation for old buildings.

If the petitioners could have made the lease on the same terms without the buildings being on the land, and this we say, is the only reasonable view to take, then the undepreciated cost of the old buildings can represent nothing but a loss to them for which they have received no compensation.

Could the petitioners have foreseen in 1917 what was to happen in 1924 it is hardly reasonable that they would have invested $50,000 in brick structures. What happened in 1924 was unforeseen and while *on the whole* it was advantageous, specifically there was a loss. Revenue laws operate specifically, not generally. They operate on specific items of property and income regardless of the general betterment or detriment of the taxpayer's condition. For example, suppose a man who had constructed a factory was offered a ten year salary contract elsewhere which would pay him substantially more than he could hope to realize in profit from his factory. He accepts the contract, thereby necessitating the complete abandonment of his factory. Would this mean that the factory was not a loss to him? It is true his economic situation has improved, but has there been any specific compensation for his loss? Of course, if he had built the factory with the view to obtaining the contract the situation would have been quite different. The abandonment of the factory was a necessary incident in the acceptance of the contract, and likewise the demolition of the old buildings in the instant case was an incident necessary to the execution of a long-term lease. But in neither case was the new contract procured nor influenced by the abandoned or destroyed asset. In fact, the Board states in its findings that "the petitioners received no insurance or other compensation on the demolition of the buildings", but since it has based its opinion upon the decision in the Manning case, which turns almost entirely upon compensation, we thought it necessary to discuss the issue more fully.

Section 202 of the Revenue Act of 1924 provides in part as follows:

> "(a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of *such basis* over the *amount realized*.
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> *　*　*　*　*　*　*　*
>
> (c) The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

"Such basis" in the instant case means cost which is agreed to be $42,215. The "amount realized" under the Board's theory would be the cost of the property, the taxpayers waiting, however, 99 years to get such cost, that being paid at the rate of $426.41 per year without interest. Paid in a lump sum in the year 1924, this would mean approximately the sum of $7,000.00. In other words, what the Board's decision allows to these petitioners is the equivalent of $7,000.00 paid to them in the year 1924, which means a direct loss to these petitioners of approximately $35,000.00. This is the result even under the Board's theory of the case, and we submit that it can hardly be called full compensation. Under our view, there was no amount realized for the old buildings, all payments made being for rent of the land itself, and the full $42,215 was a realized loss in 1924. Section 203 provides as follows:

> "(a) Upon the sale or *exchange* of property the entire amount of the gain or loss, determined under section 202, *shall be recognized,* except as hereinafter provided in this section.
>
> (b) (1) No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is *exchanged solely for property of a like kind* to be held either for productive use in trade or business or for investment, or if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation. * * *"

(The remaining sub-sections are not pertinent.) The Board says that the old buildings are a part of the cost of the lease. If so, the building being physical property, the transaction cannot be a purchase, so it must be an *exchange*. In fact, the Board terms it a substitution of assets, expressly stating that "instead of an asset in the form of buildings, the petitioners now have another asset, namely, a lease". Section 203 (a) and (b) above quoted clearly provides that the gain or loss from each exchange of property shall be recognized unless "property held for productive use for trade or business or for investment is exchanged solely for property *of a like kind*". It can hardly be contended that brick buildings and a 99-year lease are of a like kind. It, therefore, follows that the loss to which the petitioners are entitled must be recognized in the year 1924.

The Board in its opinion cites two court decisions, the first is that of the *Liberty Baking Company v. Heiner,* 37 Fed. (2nd) 703. The facts in that case are that the taxpayers bought land for the purpose of enlarging their plant and contemplated the demolition of the buildings already on the land at the time of the purchase. The case, therefore, comes squarely within article 142, above quoted, and furnishes no precedent for the instant case. The other case, is that of *Anahma Realty Corporation v. Commissioner*, 42 Fed. (2nd) .... In that case the taxpayers bought the land with the old buildings thereon on January 30, 1920, and in May, 1920 executed a 21-year lease which was renewable, and pursuant to said lease the old buildings were destroyed in June and July, 1920. The court (1) quoted article 142 (above set out) and held it a valid regulation and applicable to the case; (2) it referred to section 215 (b) of the Revenue Act of 1918 providing that there may be no deduction of *amounts* paid out for permanent improvements to property and that no deduction could be allowed in the case for that reason; (3) the court held that the "long-term lease of the land with the rentals as stated was a valuable asset to take the place of the demolished buildings".

As to the first ground, we have already observed that article 142 has no application to the instant case. As to the second ground, the statute says "any *amount* paid out for new buildings". This could not refer to physical properties but only to money, or its equivalent. As to the third ground, the court clearly states that the demolished buildings were exchanged for the long-term lease. As already pointed out, the only exchanges that are not taxable under the statute are those of like properties.

The Board admits that the demolition of the old buildings taken by itself represents a loss. What its decision does then is to spread this loss over a period of 99 years. There is no provision in the Revenue law for so spreading a loss. The statute says a loss shall be allowed in the year in which sustained.

III.

It Is Important to Consider That the Petitioners Were Filing Their Returns on a Cash Basis.

There is no contention by the respondent in this case that the cash basis is not a proper one to be used by the petitioners. Both the decisions of the courts and of the Board of Tax Appeals have been very strict in not permitting taxpayers reporting on a cash basis to deduct any amounts or losses in a given year except those actually paid out or sustained during that year. They have been equally strict in requiring all amounts received to be included in the income of the given year. *Eckert v. Commissioner*, 42 Fed. (2nd), 9 C. C. A. *Fidelity Title and Trust Company v. Heiner,* 34 Fed. (2nd) 350. *Osterlich v. Lucas,* 37 Fed. (2nd) 277 (9 C. C. A.). *Appeal of Seaboard Oil Company,* 1 B. T. A. 1259. It follows that the courts and the Board of Tax Appeals should be equally strict in permitting taxpayers on a cash basis to deduct amounts actually paid out and losses actually sustained in the year of payment or loss, and the more so, because the taxpayers' right to deduct such amounts or losses in other years may very properly be questioned. This was emphasized by the court in its opinion in *Daly v. Anderson, supra,* in the following language:

"Coming to the second question, the taxpayer had the right under the laws to keep his books on a cash basis. He did so.

Section 214 (a) of the Tax Law of 1921 (42 Stat. 239) provides in part:

'That in computing net income there shall be allowed as deductions:

'(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business'.

Section 200 of the same law says:

'* * * The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212 * * *'.

Section 212 (b) of the same law says:

'The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer * * *'.

(3) What the government is entitled to tax is the true net income computed as the law allows.

(4) In the case of taxpayers on a cash basis, that is reflected by deducting, from all money receipts during the year, all expenditures incurred in business, not to mention other deductions not here involved. Decisions involving taxpayers on an accrual basis, such as American Can Co. v. Bowers, 35 Fed. (2d) 832, decided by the Circuit Court of Appeals for this Circuit, on November 4, 1929, are beside the mark. In those cases, of course, accrued deductions must march with the taxable year.

The government's complaint, aside from the question of the payment being a capital expenditure above disposed of, is, as I understand it, that it is dislocated in time, so to speak, and bears no relation to the plaintiff's 1923 income.

In that contention the government is trying to change the reading of section 214 (a) of the act so that it would read in effect that deductions could only be allowed for expenses paid 'for carrying on any trade or business during the taxable year'.

But that is distortion of the meaning of the clause. The section in question says: 'Paid * * * during the taxable year in carrying on any trade or business'.

(5) The taxpayers on a cash basis, therefore, could not deduct an expense, except in the year when it was paid.

(6) Mr. Daly cannot pro-rate the commission and deduct it yearly from the rent for 21 years after 1931, because he will not have paid it in those years. If he made such a deduction, the government would properly meet such a claim by saying to him, 'You should have deducted it in 1923 when you paid it'.

But the government can and will tax the whole rent as income during the period of the lease.

It may be that those years will be years of low taxes, but, if so, it will be a legitimate incidental advantage to Mr. Daly.

It may be that those years will be high tax years. If so, that will be a legitimate incidental advantage to the government.

As to the present question, however, the government cannot have a right to refuse this deduction now and tax the full rent hereafter. That is what their reading of section 214 (a) means.

The United States cannot have it both ways."

In the McNeill case the Board "after careful consideration" flatly said:

> "If he (owner) incurs any cost in the creation of the leasehold estate, he may be entitled to deduct the amount thereof from his gross income, *but certainly not ratably over the term of the lease since such expense is for a service in connection with the transaction which is closed when the leasehold is created.* The lessor is, therefore, in the situation of one who pays a commission for a service rendered and in this case is within the rule established in Olinger Corporation, 9 B. T. A. 170, which is based on American National Company v. U. S., 274 U. S. 99."

In the dissenting opinion of the Lovejoy case, four members of the Board, speaking of taxpayers on a cash basis, who had paid our commissions, spoke as follows:

> "It is not to be presumed that Congress contemplated the spread of an expense of the nature of that paid out by the petitioners in 1924 over a series of years. Such a method of charging off the expense is entirely foreign to the petitioner's method of keeping her books of account and making her tax returns. It needlessly complicates the administration of the income tax law. If the petitioner were on an accrual basis it might be proper to treat the amount as deferred expense and then to spread the charge. But the petitioner was not on the accrual basis. The income tax is levied not on economic income but on net income, to be determined by the manner prescribed in the taxing statutes. In years subsequent to 1924 the petitioner is not entitled to deduct any part of the amount paid by her in 1924 in securing the money borrowed."

In reaching its opinion in the instant case the Board seems to be persuaded that unless the commissions and other expenses paid are spread over the 99-year period that the result will not reflect the petitioner's true net income. Such an argument is very effectively answered by the opinion of the Ninth Circuit in the case of *Osterloh v. Lucas,* 37 Fed. (2d) 277. We quote below a portion of the opinion:

> "* * * The method of accounting regularly employed by the petitioner is a recognized one within the meaning of the act, and should be accepted as controlling unless such method does not clearly reflect the income. And it is conceded that the deduction claimed does not appear on the books of the petitioner because of the method of accounting adopted, and that for the same reason an unpaid gain or profit would not appear. The method of accounting thus adopted and recognized will be of little value to either the taxpayer or the government, if the former is at liberty to go outside of the books to show unpaid losses and the latter to show uncollected gains or profits. We do not think that either course is permissible. The case turns largely upon what is meant by the requirement that the method of accounting shall clearly reflect the income. *If this requirement is absolute, it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid.* But we do not think that any such literal construction was contemplated. In our opinion, all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax. This construction may work to the disadvantage of the taxpayer or

> the government at times, but if followed out consistently and honestly year after year the result in the end will approximate equality as nearly as we can hope for in the administration of a revenue law."

The purpose of the accrual basis is to enable each period to reflect its true income, but this is not the purpose and only rarely the result of the cash receipts and disbursements method. Although, as the court states, when the latter method is followed out consistently and honestly year after year the result will approximate equality as nearly as can be hoped for. The two methods, however, are distinct and separate. There is no reason or justification for merging the two methods, and any tendency to do so should be discouraged, for this would only result in confusion and inequality. Both methods are recognized by the revenue laws and the Commissioner of Internal Revenue has found no fault with the use by these petitioners of the cash basis. Possibly the cash basis works to the advantage of these petitioners in the years 1924 and 1925, but doubtless it has worked to their disadvantage in other years and will do so in some future years. If payment of rent had been expedited so that petitioners received two years in advance they would be required to report the entire amount in the year in which such rent was received. Why should not the same rule apply where payment of expenses is expedited? They actually paid out in cash in the years 1924 and 1925 for services rendered the amounts they are claiming as deductions, and they actually sustained in 1924 the loss which they claim, and the same should be allowed to them in conformity with the cash basis provided for by statute.

Conclusion.

The commission, attorney's fees and title insurance premium should be allowed as expenses in 1924 and 1925, for the petitioners paid them out not to purchase a capital asset but as an ordinary and necessary expense in the management of their land. The land and not the lease is the real income-producing factor.

II.

The unextinguished cost of the brick buildings is deductible as a loss in the year 1924 for the following reasons:

(1) The case is clearly not within the provisions of Article 142.

(2) Even though the Board were correct in saying that the old buildings were part of the cost of the lease the transaction was nevertheless an exchange of unlike properties and the statute compels recognition of the loss in the year in which such an exchange is made.

(3) Even though the Board were correct, waiting 99 years to get back the cost without any interest is not full compensation.

(4) The stipulation of facts and the findings of the Board establish that the petitioners sustained a loss of $42,215 invested in their buildings for which they have received no compensation.

III.

The petitioners filed their returns on a cash basis. There is no contention that that was not a proper basis for them. To those on a cash basis the law allows the deduction of amounts paid for services *only* in the year in which paid and of losses only in the year in which actually sustained. Petitioners paid the amounts claimed in 1924 and 1925 and sustained their loss on buildings in 1924 and should be allowed the deductions in those years and not in years in which no payment was made and no loss sustained.

Respectfully submitted,

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Ingle vs. Gage, U.S.D.C. W.D.N.Y.
decided Sept. 29, 1931.
Reverses Bd. of Tax Appeals
and allows loss for
Demolition of Buildings.