Problems of Casualty Losses, Insurance, Improvements and Repairs, and Depreciation

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Tax Problems Incident To the Management of Acquired Real Estate

III

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CASUALTY LOSSES

Proposed Treasury Regulations published on October 8, 1959, make significant changes in the casualty losses allowed on business property. Without a doubt, the most important is the recognition given to a 1956 court of appeals decision which held that the computation of the loss deduction is the same for business property as for non-business property. The Proposed Treasury Regulations eliminate the requirement, which has been enforced by the Internal Revenue Service for many years, that a partial business casualty loss be limited to a fraction of the adjusted basis of the property, even though the actual economic loss is much larger.

The Proposed Treasury Regulations continue the general rule that the deduction in the case of any casualty loss is the lesser of: (1) the decrease in fair market value immediately before and immediately after the casualty, or (2) the amount of the adjusted basis of the property.

With respect to methods of determining the amount of loss, the Proposed Treasury Regulations state that:

The cost of repairs to the damaged property is acceptable as evidence of the loss of value if the taxpayer shows that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for such repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d) the repairs do not increase the value of the property.

2. Alcoma Ass'n v. United States, 239 F.2d 365 (5th Cir. 1956).
This recognition of cost of repairs as proper evidence for determining the amount of a casualty loss will provide taxpayers with a readily available and realistic basis for determining the amount of loss sustained in those cases where restoration is made.

A new distinction between business and non-business property requires that where a loss is incurred on business property the amount of the loss must be determined by reference to each single identifiable property damaged or destroyed. On the other hand, a loss incurred on non-business property need not be segregated and may be determined by reference to the whole. Examples contained in the Proposed Treasury Regulations point out the effect of this distinction, which is that aggregation of assets, permitted with non-business property, will lessen the effect of the "adjusted basis" limitation as to non-business property, while segregation of assets on business property will make this limitation more restrictive as to business property.

The Proposed Treasury Regulations provide that no portion of a loss shall be considered sustained if there is a reasonable prospect of recovery. The question of the reasonableness of this prospect is a factual one. Where only a part of the loss is expected to be recovered, the balance is considered as being sustained and must be deducted in the year the loss occurs.

In the event a loss is deducted, and reimbursement through insurance or otherwise is received in a later year, the taxpayer must include such reimbursement in gross income in the year received, subject to an adjustment.

The section of the Proposed Treasury Regulations dealing with casualty losses provides that its rules are applicable to any taxable year beginning after the date of publication in final form. It further provides that a taxpayer has the option to amend his income tax return for any open year in order to recompute his casualty loss in accordance with the provisions of the new regulations. Immediate action to effect this option may be necessary with respect to any year which soon may be closed by the running of the statute of limitations.

**INSURANCE**

Insurance on real estate used in business must be viewed from two aspects: first, the cost of carrying insurance, and second, the effect on the amount recoverable in the event the property is damaged or destroyed. Premiums, of course, are deductible as an ordinary and necessary business expense and generally present no tax problem. One exception arises in the case of a cash basis taxpayer when the

premium paid is for insurance that extends beyond the year of payment. The position of the Internal Revenue Service is that such premiums must be treated as a deferred charge and be deducted over the period of years benefited.\textsuperscript{11} However, the Eighth Circuit allowed the total premium to be deducted in the year of payment when the taxpayer had consistently followed this practice.\textsuperscript{12}

Where the proceeds of insurance on damaged or destroyed business property exceed the recognized tax loss, a taxpayer may have an involuntary conversion if he reinvests the proceeds to replace the property,\textsuperscript{13} or he may have a section 1231 gain,\textsuperscript{14} or he may have a combination of both results.

Where insurance proceeds are less than the recognized tax loss, the insurance proceeds reduce the amount of the loss. This loss is a section 1231 loss.\textsuperscript{15} However, an amendment to the Internal Revenue Code in 1958 provides that an ordinary loss results when business property is damaged or destroyed and there is no insurance recovery.\textsuperscript{16}

The distinction between insurance against loss of property and insurance against loss of income is important from a tax standpoint, as recovery of the latter always results in ordinary income.\textsuperscript{17} Use and occupancy, and business interruption insurance contracts may produce either result, depending upon the particular contract. Thus, the tax result should be considered at the time the insurance is purchased.\textsuperscript{18}

**IMPROVEMENTS AND REPAIRS**

One of the most frequent causes of controversy between taxpayers and the Internal Revenue Service is the factual question of whether a particular expenditure is an improvement or a repair; or stated another way, whether the expenditure results in a capital asset or in a current deduction.

The code\textsuperscript{19} and the regulations thereunder provide broad rules with respect to this problem. Generally, expenditures that prolong the life of property or that adapt property to a new or different use are of a capital nature,\textsuperscript{20} whereas expenditures that keep property in

\textsuperscript{12} Waldheim Realty & Investment Co. v. Commissioner, 245 F.2d 823 (8th Cir. 1957).
\textsuperscript{13} Int. Rev. Code of 1954, § 1033.
\textsuperscript{14} Int. Rev. Code of 1954, § 1231(a).
\textsuperscript{15} Int. Rev. Code of 1954, § 1231(a) (1).
\textsuperscript{16} Int. Rev. Code of 1954, § 1231(a).
\textsuperscript{18} See Merritt, How the Proceeds of Use and Occupancy, or Business Interruption, Insurance Are Taxed, 36 Taxes 306 (1958).
\textsuperscript{19} Int. Rev. Code of 1954, §§ 162, 263.
\textsuperscript{20} Treas. Reg. § 1.263(a)-1 (1958).
ordinary, efficient operating condition are in the nature of a current repair and may be expensed. 21

The amount of an expenditure is not a factor in the application of these rules. In any case, the particular circumstances surrounding the expenditure must be analyzed when this question exists. If expenditures are made for a combination of improvement and repairs, it is essential that the taxpayer maintain adequate records with respect to each type of expenditure. 22 Improvements on business property are capital items, and may be depreciated.

**Depreciation**

An important long-range decision with respect to depreciation must be made in the first tax return filed after an acquisition of real property has been made. This decision should be made only after complete analysis of the effect of depreciation on taxable income and on the cash made available for use in the business. Both of these will vary with the method of depreciation that is selected.

When items are capitalized, the taxpayer may, without formal election, select a method of depreciation. 23 It is important to recognize that once a depreciation method is selected, then, with one exception which is discussed below, the method cannot be changed without securing permission from the Commissioner of Internal Revenue. 24

Each asset may be considered separate and apart from all other assets for the purpose of computing depreciation. Therefore, it is possible for a taxpayer who acquires a number of separate depreciable assets in one year to use a different method of depreciation as to each asset. 25

Where real property is acquired, a taxpayer may depreciate the whole (with the exception of land) as a single asset, or may apportion the cost of the various assets acquired (e.g., the building, plumbing, and other fixtures) and depreciate them separately. 26 Where an apportionment is made, various methods of depreciation and various lives may apply to each classification established.

**Methods of Depreciation**

The 1954 Internal Revenue Code provides that a taxpayer may use the straight line, sum of the years-digits, declining balance, or any

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23. Treas. Reg. §§ 1.167(b)-0(a), (r) (1956).
25. Treas. Reg. § 1.167(a)-7(c) (1956).
other method of depreciation with certain restrictions.\textsuperscript{27} The two accelerated methods (sum of the years-digits and declining balance) may be used only when the property: (1) has a life in excess of three years (which should include all real property) and is new since 1953, or (2) has been constructed or reconstructed, and was finished after 1953.\textsuperscript{28}

The declining balance method permits the use of a rate not in excess of twice the rate as computed by the straight line method and requires that this rate be applied to the adjusted basis of the property. The result is that the same percentage is used each year, but it is applied to a basis that "declines" each year by the amount of the previously allowed depreciation, so that the maximum depreciation allowance is received in the first year and then becomes less and less each succeeding year.\textsuperscript{29} As an exception to the general rule, a change from the declining balance method to the straight line method is permitted without securing the permission of the Commissioner.\textsuperscript{30} An important aspect of the declining balance method is that the salvage value need not be deducted from the basis to which the rate is applied.\textsuperscript{31}

The second accelerated method is the sum of the years-digits, which again produces the maximum depreciation in the first year and progressively lower depreciation in each subsequent year. The sum of the years-digits name refers to the denominator of the fraction which is the sum of the years of useful life to the user.\textsuperscript{32} The numerator for any year is the number of years remaining as of the beginning of the year, and, of course, changes each year. This fraction is applied to the cost (usually the purchase price) of the property, less salvage.\textsuperscript{33}

\textsuperscript{27} \textit{Int. Rev. Code of 1954}, § 167(b).
\textsuperscript{28} \textit{Int. Rev. Code of 1954}, § 167(c).
\textsuperscript{29} Treas. Reg. § 1.167(b)-2 (1956).
\textsuperscript{30} \textit{Int. Rev. Code of 1954}, § 167(c). This subsection is applicable in the absence of an agreement with the Commissioner as to the method of depreciation, as provided for in subsection 167(d).
\textsuperscript{31} While salvage value need not be deducted from this basis initially, Treasury Regulations (§ 1.167(b)-2 (1956)) provide that in no event may an asset be depreciated below a reasonable salvage value. This position was upheld by the Third Circuit Court of Appeals against the contention that depreciation deductions could be taken over the useful life of the item and then capital gain treatment be given to the amount by which the sale price exceeded the adjusted basis. Hertz Corp. v. United States, 268 F.2d 604 (3d Cir. 1959), \textit{cert. granted}, 361 U.S. 811 (1959). See also note 35 \textit{infra}.
\textsuperscript{32} In regard to any method of depreciation, it is not definitely settled whether "useful life" as used in § 167 of the Internal Revenue Code means the "useful life to the taxpayer," or the "physical or economic life of the asset." The Treasury Regulations state (§ 1.167(a)-1(a)) and two cases have held (Hertz Corp. v. United States, 268 F.2d 604 (3d Cir. 1959); United States v. Massey Motors, Inc., 264 F.2d 552 (5th Cir. 1959)) that the former definition is proper, while another court (Evans v. Commissioner, 264 F.2d 502 (9th Cir. 1959)) applied the latter definition. However, the Supreme Court has granted certiorari in the Hertz case (361 U.S. 811 (1959)).
\textsuperscript{33} Treas. Reg. § 1.167(b)-3 (1956).
Salvage

Salvage must be considered in computing any depreciation allowance, unless the declining balance method is used. Its purpose is to recognize that portion of the cost of an asset that will be recovered upon disposition, and consequently cannot be recovered through depreciation. Salvage may be a fixed dollar amount that will reduce the basis to which the depreciation rate (or fraction) is applied, or salvage may be reflected by using a life longer than the useful life to a taxpayer.34 If the declining balance method is used, the regulations provide that even though salvage is not taken into account when determining the annual allowance, in no event will an asset be depreciated below a reasonable salvage value.35

Advantages of Fast Depreciation

Reference was made above to the effect of depreciation on cash made available to the business. Depreciation, being a non-cash item, must be added back to the net income in order to determine the amount of cash that will be available for the cash requirements of the business, including debt financing. In addition, the larger depreciation deduction available in the early life of an asset provides additional cash savings because of the reduction in federal income taxes.

One other advantage of accelerating depreciation is the tax savings through capital gain treatment under section 1231, which savings result when business assets which have been subjected to accelerated depreciation are sold for an amount in excess of the adjusted basis.36 The effect is that depreciation deductions which reduced ordinary income are converted into capital gain with a resultant tax savings of the difference between ordinary rates and the capital gain rate.37

34. Treas. Reg. § 1.167(a)-1(c) (1956).
36. INT. REV. CODE OF 1954, § 1231.
37. However, this advantageous treatment may not be available, or may be of limited value, depending upon the determination of the questions concerning salvage and useful life. See notes 31, 32, and 35 supra.