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# Federal Taxation--Deductions for Exhaustion of Property--Space as a Valid Deduction (*John J. Sexton*, 42 T.C. 785 (1964))

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under the compulsory terms of a union contract was involuntary termination and therefore awarded unemployment compensation. The *Leach* decision and other conflicting cases therefore present an issue deserving final resolution by the Ohio Supreme Court.

In light of the required liberal construction of the Ohio Unemployment Compensation Act,[19] the supreme court ought to affirm the granting of unemployment compensation benefits to a pensioner retired under a union contract. Further support for this approach can be found in the statute itself. In drafting the statute, the legislature is presumed to have had full knowledge and information concerning this issue,[20] and it is therefore submitted that by enumerating all disqualifications under the statute,[21] the General Assembly clearly did not intend to prohibit dual benefits.[22]

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## FEDERAL TAXATION — DEDUCTIONS FOR EXHAUSTION OF PROPERTY — SPACE AS A VALID DEDUCTION

*John J. Sexton*, 42 T.C. 785 (1964).

Federal income tax is as a general rule based upon net income derived over a specified period. In determining net income derived from the operation of a trade or business, all operating costs and expenses allowable as deductions must be determined and deducted from gross income. The production of net income usually involves the use of capital assets which wear out or are exhausted in use. Such wear or exhaustion as the case may be is usually gradual, extending over a period of years. With respect to trade or business capital, such wear or exhaustion, ordinarily called depreciation, constitutes an operating cost and hence is deductible from gross income.[1]

A new dimension was added to this basic concept of depreciation in *John J. Sexton*.[2] There, the petitioner, who was in the business of operating refuse dumps, purchased an eighty acre tract of land for $150,000. On this land was a clay pit into which he

19. Albaugh v. Alsco, Inc., 179 N.E.2d 564 (Ohio C.P. 1961); see OHIO REV. CODE § 4141.46.

20. 54 OHIO JUR. 2d *Unemployment Compensation* § 5 (Supp. 1964).

21. See OHIO REV. CODE § 4141.29(D).

22. See also OHIO REV. CODE § 4141.36; Teple, *Supplemental Unemployment Benefits*, 20 OHIO ST. L.J. 583 (1959).

dumped refuse collected from patrons of his business. The petitioner determined that the reasonable salvage value of the land after the pit was filled was $44,000.[3] Hence, the $106,000 difference between the cost price and the salvage value was the value of the air space which would be exhausted by his business use of filling the pit with refuse collected from his patrons.[4] After having this land surveyed, the petitioner determined that there were 2,528,787 cubic yards of air space available for dumping. The total value of the air space divided by this number of cubic yards of air space available for dumping was found to amount to a charge-off of 4.19 cents per cubic yard of air space exhausted. Petitioner had surveys taken at the end of each year to determine the space filled by a year's dumping;[6] that figure times the charge per cubic yard of air space exhausted was the amount of depreciation taken for that particular year.

In seeking to sustain the validity of this deduction, the petitioner contended that he had not purchased the eighty acre tract of land for the value of the land, but rather for the value to him of the dumping space made available by the clay pit located thereon. A part of this space, the petitioner contended, was being consumed each year for business purposes. On the other hand, the Commissioner argued

1. INT. REV. CODE OF 1954, § 167(a) states: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) — (1) of property used in the trade or business, or (2) of property held for the production of income."

2. 42 T.C. 795 (1964).

3. The salvage value was based on the price of corresponding property in this same area. Petitioner paid almost four times the usual selling price because: (1) dumping space in the Chicago area was at a premium; and (2) the seller knew why petitioner wanted the property and priced the land accordingly. Salvage value is determined in Treas. Reg. § 1.67(a)-1(c)(1) (1954) as: "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful . . . in the production of his income and is to be retired from service by the taxpayer. . . ."

4. Respondent argued that the value of the land when filled would be more than the original cost. However, the Tax Court observed that excavated areas subsequently filled with garbage are not suitable for building construction without extensive use of costly pilings and cassions.

5. The method of apportionment usually termed the "unit of production method" is peculiarly applicable in determining depreciation for property used in the exploitation of natural resources. By dividing the cost less the estimated salvage value by the estimated available reserve of raw material, a unit cost is obtained which, when multiplied by the units produced during a given year, indicated the depreciation sustained for the year.

6. Initially, the petitioner attempted to compute the air space used by keeping a daily tally on the amount dumped into the pit. However, the method proved ineffective due to compaction after dumping. It was at this point that petitioner recognized the need for annual surveys.

that the only asset purchased by the petitioner was land;[7] that the only time the cost of land could be depreciated as a business loss is when the land is sold and there is a loss sustained in a closed transaction.

The Tax Court allowed the deduction, holding that a separate right to ownership in the air space could be recognized as property. In reaching this conclusion, the court relied on two authorities: (1) the decision in *Mattie Fair*,[8] where a gift of a right to air space was upheld as a valid deduction; and (2) Internal Revenue Bulletin No. 1964-30,[9] which recognized a gratuituous conveyance of a restrictive easement to the United States Government as a charitable contribution. In light of these two authorities, the court stated: "We perceive no reason why such rights should not be the subject of depreciation as wasting assets in the business of this paxpayer."[10]

The court held that petitioner's method of computation was within section 1.167(a)-1(a) of the Treasury Regulations governing a reasonable allowance for depreciation.[11] Petitioner had set aside an amount in accordance with a reasonable, consistent plan so that the aggregate of the amounts set aside, plus the salvage value, would equal the cost of the property.[12]

Although this case might initially appear to present a novel situation, the Tax Court applied nothing more than basic principles of property and tax law in resolving the issues.[13] The extent of owner-

7. Land is generally recognized as non-depreciable simply because it is not subject to wear and tear, exhaustion, or obsolescence. This proposition is specifically stated in Treas. Reg. § 1.167(a)-2: "The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, *or to land* apart from the improvements or to physical development added to it. . . ." (Emphasis added.)

8. 27 T.C. 866 (1957). Here, petitioners claimed as a charitable deduction the gift of a perpetual right to build, own, and maintain five additional stories over an existing two-story building. The Tax Court allowed this deduction, stating: "The right to use the air space super-adjacent to the ground is one of the rights in land. These air rights are frequently the most valuable rights connected with the ownership of land since the value of commercial property consists almost exclusively of the right of the owner to erect business and industrial structures thereon." *Id.* at 872.

9. Rev. Rul. 64-205, 1964 INT. REV. BULL. NO. 30, at 6.

10. John J. Sexton, 42 T.C. 795, 801 (1964).

11. Treas. Reg. § 1.167(a)-1(a).

12. Petitioner had, in filing his tax return for the years 1953 through 1956, called this deduction a depletion. The Commissioner disallowed the deduction as a depletion, but did allow the deduction as amortization. The court distinguished depletion and amortization as not applying to the present case and permitted the deduction as depreciation.

13. Extensive research has revealed no other instance where the court has allowed depreciation of air space.

ship of land has traditionally been regarded as including any adjacent air space controlled by the owner above the land. This view was apparently derived from the maxim *usque ad coelum*, generally regarded as having originated with Lord Coke.[14] This recognition of control of the use of air space over land progressed until courts began to permit a landowner to maintain an action for trespass for invasion of the air space immediately over his land.[15] The landowner's right to maintain this trespass action is derived through his title to the land. Similar results have been reached in eminent domain cases where it has been found that the landowner owns at least a portion of the overlying space.[16]

Another test of ownership in this area is whether the property is capable of being divided and conveyed to another.[17] Two states, Colorado[18] and New Jersey,[19] have settled the question as to ownership, subdivision, and conveyance of air space to third parties by legislation. These statutes expressly permit estates, rights, and interests in areas above the ground to be conveyed to persons other than the owners of the land. Also, an Illinois statute specifically empowers railroads to divide their real estate into different lots or levels, and to sell or lease any part or parts of such real estate at, above, or below the surface of the ground, providing there is no im-

14. 2 TIFFANY, REAL PROPERTY § 583 (3d ed. 1939).

15. Overhanging projections have been held to constitute trespasses. Purato v. Chieppa, 78 Conn. 401, 62 Atl. 664 (1905) (eaves of a house); Cumberland Tel-Co. v. Barnes, 30 Ky. L. Rep. 1290, 101 S.W. 301 (Ct. App. 1907) (crossarms on a telephone pole). *Accord*, Hall v. Browning, 195 Ga. 423, 24 S.E.2d 392 (1943) (firing a projectile across another's land); Town of Akley v. Central States Elec. Co., 204 Iowa 1246, 214 N.W. 879 (1927) (stretching a wire across another's land).

16. These cases generally have held that some right of the owner to his surface air space has been "taken." United States v. Causby, 328 U.S. 256 (1945) (continuous low flights over appellee's land constituted a compensable taking by the federal government); Portsmouth v. United States, 260 U.S. 327 (1922) (repeated firings of coastal guns across plaintiff's land). In *United States v. Causby*, *supra* at 264, the Court at least defined the *minimum* amount of air space the landowner may claim: "The landowner owns at least as much of the space above the ground as he can occupy or use in connection with the land." *Accord*, Griggs v. Allegheny County, 369 U.S. 84 (1962). noted in 14 W. RES. L. REV. 376 (1963).

17. For an excellent treatise on many of the early problems in this area see Bell, *Air Rights*, 23 ILL. L. REV. 250 (1928). Well aware of the apparent incongruity of the situation, this writer noted:

> Land has been the most corporeal of corporeal things. It is *real* estate. Can an abstract thing like space be bought and sold as land? The air as such obviously cannot. But can space, as such, be dealt in? It is a long cry from transferring Whiteacre by handing over a piece of sod, to a written conveyance of a right to all space within the boundaries of Whiteacre beginning at a certain imaginary plane and extending from there on up. *Id.* at 252.

18. COLO. REV. STAT. ANN. § 118-12-1 (1963).

19. N.J. STAT. ANN. § 46:3-19 (1964).

pairment of the property for railroad purposes.[20] Surely if the right of an owner to convey air space separate from the land is cognizable by the law of real property,[21] then the use of air space in conjunction with the land, as in the instant case, ought to be similarly recognized in the application of tax principles.

The second basic principle of law involved in the *John J. Sexton* case concerned the depreciation requirements. Although depreciation rights are usually thought of as applying to tangible property,[22] the Regulations also provide for the depreciation of intangible assets,[23] if such assets are known from experience or other factors to be of use in business or in the production of income for a limited period of time. The length of such use must be capable of determination with reasonable accuracy. In the subject case, the petitioner merely sought recognition of the fact that an asset was being consumed by his business, and thus aptly urged application of section 1.167(a)-(3) of the Regulations. The principle question with respect to intangible property is: does it have a definitely limited useful life? In the subject case, petitioner's intangible asset *did* have a definitely limited useful life — the air space could be used only until exhausted by becoming filled with refuse. Furthermore, petitioner knew exactly when the asset would be exhausted.[24] It is therefore clear that this use of air space could be properly classified as an intangible asset.[25]

Although this case presents an interesting example of the novel results that can be reached by combining two seemingly unrelated areas of the law, it nevertheless will serve as an important and valuable precedent for land owners concerned with the tax aspects of utilizing the space above and below the surface of their lands.

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20. ILL. ANN. STAT. ch. 114, § 174a (Smith-Hurd, 1954).

21. The builders of the Merchandise Mart Building reportedly paid $2,500,000 for air space alone. Drew, *Usque Ad Coelum*, 4 CONN. B.J. 276, 277 (1930).

22. Treas. Reg. § 1.167(a)-2.

23. Treas. Reg. § 1.167(a)-3.

24. The necessary element lacking in most unsuccessful attempts at depreciation of intangibles is that a definite period of use cannot be determined. See, *e.g.*, Falstaff Beer, Inc. v. Commissioner, 322 F.2d 744 (5th Cir. 1963) (beer distributorship); Fromm Labs., Inc. v. Commissioner, 295 F.2d 727 (7th Cir. 1961) (research and development costs); Battle Creek Food Co. v. Commissioner, 181 F.2d 537 (6th Cir. 1950) (back royalties); National Weeklies, Inc. v. Reynolds, 43 F. Supp. 554 (D. Minn. 1942) (subscription lists).

25. Confusion could arise from the instant case in that it may be thought that air was allowed to be depreciated. However, it was not air, but rather the exhaustion of air space which was permitted as a valid deduction.