Bonwit Teller & Co. v. Commissioner

17 B.T.A. 1019 (B.T.A. 1929)

Docket Nos. 21859, 27824, 28700.

Board of Tax Appeals.

Promulgated October 18, 1929.

Arthur B. Hyman, Esq., for the petitioner.

John D. Foley, Esq., for the respondent.

These proceedings involve deficiencies in income and profits taxes for the following fiscal years ended January 31: 1922, $20,691.19; 1923, $4,633.69; 1924, $14,759.08. Numerous issues are raised by the pleadings which will appear sufficiently in the opinion.

FINDINGS OF FACT.

Petitioner is a New York corporation with its principal place of business at 417 Fifth Avenue, New York City. It deals in feminine apparel. Its accounts were kept in accordance with an accrual method.

1. Petitioner's income and profits-tax returns were filed on the following dates: for the year ended January 31, 1922, on June 10, 1922; 1923, on June 14, 1923; 1924, on October 15, 1924. For the last named fiscal year a tentative return was filed on April 15, 1924. On January 23, 1926, petitioner filed with the Commissioner the following:
Parent: Bonwit-Teller & Company JAN 23 AM 10 25 INTERNAL REVENUE CENTRAL MAIL ROOM INCOME AND PROFITS TAX WAIVER FOR TAXABLE YEARS ENDED PRIOR TO JANUARY 1, 1922 DISTRIBUTION CENTER IT:CR:E JAN 23 1926 FLH-1 CON. RET. DIVISION Jan. 21st, 1926.

In pursuance of the provisions of existing Internal Revenue Laws Bonwit-Teller & Company of New York, a taxpayer of New York, N. Y., and the Commissioner of Internal Revenue hereby waive the time prescribed by law for making any assessment of the amount of income, excess-profits, or war-profits taxes due under any return made by or on behalf of said taxpayer for the year (or years) fiscal ended January 31, 1922 under existing revenue acts, or under prior revenue acts.

This waiver of the time for making any assessment as aforesaid shall remain in effect until December 31, 1926, and shall then expire except that if a notice of a deficiency in tax is sent to said taxpayer by registered mail before said date and (1) no appeal is filed therefrom with the

United States Board of Tax Appeals then said date shall be extended sixty days, or (2) if an appeal is filed with said Board then said date shall be extended by the number of days between the date of mailing of said notice of deficiency and the date of final decision by said Board. BONWIT TELLER & CO. Taxpayer. (Corporate Seal). By PAUL J. BONWIT Pres. D. H. BLAIR Commissioner.

On July 30, 1926, in a protest filed by the petitioner against a proposed determination of deficiency of $20,965.59 for the fiscal year ended January 31, 1922, a statement was made that petitioner claimed refund because of amortization of its leasehold. A similar statement was made in protests filed in respect of proposed deficiencies for the fiscal years ended January 31, 1923 and 1924. The notices of deficiency were mailed to petitioner on the following dates: for the fiscal year ended January 31, 1922, on October 15, 1925; 1923, on March 3, 1927; 1924, on April 7, 1927.

2. The respondent in computing the deficiency for each of the years in question disallowed deductions for exhaustion, wear and tear of furniture and fixtures which had been acquired prior to and during the fiscal years 1913, 1914, and 1915, respectively.

3. During the fiscal year 1921 petitioner purchased two brown stone buildings, Nos. 14 and 16 East Thirty-eighth Street, in order to secure additional work rooms. Of the purchase price for the land and buildings petitioner allocated $26,000 to the buildings. Thereafter petitioner spent $44,000 for alterations to the buildings. The probable useful life of the buildings was not to exceed 10 years. They were sold in the fiscal year 1924.

4. Petitioner was lessee of a building on the northeast corner of Fifth Avenue and Thirty-eighth Street. In 1922 it leased to the Primrose Silk Co. its entire interest in the building. For effecting this transaction, petitioner paid in 1922 a brokerage fee of $20,000.

5. The petitioner in the fiscal year 1922 sustained a loss of $23,813.57 in the operation of its building. It included this in a "deferred asset" account as part of an amount of $70,501.60.

6. Included in the "deferred asset" account was $46,689.50 which was not a "deferred asset" or a part of surplus, but represented accumulated losses for prior years resulting from unoccupied space in its building.

7. The petitioner under date of July 14, 1910, entered into a contract pursuant to which it became for 21 years from October 1, 1911, the lessee of property on the southeast corner of Fifth Avenue and Thirty-eighth Street, New York City, being 93 feet 5 inches, on Fifth Avenue and 175 feet on Thirty-eighth Street. The yearly rent specified was $100,000 for the first 2 years until October 1, 1913, $110,000 for the next 8 years until October 1, 1921, and $130,000 for the remaining 11 years until October 1, 1932, plus additional amounts during construction of 6 per cent on the cost of a building to be erected, including interest and carrying charges during construction. The rent was payable quarterly. The lessor was to erect, before October 1, 1911, an 11-story building costing not less than $500,000 nor more than $700,000, suitable for the purpose of the lessee and in accordance with specifications to be furnished by lessee. The lessee was to keep in repair, obey all ordinances, pay all taxes and assessments, water rents, insurance, etc. The lessor might mortgage the premises up to an amount requiring interest not to exceed $125,000 yearly. The lessee had the right to renew for 21 years at a rent agreed upon or of 5 per cent of the value of the land and building as shown by an appraisal to be made at the time of renewal, the land to be

valued at not less than $2,400,000. The lessee's performance was to be guaranteed by certain persons or by the deposit after 1916 of $100,000. The building cost $995,000, but it was agreed between the parties that petitioner should pay 6 per cent on $850,000, or $51,000 a year in lieu of 6 per cent on the maximum of $700,000 as provided in the contract.

Petitioner moved into the building October 15, 1911, and occupied the basement, store floor, and three other floors. The remaining floors were rented by petitioner. Each floor rented for between $17,000 and $18,000 a year, totaling about $120,000 gross; the running expenses were about $12,000 to $15,000. For the first two years, beginning October, 1911, petitioner paid for the use of the building $100,000 rent, $51,000 interest on cost of building, $30,000 in taxes, and about $15,000 running expenses, aggregating $196,000.

The fair market price or value on March 1, 1913, of petitioner's interest in the leasehold was $350,000. A reasonable allowance for the exhaustion of the leasehold is $8,850 for each of the years in question.

8. In 1923 petitioner found it expedient for business reasons to change its heating system from coal-burning to oil-burning. The cost of the change was $11,104.98. This change was the result of the fact that, because of a coal strike in 1920 or 1921 which impaired the supply of anthracite coal in New York, soft coal was used, and this soiled petitioner's merchandise. After engineering advice, petitioner decided that in its business interests it should substitute an oil-burning device for its coal-burning device. The change was made slowly enough to prevent a temporary discontinuance of heat and light in the building, and this may have involved greater cost than the immediate and direct change would have involved. Petitioner would have preferred to continue the use of anthracite coal, but this was not possible.

9. In 1923 petitioner expended $5,447.49 and in 1924, $2,640.64, which amounts were entered on petitioner's books as charitable contributions, deduction taken by petitioner and disallowed by respondent. They were paid for theater tickets, program advertising, hospital contributions and other similar things "to pacify" the petitioner's women customers.

10. Petitioner was incorporated in 1907 to conduct a business formerly owned by Paul J. Bonwit, who sold a portion of his holdings prior to the incorporation. Common stocks and bonds of the face value of $60,000 and $600,000, respectively, were issued in exchange for this business, which was thereafter conducted under the name of Bonwit Teller & Co. Among the assets conveyed to the corporation were merchandise, accounts, and fixtures worth from $300,000 to $350,000, and good will. In 1911 the corporation issued common stock aggregating $800,000 and preferred stock aggregating $200,000, and the bondholders exchanged their bonds for common stock. At that time, the value assigned on the books to good will was reduced from $340,000 to $280,000. For the fiscal year ended January 31, 1922, the Commissioner assigned to petitioner's good will a book value of $285,000.

OPINION.

STERNHAGEN:

1. The petitioner formally pleads the bar of the statute of limitations, but counsel submits neither reason nor authority to support it, asking only that the facts be found. The deficiencies are not barred. Revenue Act 1924, sec. 277 (a) (1); Revenue Act 1926, sec. 277(a) (2).

2. The respondent, for each of the three years, reduced the deduction for exhaustion, wear and tear of furniture and fixtures. There is no evidence on the point, and hence no facts can be found and no error discovered. Respondent is sustained.

3. The evidence sufficiently establishes the reasonableness of an allowance for exhaustion, wear and tear and obsolescence of the two buildings on East Thirty-eighth Street of 10 per cent of their allocated cost of $70,000, or $7,000 in 1922. The profit from the sale in 1924 should be computed by applying such depreciation, including $3,500 for 1921, to such cost.

4. Petitioner claims the right to deduct in 1922 the entire brokerage fee of $20,000 paid in that year in connection with its transaction with the Primrose Silk Co. It does not appear in evidence in precise terms whether petitioner assigned its entire right and obligation in respect of the building so as to terminate entirely its relation to the building and its owner, or contracted with the Primrose Co. to make the latter its sublessee (as stated by counsel in brief) thus retaining its rights and obligations to the fee owner and securing rights against the Primrose Co. It does not appear what were petitioner's obligations as to rent or what were its emoluments from the Primrose Co., nor does it appear what period of time the original lease or subsequent contract was to endure. Since the burden of proof is upon petitioner and it has left these facts unproven, we must supply the omission by an unfavorable hypothesis of consonant facts.

It is consistent with the evidence to suppose petitioner a lessee for a long term at a fixed annual rental. It pays a brokerage fee of $20,000 to secure a subtenant from whom it receives a substantially larger rental, thus enjoying a regular annual gain during all of the term. It seems clear that under such circumstances the brokerage fee is an investment of capital in a contract yielding income and not an ordinary and necessary expense of carrying on a trade or business, and hence that it should not be deducted from the income of the initial year. The correlation between income and outgo recognized in American National Co. v. United States, 274 U. S. 99, would discontinuance such treatment, and would require the periodic amortization of the expenditure proportionately as the resulting income is derived. The respondent is sustained.

This is contrary to some of the discussion found in Robert H. McNeill, 16 B. T. A. 479, overruling Crompton Building Corporation, 2 B. T. A. 1056. In the McNeill case the discussion went beyond the necessity of the case. The fee paid there was by the owner for general services of looking after the property, effecting the lease for two years, and attending to other matters. It was not necessarily a single brokerage fee to procure steady income. That the question is not free from difficulty will appear from several decisions of the Board involving close distinctions. Crompton Building Corporation, supra; D. N. & E. Walter & Co., 4 B. T. A. 142; Higginbotham-Bailey-Logan Co., 8 B. T. A. 566; Henry B. Miller, 10 B. T. A. 383; C. M. Nusbaum, 10 B. T. A. 664; Marjorie Post Hutton, 12 B. T. A. 265; Robert H. McNeill, supra. See, also, Duffy v. Central R. R. of N. J., 268 U. S. 55. We are of opinion the respondent correctly disallowed the deduction.

5. The respondent in his answer admits the fact that in 1922 petitioner sustained an operating loss in respect of its building, some part of which was regularly occupied by tenants. The disallowance of the loss was the result of a misconstruction by respondent of petitioner's accounts for the building, by which it apparently mingled its current operating losses with the accumulations of "deferred assets" set up in respect of empty space for prior years. In accordance with respondent's admission of the facts and the statement made at the hearing that the

deductibility of the item was not in dispute, the respondent's disallowance is reversed and the deficiency should be redetermined accordingly.

6. The respondent reduced invested capital by $70,501.60, representing the aforementioned "deferred asset" account. Petitioner alleges and respondent in answer admits in respect of this item that "surplus should have been reduced only by the sum of $46,687.59." The deficiency should be modified accordingly.

7. The petitioner contends that it is entitled to a finding of fact that its interest as lessee in the leasehold of the land and building which it occupied at Fifth Avenue and Thirty-eighth Street had on March 1, 1913, a fair market price or value of $1,000,000 to be used as the basis of a deduction in each of the years 1922, 1923, and 1924 of a "reasonable allowance for exhaustion." Sec. 234(a)(7); Grosvenor Atterbury, 1 B. T. A. 169. The respondent has determined that petitioner's interest had no value on that date and hence no basis for an exhaustion allowance. The burden of proving any value therefore rests upon petitioner.

The issue is whether the terms of the lease were on March 1, 1913, so favorable to the lessee that his net interest, consisting of both his rights and obligations, could have been sold by him to another; and, if so, at what price. The terms were fixed at arm's length in July, 1910, less than three years before, and occupancy of the newly constructed building had commenced less than a year and a half before the valuation date. On that date petitioner possessed the property with over 19 years to run and a right to renewal. Some of the burdens of his lease were behind him, such as the carrying charges during construction. The burdens to come were the rental at $110,000 for 8 years and $130,000 for the remainder, plus the uncertain carrying charges, including taxes, insurance, repairs, and running expenses. Apparently 5 per cent was regarded as a fair money rate for the renewal rental was to be measured by it. The lessor was permitted to mortgage at interest of $125,000, which at 5 per cent would represent a mortgage of $2,500,000, which in turn was no doubt substantially less than the full value of the land and building. The lessee's experience prior to March 1, 1913, justified the expectation that $120,000 gross rent would be received for the seven floors rented.

That these facts indicate a substantial value in the lessee's interest is quite clear. We are, however, of opinion that petitioner's evidence does not support the value claimed. Its principal witness was a real estate dealer whose opinion of value was asked. This witness' opinion was, we think, not entitled to full weight, since in his method of valuation he used factors which were not entirely in accord with the facts as to this property. One such discrepancy lay in his use of an annual rental of $110,000 for 19 years, whereas the lease provided an increase to $130,000 after 8 years. There are other discrepancies. The rental values given by him for other properties were not shown to be comparable. Bare figures are of little use apart from the substantive terms and circumstances of the leases.

On the other hand, respondent with equal opportunity to investigate and present evidence of factors of value or lack of value, has introduced no evidence on the point, but stands on his official determination.

After considering all the evidence fully, we have fixed a value of $350,000, and exhaustion should be computed by spreading this over the original and renewed term of 39 years 7 months, or at a rate of over 2½ per cent. 719 Fifth Avenue Co., 5 B. T. A. 565. The reasonable annual

exhaustion allowance is $8,850, and this should be deducted in redetermining the deficiency for each of the three years.

8. The petitioner claims that the cost of $11,104.98 occasioned by the change of its heating system from coal-burning to oil-burning is deductible in 1923 as an ordinary and necessary expense of carrying on its trade or business during that year. Sec. 234(a)(1). Its principal argument seems to be that because its president thought that it added nothing to the value of the building, it could not be be called a capital investment. Leaving out any doubt as to the correctness of the president's view as to the fact of increased value, this is not the criterion of a capital expenditure. Necessary replacements or useful improvements may properly be capitalized and their cost amortized out of income of the years of their useful life, even although the market value of the whole property shows no perceptible increase.

But aside from this, the issue here is in terms of the statute — not whether the cost is a capital expenditure, but whether it is an ordinary and necessary expense of carrying on the business. We think it is not and is not deductible. Sec. 215; Simmons & Hammond Mfg. Co., 1 B. T. A. 803. The fact that it was occasioned by a circumstance outside of petitioner's control does not bring it within the statutory deduction. Robert Buedingen, 6 B. T. A. 335; Frank & Seder Co., 13 B. T. A. 1; Woodside Cotton Mills Co., 13 B. T. A. 266.

9. The evidence is not sufficient to establish, as petitioner contends, that the amounts of $5,447.49 for 1923 and $2,640.64 for 1924 were "ordinary and necessary business expenses." The respondent, as we must assume, has investigated and found and, hence, has determined that these amounts were made up of charitable contributions, which are not deductible when made by corporations as they would be by individuals. The petitioner offered only a most cursory conclusion by its president that these in the aggregate were expenses. Thus, without more, the issue is only whether we should give credence to the witness' characterization or the Commissioner's, when petitioner has not proved the facts. We sustain the respondent. Stephens Fuel Co., 13 B. T. A. 666.

10. Petitioner contests the respondent's computation of invested capital in respect of good will. The principal fact relied upon in evidence is that respondent for 1922 allowed a lower good will than he allowed for previous years. There is no factual evidence of the value of good will at the time paid in, and, except for the president's opinion in testimony, there is nothing by which to test the existence or value of good will in 1907 or 1911. Respondent's allowance for prior years is not a binding determination of the fact, properly denied in the pleadings, as to the year before the Board. See James Couzens, 11 B. T. A. 1040.

This also disposes of the corollary attack upon the respondent's method of applying the 25 per cent limitation provided in the statute as to intangible invested capital. The respondent has taken $859,433.34 as the value of capital stock outstanding at the beginning of the taxable year. There is no reason in the record to question the correctness of this. Clearly then no amount may be included for intangibles greater than 25 per cent of that amount. The respondent is sustained in his treatment of good will.

11. There is a further issue as to invested capital, but no evidence was introduced to support it, and respondent is sustained.

Reviewed by the Board.

Judgment will be entered under Rule 50.

MURDOCK concurs in the result.

SMITH did not participate.