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Fackler v. Commissioner

45 BTA 708

The respondent determined a deficiency of \$4,639.67 in the petitioner's income tax for 1938. The only issue presented is whether a certain lease sold by the petitioner in 1938 was a capital asset and the gain realized from the sale taxable as capital gain.

FINDINGS OF FACT.

The petitioner is a lawyer and has been engaged in the practice of law since 1905. From 1905 to 1933 he conducted his practice alone. On January 1, 1933, he formed a law partnership known as Fackler & Dye. This partnership has its office in Cleveland, Ohio, and during 1938 was composed of the petitioner and two other lawyers. The petitioner filed his income tax return for 1938 with the collector of internal revenue for the eighteenth collection district of Ohio.[pg. 709]

On August 22, 1933, the petitioner leased from Maggie A. Reimer the premises known as the Sloan property, situated in the business district of Cleveland and consisting of certain land upon a portion of which stood a six-story building with a basement. The term of the lease was for 99 years from September 1, 1933, with the right of renewal for like periods of 99 years forever and with the further right, conditioned upon the continuance in effect of the lease or renewals thereof, of purchase of the property for \$250,000 during the term of the lease or any renewal thereof but after the death of the lessor. The rental was \$10,000 per year for the first five years and \$12,000 per year during the balance of the term and any renewals thereof and was payable quarterly in advance. The lessee was to pay all real estate taxes, special or other assessments, water rents, and other public charges already assessed, or imposed upon the premises and unpaid and that might thereafter during the term of the lease be assessed or imposed on the premises. He was to keep the premises, including improvements, in a good, safe, secure, and sanitary condition and repair, and, in the event he should demolish or remove the building, he was to construct a new building having a cost of not less than \$200,000, which in event of forfeiture or nonrenewal of the lease would become the property of the lessor without any payment to the lessee therefor. He was also to keep all buildings and improvements on the premises insured against loss or damage by fire.

At the time the petitioner entered into the above mentioned lease the premises were under a lease entered into in 1916, from Maggie A. Reimer to Thomas G. Sloan, whose interest therein was subsequently transferred to the Sloan-Prospect Corporation. The petitioner's lease was made specifically subject to the underlying lease and all rights of the lessor under the underlying lease were by petitioner's lease assigned to the petitioner. Petitioner paid certain taxes which were outstanding against the premises on August 22, 1933. He also purchased the underlying lease which was sold in the early part of 1934 under foreclosure proceedings against the Sloan-Prospect Corporation. The price paid for the underlying lease and the amount of said taxes less certain recoveries obtained from the Sloan-Prospect Corporation with respect thereto, or an amount of \$5,461.08, constituted the cost to petitioner of his lease.

In 1934 and at about the time of the foreclosure of the interest of the Sloan-Prospect Corporation in the premises, the petitioner at a cost of about \$600 acquired from that corporation certain personal property used in and about the building, consisting of office furniture and some barber shop chairs. The reasonable life expectancy of this personal property at the time of acquisition by the petitioner was estimated by him at ten years.[pg. 710]

At the time the petitioner acquired his lease on the Sloan property all six floors of the building were rented to tenants engaged in various types of business. When vacancies occurred the petitioner did not list the property with a real estate agency but sought tenants himself. However, he would have paid a commission to anyone who procured tenants. On some undisclosed date, but probably about 1936, the petitioner discontinued elevator service in the building and closed the upper five floors and did not try to get tenants therefor for the reason that the cost of operations with respect to such floors exceeded the rentals obtainable therefrom. Thereafter only the ground floor and the basement were rented. In 1938 the rear of the first floor was occupied by the Western Union Telegraph Co. The remainder of that floor was used by various tenants for the operation of a drug store, an electrical goods store, a haberdashery store, and a polish store, respectively. The tenants of the basement used it for the conduct of a restaurant and a barber shop. One tenant moved out in March 1938 and another in the following month. During 1938 the petitioner did not make any leases of space in the building. In 1938 the petitioner did not furnish janitor service to the tenants of the building and, aside from a parking lot guard hereinafter referred to, the only employee the petitioner had in connection with the building was a watchman. During 1938 the petitioner was in the building not more than once or twice a month and, exclusive of negotiations for the sale of the leasehold, did not devote to the property more than one or two hours a month of his time.

The item "Service Income" as reported by petitioner in his 1938 income tax return consisted mainly of income received for electric current furnished to tenants.

In his income tax return for 1933 the petitioner reported the receipt from the Sloan property of rentals, less certain operating expenses, of \$5,784, the payment of \$5,000 as rent under his lease, and a net income from the property of \$784.

In his income tax returns for the years 1934 through 1938 the petitioner reported the following indicated amounts of rentals received, expenses incurred, and net profit or loss with respect to the Sloan property:[pg. 711]

	1934	1935
Rent _____	\$33,983.69	\$35,932.57
Service income _____	-----	-----
Expenses:		
Depreciation (personal property)<2> _____	58.70	58.70
Amortization (leasehold)<3> _____	-----	-----
Repairs _____	639.96	-----
	=====	=====
Other expenses:		
Electric current _____	639.16	613.03
Electrical supplies _____	86.98	271.97
Elevator repairs _____	223.87	556.79
Ground rent _____	10,000.00	10,000.00
Hauling _____	169.50	182.50
Heat and steam service _____	2,381.83	2,579.34

Insurance	643.43	605.97
Janitor supplies	174.86	215.53
Office supplies and expenses	13.89	12.85
Miscellaneous taxes	24.70	17.44
Telephone	60.59	74.78
Wages	10,346.17	10,229.06
Water	460.27	406.73
Window cleaning	444.00	480.00
Taxes<4>	9,527.97	-----
Maintenance and repairs	-----	695.81
Real estate taxes	-----	10,662.45
Bad debts	-----	162.52
Miscellaneous expenses	233.08	316.41
	-----	-----
Total	35,430.30	38,083.18
		=====
Less purchase discounts	10.95	

	38,072.23	

Profit or (loss)	(2,145.27)	(2,198.36)
	1936	1937
		<1>1938
Rent	\$32,142.67	\$25,522.30
Service income	-----	-----
		3,018.56

	19,349.78	
	=====	=====

Expenses:

Depreciation (personal property)<2>	50.50	47.00	} 84.81
Amortization (leasehold)<3>	-----	-----	}
Repairs	1,620.48	504.01	-----
	=====	=====	

Other expenses:

Electric current	104.02	-----	1,959.02
Electrical supplies	57.54	-----	-----
Elevator repairs	-----	-----	-----
Ground rent	10,000.00	10,000.00	5,833.31
Hauling	201.25	-----	-----
Heat and steam service	2,184.58	1,570.62	821.80
Insurance	640.54	-----	-----
Janitor supplies	96.54	-----	-----
Office supplies and expenses	10.53	-----	-----
Miscellaneous taxes	18.06	-----	-----
Telephone	72.56	-----	-----
Wages	8,522.98	1,596.67	750.02
Water	440.89	-----	582.52
Window cleaning	360.75	-----	-----
Taxes<4>	-----	-----	-----

Maintenance and repairs _____	-----	-----	166.54
Real estate taxes _____	8,215.71	13,925.96	7,059.44
Bad debts _____	-----	-----	-----
Miscellaneous expenses _____	1,396.24	<5>707.25	357.66
	-----	-----	-----
Total _____	32,322.19	27,800.50	17,615.12
	=====	=====	=====
Less purchase discounts _____	-----	-----	-----
Profit or (loss) _____	(1,850.50)	(2,829.21)	1,734.66

- <1>Receipts and expenditures for first nine months of 1938.
 <2>So far as disclosed the personal property acquired by petitioner from Sloan-Prospect Corporation was continued in use in and about the building.
 <3>The return for 1938 was the only one in which the petitioner took a deduction for amortization of the leasehold.
 <4>Apparently real estate taxes.
 <5>Includes expenditures for water.

On June 1, 1936, petitioner acquired at a cost of \$36,800 an apartment house and two old residences situated in Cleveland (apparently in fee) and known as the Carnegie property, from which he reported the receipt of rentals in his returns for the years 1933 through 1937, in the latter of which he reported the sale of the property. From the rentals so reported the petitioner took deductions for depreciation and repairs and such other expenses as heat, light, water, insurance, real estate commissions, real estate taxes, and miscellaneous expenses and reported net income or loss as follows:

1933 _____	\$579.89
1934 _____	(1,821.08)
1935 _____	277.60
1936 _____	1,019.64
1937 _____	(1,143.37)

The principal source of income reported by the petitioner for the years 1933 through 1938 was from his business as attorney and a member[pg. 712] of the partnership of Fackler & Dye, the amounts for the respective years being as follows:

1933 _____	\$75,072.27	1936 _____	\$67,271.63
1934 _____	82,104.60	1937 _____	67,314.00
1935 _____	99,445.40	1938 _____	55,856.12

During that period other income of comparatively small amounts was reported as received as director's fees and salary from corporations. The returns disclose the receipt of interest in all years of the period and the receipt of dividends in all years except 1934. In his return for 1934 the petitioner, in addition to showing his principal occupation as that of lawyer, stated that his other occupation was that of speculator in securities and lands. During the years 1936 through 1938 he also made purchases and sales of securities, his security transactions, so far as disclosed by his 1938 return, consisting of the sale of one share of corporate stock.

The petitioner did not use the Sloan property in connection with his law practice and his purpose in acquiring the lease thereon was to obtain income from the operation of the property or its sale. The petitioner did not offer the lease for sale and did not decide to sell it until in 1938, after the rental income had declined. He offered to sell it to a neighbor and concluded the sale on September 30, 1938, at a price of \$35,000 for the lease and the personal property acquired by petitioner from the Sloan-Prospect Corporation in the early part of 1934. The property had the same improvements on it at the time of the sale of the leasehold in 1938 that it had when the petitioner acquired it in 1933.

In his income tax return for 1938, as amended, the petitioner reported a gain of \$29,064.32 on the sale of the lease and the personal property, showing said gain as a long term capital gain from assets held for more than 24 months and including only 50 percent thereof, or \$14,532.16, as taxable income. In determining the deficiency the respondent determined that the lease and the personal property were not capital assets as defined in section 117 (a) of the Revenue Act of 1938 and that the entire gain of \$29,064.32 realized from the sale thereof constituted taxable income.

OPINION.

Turner:

The petitioner appears to have acquiesced in the respondent's determination in so far as it concerns the personal property acquired from the Sloan-Prospect Corporation and apparently used in and about the building until its sale along with the leasehold in 1938. No issue was raised in the petition with respect to it, nor was any contention made by petitioner at the hearing or on brief that the respondent's determination with respect thereto is erroneous. The [pg. 713]issue and the argument relate only to respondent's determination with respect to the lease.

As to the lease, the petitioner takes the position that during 1938 his business was the practice of law and that the lease (1) was not used by him in his business, and (2) was not subject to an allowance for depreciation, but was a capital asset as defined by section 117 (a) (1) of the Revenue Act of 1938 and only 50 percent of the gain realized from the sale thereof was taxable income. The respondent did not file a brief, but, as indicated by statements of his counsel at the hearing, takes the position that the use made by the petitioner of the lease was in a trade or business, and that the lease, being depreciable property under section 23 (l), was not a capital asset within the meaning of the act.

The Revenue Act of 1938 provides as follows:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) Definitions.-As used in this title-

(1) Capital assets.-The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include *** property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

*** SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*** (1) Depreciation.-A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. ***

It is accordingly noted that with respect to "property used in a trade or business" Congress, through section 23 (l), has provided under the heading "Depreciation" for the deduction of "a reasonable allowance for the exhaustion, wear and tear" of such property "including a reasonable allowance for obsolescence." It is further noted that in defining capital assets Congress, in section 117 (a) (1), has excluded exactly the same property, namely, "property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l)."

In the instant case the petitioner was the owner of a lease on the Sloan property, the lease having been acquired in 1933 at a cost of \$5,461.08. From the date of acquisition to September 30, 1938, when the lease was sold, petitioner rented space in the building located on the property to various tenants, managing and maintaining the building for the use of those tenants under his agreements with them, and during that part of the period falling in 1938 petitioner, in addition to rents, received other income for furnishing electric current to tenants. In short he was operating and using the property for the [pg. 714]production of taxable income. Although the Revenue Acts of 1913 and 1916 contained provisions similar to that set out above in section 23 (l) respecting an allowance for depreciation, and all acts since that of 1916 have contained a provision identical with that in section 23 (l), we have been unable to find any decision holding that where the owner of depreciable property devoted it to rental purposes and exclusively for the production of taxable income, he was not engaged in a trade or business. On the contrary, such decisions as bear on the question indicate otherwise. In *W. B. Brooks*, 12 B. T. A. 31; *aff'd.*, 35 Fed. (2d) 178, the taxpayer purchased a dwelling house in 1896 and used it as his personal residence until 1910 or 1911, when its use for that purpose was abandoned. Thereafter it was rented and held for sale until in 1919, when it was sold. The question involved was whether the taxpayer had sustained a deductible loss on the sale, and, if so, the amount thereof. In holding that a deductible loss had been sustained, we said:

*** After March 1, 1913, of course, depreciation must be taken into consideration in the instant case, since the petitioner was then required to make a return of his income and pay a tax thereon and was also entitled to deduct depreciation on the building in question, a depreciable asset which was being used in the production of income.

For other cases of the same import see *Walter L. Ball et al., Co-executors*, 8 B. T. A. 180; *Joseph F. Cullman, Jr.*, 16 B. T. A. 991; *Edward L. Parker*, 19 B. T. A. 171; *Edwin Vosburgh*, 23 B. T. A. 780; *Kay Kimbell*, 41 B. T. A. 940. In *Flint v. Stone Tracy Co.*, 220 U. S. 107, it was held that a corporation owning and leasing taxicabs and collecting the rents therefrom was doing business within the meaning of the excise tax act of 1909, which imposed a tax on corporations with respect to the "carrying on or doing business" by such corporations. In *George S. Jephson*, 37 B.T.A. 1117, the taxpayer, who was a manufacturer of food products, purchased in 1925 a five-story residence for the purpose of renting it. From then until 1934 he attempted to rent it but without success and the house remained unoccupied. We there held with respect to the years 1932, 1933, and 1934 that there was a continuing devotion of the property to a business use and purpose and that the depreciation sustained thereon in those years represented depreciation sustained on property used in carrying on a business and deductible under the provision of the applicable acts identical with that in section 23 (l) set out above.

The rule deducible from the above decisions is that, where the owner of depreciable property devotes it to rental purposes and exclusively to the production of taxable income, the property is used by him in a trade or business and depreciation is allowable thereon. A lease is property and when its owner uses it for business purposes, including subletting to tenants, a deduction for

exhaustion is allowable [pg. 715]with respect to it on account of such use. Minneapolis Security Building Corporation, 38 B. T. A. 1220, and cases there cited.

In support of his contention that the leasehold was not property used in a trade or business and of a character subject to the allowance for depreciation and not therefore a capital asset under section 117 (a) (1), the petitioner states that there is great likelihood of continued renewals of the lease; that in accordance with certain of his testimony and the real property law of Ohio his relation to the Sloan property was essentially that of a fee owner, and that there was nothing to amortize or exhaust because the property had no limit of duration. In *Weiss v. Wiener*, 279 U. S. 333, the Court pointed out that in Ohio leases for 99 years, renewable forever, are treated in many respects like conveyances of the fee, but stated that the taxing act had its own criteria, irrespective of local law, with respect to liability and exemption, whatever the lessees may be called. It is unnecessary for us to decide whether the petitioner in acquiring the leasehold became the fee owner. If we should decide that he was, his position here would not be improved. The property, including the building, was used by him in a trade or business and the building was property of a character subject to an allowance for depreciation, which would exclude it from classification as a capital asset under section 117 (a) (1). The record affords no basis for making an allocation of either the cost or the selling price between the land and the building, nor does it afford any basis for ascertaining the life of the building at the time of the acquisition of the leasehold in 1933 or what would be a proper rate of depreciation thereon. Under these circumstances we would be in no position to modify the amount of the deficiency as determined by respondent.

In view of the foregoing, it is our opinion that the use made by the petitioner of the leasehold in 1938 brings it within the meaning of property "used in the trade or business" as that phrase is employed in section 117 (a) (1) and 23 (1) of the Revenue Act of 1938 and that it is property of a character subject to the allowance for depreciation provided in the latter section. It accordingly follows that the leasehold was not a capital asset within the definition of section 117 (a) (1) and that taxation of the gain resulting from the sale thereof is not controlled by the capital gain provisions of the act.

The conclusions reached herein are consistent with our opinion at 39 B. T. A. 395, which involved an appeal of this petitioner for 1934 and 1935 as to the deductibility, as ordinary and necessary business expenses, of real estate taxes which were paid by him for 1931 and 1932 on the Sloan property and were past due at the time he acquired the lease in August 1933. We there held that the amount of such taxes, less certain recoveries with respect thereto, constituted consideration paid by the petitioner for the lease and was not deductible from income [pg. 716]in either the year in which assumed or in the year paid, but was proratably deductible over the life of the lease as part of the cost thereof.

Decision will be entered for the respondent.