3 T.C. 381 (1944)

A corporation in an unsound financial condition may exclude income from the discharge of indebtedness if certain conditions are met, but a deduction for obsolescence requires showing that normal depreciation is insufficient due to external factors making the property's original use obsolete.

Summary

Southeastern Building Corporation sought a redetermination of tax deficiencies, arguing that it should have been allowed to exclude income from the discharge of debt under Section 22(b)(9) of the Internal Revenue Code and that it was entitled to an obsolescence deduction for a building leased to Western Union. The Tax Court held that the corporation could exclude part of the income from debt discharge because it was in an unsound financial condition, but denied the obsolescence deduction because the building still had economic value, even if not for its original specialized purpose.

Facts

Southeastern Building Corporation (Southeastern) owned a building in Atlanta, Georgia, subject to a mortgage securing bonds issued by Atlanta Postal Building Corporation. Southeastern purchased and retired $9,000 face value of these bonds at a discount during 1939. The building had been leased to Western Union for a term expiring December 31, 1943, but Western Union ceased using the building for its intended purpose in 1934. Southeastern subsequently leased the building to other tenants at lower rental rates. In March 1939, there was a change in the officers of the Corporation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Southeastern's income and excess profits taxes for 1939. Southeastern petitioned the Tax Court for a redetermination, contesting the Commissioner's disallowance of an income exclusion related to bond retirements and an obsolescence deduction for its building. The Tax Court considered the evidence and arguments presented by both parties.

Issue(s)

1. Whether Southeastern, in an unsound financial condition, could exclude from gross income the gain from the retirement of bonds under Section 22(b)(9) of the Internal Revenue Code.

2. Whether Southeastern was entitled to an obsolescence deduction for its building under Section 23(l) of the Internal Revenue Code.

Holding

1. Yes, in part, because Southeastern was in an unsound financial condition, it could exclude income related to the retirement of bonds after June 29, 1939, the effective date of the relevant amendment to the tax code.

2. No, because Southeastern did not demonstrate that normal depreciation deductions were insufficient due to the building's loss of usefulness for its original, specialized purpose, and the building retained economic value for other uses.

Court's Reasoning

Regarding the exclusion of income, the court found that Southeastern had discharged indebtedness evidenced by a security and had filed the required consent to regulations. The court relied on the deficiency notice to establish that the retired bonds were Southeastern's liability. The court determined that Southeastern was in an unsound financial condition because its current liabilities exceeded its liquid assets, and its only significant asset was encumbered by substantial debt. However, because the provision allowing the exclusion was enacted on June 29, 1939, only the income from bonds retired after that date could be excluded. As to the obsolescence deduction, the court cited *Real Estate-Land Title & Trust Co. v. United States, 309 U.S. 13*, emphasizing that obsolescence requires more than non-use; it necessitates "economic conditions" causing property to be abandoned before the end of its normal useful life, making normal depreciation insufficient. The court found that Southeastern had not proven that its building would be abandoned or that its useful life was shortened. The court reasoned, "In general, obsolescence under the Act connotes functional depreciation… But not every decision of management to abandon facilities or to discontinue their use gives rise to a claim for obsolescence. For obsolescence under the Act requires that the operative cause of the present or growing uselessness arise from external forces which make it desirable or imperative that the property be replaced."

Practical Implications

This case clarifies the requirements for excluding income from debt discharge under Section 22(b)(9), emphasizing the need to demonstrate unsound financial condition. It also highlights the stringent requirements for claiming an obsolescence deduction under Section 23(l), indicating that a mere decline in profitability or a change in use is insufficient. Taxpayers must prove that external factors have rendered the property functionally obsolete and that normal depreciation will not adequately recover the property's basis by the end of its shortened useful life. This case is frequently cited in disputes over obsolescence deductions, particularly when a property retains some economic value despite no longer serving its original purpose. This case emphasizes that the mere fact that the property is no longer used for its original purpose is insufficient to establish obsolescence; the taxpayer must show that the property has been rendered useless by external forces, such as changes in technology, regulations, or market conditions.

