6 T.C. 1 (1946)

Taxpayers must adjust the basis of property for depreciation deductions that were 'allowed' in prior years, even if those deductions did not result in a tax benefit due to net losses, unless a formal settlement specifically altered the allowance for those prior years.

Summary

El Patio Company claimed depreciation deductions on its income tax returns from 1934-1937. These deductions were 'allowed' because the Commissioner did not deny them. Later, in a settlement for 1938 and 1939, a different depreciation amount was used for 1934-1937 to calculate residual value. The Tax Court addressed whether this settlement changed the 'allowed' depreciation for 1934-1937. The court held that the original amounts claimed and not denied were still the 'allowed' amounts for calculating depreciation in subsequent years (1940-1942), and the settlement for later years did not retroactively alter this.

Facts

El Patio Company erected a building in 1927 and claimed depreciation based on a 25-year life. From 1934 to 1937, El Patio reported net losses but still claimed a depreciation deduction of $4,504.77 each year. For 1938 and 1939, El Patio again claimed $4,504.77 depreciation. An IRS investigation in 1939 suggested a longer remaining life for the building. El Patio protested, arguing that the depreciation should be adjusted retroactively to 1934 due to the net losses in those years.

Procedural History

The IRS agent and El Patio reached a settlement for the years 1938 and 1939, using a revised depreciation calculation that affected the building's residual value. For 1940, 1941, and 1942, the Commissioner calculated depreciation based on the original depreciation claimed in 1934-1937. El Patio petitioned the Tax Court, arguing the settlement for 1938 and 1939 should control depreciation calculations for later years.

Issue(s)

Whether the settlement reached for the tax years 1938 and 1939, which used a different depreciation amount for the years 1934-1937 in calculating residual value, effectively changed the amount of depreciation 'allowed' for those prior years for purposes of calculating depreciation in subsequent tax years (1940-1942).

Holding

No, because the settlement for 1938 and 1939 did not constitute a specific 'allowance' regarding the depreciation amounts for 1934-1937. The original depreciation amounts claimed by El Patio in those years, and not disallowed by the IRS, remained the amounts 'allowed' for purposes of calculating depreciation in subsequent years.

Court's Reasoning

The court relied on *Virginian Hotel Corporation of Lynchburg v. Helvering, 319 U.S. 523*, which mandates that depreciation be computed considering any claims for depreciation that were 'allowed' in earlier years. A depreciation claim presented in a return and not challenged by the Commissioner is considered 'allowed.' While the 1938-1939 settlement used a different depreciation figure for 1934-1937 to arrive at a residual value, this did not constitute a formal allowance or disallowance for those prior years. The court emphasized that the years 1934-1937 were not being settled directly. The court stated, "In our view, there was no allowance in the settlement made for 1938 and 1939 of a depreciation adjustment for the years 1934 to 1937, but the settlement for 1938 and 1939 was merely made upon a basis as if there had been such allowance." Estoppel was not argued, and there was no evidence of misrepresentation or concealment.

Practical Implications

This case reinforces the principle that depreciation deductions 'allowed' in prior years (i.e., claimed and not disallowed) must be used to adjust the basis of property in subsequent years, even if those deductions didn't provide a tax benefit initially. Taxpayers cannot retroactively alter previously 'allowed' depreciation amounts unless a formal settlement specifically addresses and changes those prior allowances. This decision clarifies that a settlement for later years, which uses different figures for prior years in its calculations, does not automatically change the 'allowed' depreciation for those prior years. It highlights the importance of carefully documenting and understanding the basis for depreciation deductions, especially when net losses are involved.