*11 T.C. 538 (1948)*

A taxpayer cannot deduct a loss as an ordinary business loss if the property was never actually used in the taxpayer's trade or business due to zoning restrictions in place at the time of purchase.

**Summary**

In 1945, Davis sought to deduct a loss from the sale of a lot, taxes paid on the lot, and a bad business debt. The Tax Court addressed whether the loss from the sale of the lot constituted an ordinary loss or a capital loss, whether the taxpayer could claim both a specific deduction for taxes paid and the standard deduction, and whether the bad debt was indeed worthless in the tax year. The court held that the lot was a capital asset, the taxpayer could not claim both tax and standard deductions, but the bad debt was deductible.

**Facts**

In 1923, Davis purchased a lot in Pittsburgh intending to build a paint shop for his automobile business. However, a zoning ordinance enacted prior to the purchase restricted the lot to residential use, preventing Davis from building the shop. Davis sold the lot in 1945 for $811. Davis also claimed a bad debt deduction related to loans made to Vaughn for a plastic products business venture that proved unsuccessful. Davis made loans to Vaughn from March 23, 1941, until July 31, 1942, for the aggregate sum of $3,136.39. Petitioner made one sale of Dr. Casto products, the proceeds being $725, which amount he retained and credited on the amount due from Vaughn, making the net amount due on said loans $2,411.39. Of this amount petitioner claims the sum of $2,025.25 as a bad debt.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in Davis's income tax liability for 1945. Davis appealed to the Tax Court, contesting the disallowance of deductions for a loss on the sale of the Harvard Street lot, taxes paid on the lot, and a business bad debt. The Tax Court reviewed the Commissioner's determinations.

**Issue(s)**

1. Whether the loss incurred on the sale of the Harvard Street lot should be treated as an ordinary loss or a capital loss.
2. Whether the taxpayer could claim a specific deduction for taxes paid on the lot while also claiming the standard deduction.
3. Whether the debt owed to Davis by Vaughn became worthless in the taxable year, thus entitling Davis to a bad debt deduction.

**Holding**

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1. No, because the property constituted a capital asset, not real property used in the taxpayer's trade or business.
2. No, because a taxpayer claiming a specific deduction for taxes paid may not also claim the standard deduction.
3. Yes, because the bad debt was proven to be worthless in the taxable year.

**Court's Reasoning**

The court reasoned that the Harvard Street lot was a capital asset because Davis never actually used it in his trade or business due to the zoning restriction. The court distinguished cases where a business use existed and was later abandoned. Here, the restriction was in place at the time of purchase. "At the time petitioner bought the lot in 1923 it was restricted property, zoned residential. Had he taken the pains to inquire he could have learned this fact. This he did not do. The consequence was that he bought a lot which he was expressly forbidden by local law from using in his trade or business."

Regarding the tax deduction, the court observed that the taxpayer's adjusted gross income was less than $5,000, and although he claimed a deduction for taxes paid, he also claimed the standard deduction. The court determined that the taxpayer could not have the benefit of both, citing Section 23(aa)(3)(D) of the Internal Revenue Code, which indicates that failure to elect to pay tax under Supplement T (which includes the optional standard deduction) implies an election not to take the standard deduction.

As for the bad debt, the court found that the money was lent to Vaughn in connection with their business relationship under a promise of reimbursement, which was never fulfilled. The court also noted that reasonable efforts to collect the debt were made without success, and an investigation revealed that the debt was uncollectible and became worthless in 1945.

**Practical Implications**

This case illustrates the importance of verifying zoning restrictions and other legal limitations before purchasing property for business use. It clarifies that the intended use of property is insufficient to classify it as business property if legal restrictions prevent that use. Taxpayers must also understand that claiming specific deductions may preclude them from also claiming the standard deduction, particularly when their adjusted gross income is below a certain threshold. This case also provides guidance on the factors considered in determining whether a debt is truly worthless and deductible as a bad debt. Later cases involving similar fact patterns will likely cite Davis to differentiate between capital losses and ordinary losses.

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