18 T.C. 99 (1952)

A taxpayer's basis in property must be reduced by the amount of depreciation that was allowable, even if the taxpayer did not claim the full allowable amount in prior years.

Summary

William R. Collins claimed depreciation on properties using assessed valuations lower than their actual costs. When he later sold these properties, the Commissioner of Internal Revenue adjusted the original costs by deducting the depreciation that was allowable based on the original cost, not just the amount Collins had claimed. Collins argued that the Commissioner couldn't increase the depreciation amounts for years prior to 1938. The Tax Court held that the basis must be adjusted for the depreciation that was allowable, regardless of whether Collins claimed it, and a deduction for depreciation cannot exceed the adjusted basis of the property at the beginning of the year.

Facts

Collins owned several rental properties acquired between 1920 and 1937. He calculated depreciation for years prior to 1938 based on the assessed value of the buildings for property tax purposes, which was less than the actual cost. From 1931-1934, he used the declining balance method; thereafter, he used the straight-line method. In 1939, an IRS agent recomputed depreciation for pre-1938 years using the straight-line method based on cost. From 1938 to 1945, Collins claimed depreciation based on cost. In 1945 and 1946, Collins sold some of these properties. When calculating gain or loss, he deducted only the depreciation he had actually claimed. The Commissioner adjusted the basis by deducting the full amount of depreciation allowable, even if unclaimed.

Procedural History

The Commissioner determined deficiencies in Collins' income taxes for 1945 and 1946. Collins petitioned the Tax Court, contesting the Commissioner's adjustments to the basis of the properties sold. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether the Commissioner erred in adjusting the basis of properties sold in 1945 and 1946 by deducting depreciation that was allowable but not claimed in prior years.

2. Whether Collins was entitled to a full year's depreciation on the 2202 Park Avenue property in 1945, even though the adjusted basis was less than the amount of a full year's depreciation.

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Holding

1. Yes, because the adjusted basis for determining gain or loss must be reduced by the amount of depreciation allowable, regardless of whether the taxpayer actually claimed it.

2. No, because a taxpayer cannot deduct depreciation exceeding the adjusted basis of the property at the beginning of the year.

Court’s Reasoning

The court reasoned that the purpose of depreciation is to allow a taxpayer to recover their capital outlay over the asset’s useful life. Deductions are a matter of legislative grace and must be taken in the year they are allowable. Citing *United States v. Ludey*, 274 U.S. 295, the court emphasized that basis should be reduced by allowable exhaustion. The court relied on 26 U.S.C. § 113, which dictates that the adjusted basis should reflect depreciation

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