Kem v. Commissioner, 51 T. C. 455 (1968)

A lessor cannot claim depreciation on leased property if the lessee's obligations under the lease restore any depreciation, ensuring the property's value at lease termination.

Summary

In Kem v. Commissioner, the U. S. Tax Court ruled that Circle Bar Cattle Co. could not claim depreciation on its leased herd of breeding cows because the lease required the lessee to maintain the herd's quality and quantity, effectively preventing any loss due to depreciation. The taxpayers, partners in Circle Bar, had leased the herd to the Hudspeth group with a provision mandating the replacement of culled cows with younger heifers. The court found that this arrangement ensured the herd's value at the lease's end, negating any need for depreciation deductions. This case highlights the importance of lease terms in determining the applicability of depreciation allowances.

Facts

Circle Bar Cattle Co. , a partnership, purchased 9,600 breeding cows and immediately leased them back to the Hudspeth group. The lease required the lessees to maintain the herd at 9,600 head of sound cows, culling at least 10% of the herd annually and replacing culled cows with 2-year-old bred heifers. The lessees were also responsible for all maintenance costs. Circle Bar claimed depreciation deductions for 1963 and 1964, but the Commissioner disallowed these, arguing the lease provisions prevented any depreciation loss to Circle Bar.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' income taxes for 1962, 1963, and 1964, based on their distributive shares of Circle Bar's partnership income. The taxpayers petitioned the U. S. Tax Court, contesting only the disallowed depreciation deductions. The Tax Court consolidated the cases and upheld the Commissioner's determination.

Issue(s)

1. Whether Circle Bar Cattle Co. is entitled to a depreciation allowance on its leased herd of breeding cows during the term of the lease?

Holding

1. No, because the lease required the lessee to maintain the herd's value, preventing any loss due to depreciation to Circle Bar.

Court's Reasoning

The court emphasized that depreciation allowances are intended to allow a taxpayer to recover the cost of property over its useful life. However, if no loss is suffered due to the property's use, no depreciation allowance is reasonable. The court found that the lease's culling and replacement provisions ensured that Circle Bar's herd would be returned at the lease's end in a condition comparable to its original state. The court noted, "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss. " Since the lessee's obligations under the lease restored any depreciation, Circle Bar could not claim a depreciation deduction.

Practical Implications

This decision underscores the importance of lease terms in determining depreciation deductions. For similar cases, attorneys should closely examine lease agreements to assess whether the lessee's obligations negate the lessor's depreciation claims. This ruling may affect how businesses structure lease agreements to optimize tax treatment. It also serves as a reminder that depreciation is intended to recover costs, not to generate profit. Subsequent cases have applied this principle, reinforcing that lease provisions can significantly impact depreciation allowances.

