



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
SCHIRM INVESTMENT COMPANY)

Appearances:

For Appellant: Arthur D. Buckley, Public Accountant

For Respondent: A. Ben Jacobson, Associate Tax
Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Schirm Investment Company to proposed assessments of additional franchise tax in the amounts of \$455.63 and \$975.45 for the income years 1947 and 1950, respectively.

Appellant is a family-operated property management corporation formed in 1918 to take over real property and other investments inherited by members of the family from an uncle of Louis Schirm, the secretary and manager of Appellant, The appeal concerns the depreciation to be used in determining the amount of gain on the sale of certain properties.

In 1918, Appellant acquired property in Los Angeles which is referred to as the Commercial Street property. There was a class "D" warehouse which was constructed on the land in 1900. Appellant's basis for the land was \$5,000 and for the building, \$5,587. Appellant originally estimated a remaining life of 25 years for the warehouse and took depreciation on it at the rate of 4 percent from 1918 through 1930. In order to reflect greater profit, it took no depreciation for the years 1931 through 1947. In 1947 the property was sold to John S. Schirm, a member of the family and one of Appellant's shareholders, for \$10,000 in cash and 75 shares of Appellant's stock, a total consideration--of \$15,775. A letter from the Los Angeles Bureau of Municipal Research, dated March 17, 1955, stated that a valuation of \$10,587, placed by Appellant on this property when it was sold, was liberal; that the warehouse was 75 percent depreciated in 1934; that it is a non-conforming structure under the fire ordinance and could not be repaired or altered for that reason.

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Also in 1918, Appellant acquired land in Los Angeles which is referred to as the Ducommon property. Appellant's basis for the land was \$10,000. A building was constructed on the land in 1927 at a cost of \$12,000 and Appellant improved it in 1928 at a cost of \$1,677.55. Additional improvements were made in 1929, 1934 and 1946 at a total cost of \$2,905.92. Depreciation was claimed on the building and the 1928 improvement at a rate of 5 percent for the years 1927 through 1930, reflecting an estimated life of 20 years. No depreciation was claimed for the years 1931 through 1947. Depreciation at the rate of 5 percent was claimed for 1948 and 1949. John S. Schirm leased the property from Appellant, and he was to pay for upkeep and repairs. The property was sold to him in 1950 for \$30,000,

Additional property, located in San Diego, was acquired by Appellant in 1918. There were two buildings on the land at that time, which were constructed in 1890. The basis for the land was \$17,300 and for the buildings, \$16,186.41. One of the buildings was improved by the Appellant at a cost of \$10,022.16. Appellant added an improvement in 1924 at a cost of \$1,784.25 and a class "D" warehouse in 1928 at a cost of \$5,121.15. For the years 1918 through 1930, Appellant claimed depreciation at rates varying between 4% and 5% on the different improvements. The warehouse added in 1928 was depreciated at a 5% rate. No depreciation was claimed for the years 1931 through 1947. Depreciation in the amount of \$460 was claimed for each of the years 1948 and 1949. The property was sold in 1950 to Raymond J. Schirm, a member of the family and one of Appellant's shareholders, for \$50,000,

The position of the Franchise Tax Board is that the buildings on the Commercial Street and the San Diego properties were fully depreciated when they were sold and that the gain should be computed on the cost of the land only. It also contends that the cost of the improvements made after 1928 on the Ducommon property may not be added to the basis for depreciation because they were paid for by the lessee,

Appellant urges that salvage values of double the property tax assessments in the years of the sales, or equal to the selling prices, should be added to the bases, and that costs of repair should be taken into consideration as reducing the depreciation. It contends that a 2% rate should be applied in computing depreciation on the Commercial Street property for the entire time that the property was owned by Appellant. In connection with the San Diego property, it argues that a 3% depreciation rate should be used for the years 1931 through 1947. As to the Ducommon property, Appellant alleges that it did pay for the improvements made after 1928 and therefore

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that the cost of the improvements should be added to the basis.

For the years in question, Section 21(b)(1) of the Bank and Corporation Franchise Tax Act provided that in determining gain on the sale of property proper adjustment to the basis should be made:

"(A) For expenditures, receipts, losses, or other items properly chargeable to capital account ...

(b) For exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained prior to January 1, 1928, and to the extent allowed (but not less than the amount allowable) under this act, except that no deduction shall be made for (1) amounts in excess of the amount which would have been allowable had depreciation not been computed on the basis of January 1, 1928, value ..."

Reg. 25101a, Title 18, California Administrative Code, provides:

"... A taxpayer is not permitted to take advantage in a later year of its prior failure to take any depreciation allowance or of its action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period ..."

The regulations of the Franchise Tax Board do not elaborate upon the reference in the statute to depreciation "**sustained**" prior to January 1, 1928, that is, prior to the effective date of the taxing act. We believe, however, that depreciation "**sustained**" prior to January 1, 1928, is the equivalent of depreciation "allowable" thereafter. Such a construction has been placed upon a comparable section of the United States Internal Revenue Code (see Fed. Reg. §1.1016-4. See also Noaker Ice Cream Co., 9 B.T.A. 1100, 1103). The proper depreciation for each of the years involved, except for depreciation actually allowed after January 1, 1928, must be determined on the basis of conditions **existing** in each of those years.

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On the use of salvage values in depreciating property, Mertens, Law of Federal Income Taxation, Vol. 4, §23.39, states:

"A depreciation rate should be selected which permits the return over the useful life of the property of the difference between the cost or other basis of a depreciable asset and its salvage value. Such salvage value is ordinarily considered to be the net amount **realiz-**able from the sale of the asset in excess of the cost of dismantling or removing the asset. Inasmuch, however, as that is ordinarily a negligible amount, in many cases seldom exceeding 5% of the cost of the asset, it is frequently ignored in fixing the rate of depreciation. Where so ignored, any amount realized **on** later sale or disposition, after full depreciation, represents taxable income."

There is no evidence before us from which we might compute a salvage value to be assigned to any of the buildings or improvements prior to their sale. There is no indication of the amount of the sales prices, if any, which was attributable to the depreciable assets as opposed to the nondepreciable land. Even if we were to accept the assessed values of the buildings in the years of sale as a guide, we have no way of determining how much those values should be reduced for costs of removal. Taking into further consideration the fact that depreciation may not be computed with the benefit of hindsight, it is entirely too speculative to assign any salvage values to the properties.

On the question concerning repairs, Appellant has failed to show that any extraordinary repairs were made to the building which might justify retarding the normal depreciation allowance (see U. S. v. Farrell, 35 Fed. 2d 38). The cost of all improvements made by the Appellant, as contrasted with the cost of ordinary repairs, has properly been added to the depreciable bases.

With respect to the Ducommon property, the Appellant has not submitted any evidence whatever to support its allegation that it paid for the improvements made to that property after 1928. Under the circumstances, the cost of those improvements may not be added to Appellant's basis for the Ducommon property (Detroit Edison Co. v. Commissioner, 319 U.S. 98).

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Appellant estimated in 1918 that the remaining useful life of the Commercial Street warehouse would expire in 1943. Since the building was constructed in 1900, this estimate would assign to it a useful life of 43 years. The letter from the Bureau of Municipal Research, which Appellant itself submitted, states that the building was 75% depreciated in 1934, indicating a useful life ending in 1945. We conclude, in accordance with the determination of the Franchise Tax Board, that this building was fully depreciated before it was sold.

In regard to the San Diego property, we conclude that those buildings constructed in 1890, together with all improvements other than the warehouse added in 1928, were fully depreciated before the San Diego property was sold, and, in fact, prior to 1948. This conclusion is in accord with the estimated lives originally adopted by the Appellant, as reflected in depreciation rates actually claimed by it and appears reasonable in view of the fact that the buildings were constructed in 1890. As to the warehouse added in 1928 at a cost of \$5,121.15, we believe that a life of 45 years might reasonably have been assigned. This is substantially in accord with the useful life prescribed for a warehouse of average construction--in Bulletin "F" of the Internal Revenue Service, as amended in 1942, and is consistent with our previous conclusion as to the Commercial Street building, which is a class "D" warehouse, as is the building with which we are now concerned,

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Schirm Investment Company to proposed assessments of additional franchise tax in the amounts of \$455.63 and \$975.45 for the income years 1947 and 1950, respectively, be modified as follows: The proposed assessment for the income year 1950 is to be recomputed by assigning a useful life of 45 years to the class "D" warehouse on the San Diego property, in accordance with the opinion of the Board herein. In all other respects the action of the Franchise Tax Board is sustained.

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Done at Sacramento, California, this 9th day of June, 1959, by the State Board of Equalization.

Paul R. Leake, Chairman

Geo. R. Reilly, Member

John W. Lynch, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary