

Farmers Creamery Co. v. Commissioner

14 T.C. 879 (T.C. 1950)

The Commissioner determined deficiencies as follows:

| Year | Excess profits tax | Declared value excess profits tax |
|------|-----------------------|---|
| 1942 | \$ 19,666.78 | |
| 1943 | 5,975.93 | \$ 496.71 |
| 1944 | 9,754.25 | |
| 1945 | 10,383.11 | 331.00 |

The issues for decision are whether the Commissioner erred in:

- (1) disallowing, as capital items, 75 per cent of expenditures in each year claimed as ordinary and necessary expenses representing repairs to a building,
- (2) disallowing \$ 16,957.37 claimed as a loss on bottles and crates for 1942,
- (3) adding to reported income for 1943 and 1944 the difference between the deposits and refunds on deposits for bottles for each year, and
- (4) disallowing a deduction of \$ 867.20 for 1944 representing a voluntary payment made on an inadvertent O. P. A. violation.

FINDINGS OF FACT.

The petitioner, a corporation, processes and manufactures various kinds of dairy products at its plant at Fredericksburg, Virginia. Its returns for the taxable years were filed with the collector of internal revenue for the district of Virginia.

The Commissioner, in determining the deficiencies, disallowed 75 per cent of the deduction claimed in each year for repairs to the "general" building of the petitioner's plant. He does not question the amount expended, but explained that the portion disallowed represented cost of improvements.

The general building was erected in 1914 and has since been in constant hard use. The cost of the building at the beginning of 1942 was \$ 35,775.52, subject to a depreciation reserve of about \$ 27,000. The building was then in bad condition, due to rotting of wood portions of floors and walls resulting from milk and water seepage. Repairs were required for sanitary, safety, and

utility purposes in order to maintain and continue the efficient use of the building. Repairs were made from time to time as occasion arose during each of the taxable years, without discontinuing the use of the building. These were not made in accordance with any over-all plan. They did not require a building permit. Typical separate repairs were replacing several joists where the old ones had rotted permitting the floor to sag, replacing small portions of rotted flooring, and patching walls and ceilings. The materials used were similar to those replaced. The work was unusually expensive because of war time costs and because much of it was done on an overtime basis, so as to interfere as little as possible with the operation of the plant. The repairs never replaced as much as one-half of any wall, ceiling, or floor and they did not in any way enlarge or change the design of the building. The costs were all charged to a repair account. The repairs were solely to mend deteriorated parts of the old building in order to restore it to a sound condition. These repairs did not appreciably prolong the original useful life of the property.

The total amounts expended and deducted by years were as follows:

| | |
|------|-------------|
| 1942 | \$ 4,600.98 |
| 1943 | 5,461.94 |
| 1944 | 8,104.62 |
| 1945 | 7,175.00 |

They were entirely for repairs and were ordinary and necessary expenses.

The book value of the petitioner's bottles and crates at the beginning of 1942 was \$ 16,957.37. Its purchases of those items during 1942 amounted to \$ 18,425.20. An inventory at the end of that year showed a total of \$ 7,978.60 on hand. It claimed a deduction for that year of \$ 27,403.97, consisting of \$ 10,079.79 for depreciation at the usual rate and \$ 17,324.18 for loss of bottles and crates over and above the usual depreciation allowance.

The Commissioner, in determining the deficiency for 1942, disallowed \$ 16,957.37, with the explanation that "the alleged loss of \$ 27,403.97 of bottles and crates deducted in your return for 1942 is reduced to \$ 10,446.60 and the balance of \$ 16,957.37 is disallowed as unsubstantiated."

The petitioner delivered large quantities of milk during 1942 to a military camp. It was not permitted to deliver directly to the post exchanges and company messes which were its customers, but had to leave the milk at a central location, from which it was picked up by the customers, many of which were on maneuvers within the military reservation. An unusually large number of the bottles and crates were never returned to the petitioner and it was not permitted to come into the reservation to retrieve them. Later in the year it discovered that many of them had been destroyed and buried at temporary bivouac sites. It changed to paper containers for such customers late in 1942. Meanwhile, it had lost during the year crates and bottles worth about \$ 17,000.

The petitioner sustained a loss of \$ 17,000 for 1942, representing an extraordinary loss on bottles and crates, in addition to the deduction of \$ 10,079.79 for usual depreciation.

The O. P. A. in 1942 required the petitioner to obtain from its wholesale customers for 1943 and subsequent years deposits of 3 cents per bottle delivered to them, which deposits were to be returned to the customer with the return of the bottles. The bottles were not sold to the wholesale

customers. The petitioner kept a record of the deposits in a liability account and debited the refunds as made. The total deposits and refunds for each year were as follows:

| Year | Deposits | Refunds | Balance |
|------------------------|-------------|-------------|-------------|
| 1943 | \$ 6,700.89 | \$ 3,905.50 | \$ 2,795.29 |
| 1944 | 5,602.57 | 2,726.69 | 5,671.17 |
| 1945 | 2,950.86 | 3,774.65 | 4,847.38 |
| 1946-1947, to November | | 4,552.93 | 294.45 |

The Commissioner, in determining the deficiencies for 1943 and 1944, added to income \$ 2,795.29 and \$ 2,875.88, described as "deposits on bottles," and explained "items reserved from income to meet contingent liabilities to refund deposits on milk bottles have been restored to taxable net income."

The petitioner's method of recording the deposits as liabilities rather than as income clearly reflected its income and the Commissioner erred in departing from that method in determining the deficiencies.

The president of the petitioner discovered in 1944 that it had charged during that year 1 cent per quart in excess of the O. P. A. price on a chocolate drink, or a total of \$ 867.20. He voluntarily reported this fact to the Chairman of the Price Board in Fredericksburg shortly before July 1, 1944, and asked what the petitioner should do. He was advised to communicate with the Richmond office. The petitioner later received a letter, dated August 21, 1944, from the district price executive of the O. P. A. at Richmond, which was as follows:

A copy of your letters of June 27 and August 5 addressed to Mr. Reed and a copy of Mr. Sanders' letter to Mr. Reed of July 26 have been brought to our attention along with your check for \$ 814.76.

We realize and appreciate to the fullest extent that you are one of the finest citizens of the State of Virginia and a business man of unquestioned ethics and character. It is for this reason and in this spirit that we are accepting your check for an overcharge on the sale of Krim-Ko chocolate milk. We know that this overcharge was not willful nor even neglect on your part, but that it was a result of a misunderstanding and misinterpretation which would be natural on the part of anyone.

If it were possible not to require settlement, we would be glad to consider it; however, the only way that we can justify the administration of the rules and regulations of the Office of Price Administration is that they be applied with no exceptions for those who have been so unfortunate as to have made an error and no undue criticism and persecution for the more careless.

The District Office as well as your local community fully appreciates the contribution which you have made to our program and wants you to understand that we hold you in the highest esteem.

The Commissioner, in determining the deficiency for 1944, disallowed \$ 867.20, described as "O. P. A. violation," and stated that it was not an allowable deduction.

OPINION.

The first question is one of fact, what was the purpose and effect of the work? The evidence shows that repairs, rather than replacements, alterations, improvements, or additions were made. *Illinois Merchants Trust Co.*, 4 B. T. A. 103. They merely permitted the continued use of the building without substantially extending its former estimated useful life. Their cost, while large in relation to the original cost and unexhausted basis for the building, has been satisfactorily explained. The arbitrary action of the Commissioner in allowing one-fourth and disallowing three-fourths of that expense for each year was in error. The entire amount expended in each year was deductible.

The Commissioner allowed a deduction for 1942 on bottles and crates somewhat in excess of the \$ 10,079.79 claimed for depreciation at the usual rate. He disallowed \$ 16,957.37 of the total claimed for depreciation and the unusual loss on the ground that it was unsubstantiated. It has now been substantiated, although proof of an exact amount is precluded by the nature of the loss and the absence of records of the exact basis of the property lost. However, the exact amount is not absolutely essential for a deduction tied in with depreciation. *Buckeye Producing Co.*, 15 B. T. A. 435.

The respondent would have the petitioner include in income the deposits on bottles as sales and then take deductions for the refunds. These were not sales. The petitioner chose to record them as true deposits, liabilities, rather than as income. That method was in accordance with the nature of the deposits as required by the O. P. A. and properly reflected the transactions for income tax purposes. *Wichita Coca-Cola Bottling Co. v. United States*, 152 Fed. (2d) 6; certiorari denied, 327 U.S. 806. The Commissioner had no right to depart from that accounting method merely to compute larger taxes for the period as a whole.

The O. P. A. violation, unlike those in *Scioto Provision Co.*, 9 T. C. 439, and *Garibaldi & Cuneo*, 9 T. C. 446, was about as insignificant as such a thing could be. The amount was small. The violation was inadvertent and unintentional rather than in deliberate or careless disregard of the law. It was unnoticed until later discovered by the president of the petitioner. He voluntarily brought it to the attention of the O. P. A. authorities and paid the amount without compulsion. Apparently the O. P. A. had no power at that time to require such a payment. See I. T. 3800, 1946-1 C. B. 82. The director's letter indicates that allowance of a deduction for the amount paid would not be contrary to any well defined public policy. *Jerry Rossman Corporation v. Commissioner*, 175 Fed. (2d) 711. Some such trivial mistakes probably occur in most businesses of any size. The argument of the respondent is that the details of the violation have not been shown adequately. That was due partly to the fact that the president, who discovered the overcharges, died prior to the trial. However, the payment is clear enough and the record justifies the conclusion that the sales were made in 1944. There is not any suggestion that they were made to the United States Government.

Decision will be entered under Rule 50.