



Tax Reduction Letter

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St. Louis Malleable Casting Co. v. Commissioner

9 B.T.A. 110 (B.T.A. 1927)

Docket Nos. 5490, 15168.

Board of Tax Appeals.

Promulgated November 15, 1927.

R. M. O'Hara, Esq., N. B. Landreau, Esq., and Beach P. Burlingham, Esq., for the petitioner.

L. L. Hight, Esq., and Granville S. Borden, Esq., for the respondent.

The Commissioner has determined deficiencies of \$17,081.80 for 1917, \$17,612.72 for 1918, and \$4,165.75 for 1920.

For the year 1918 the Commissioner originally assessed an additional tax of \$19,622.86, of which amount an abatement was allowed to the extent of \$2,010.14. The year 1919 is not involved in this proceeding since no deficiency was asserted by the Commissioner for that year.

The petitioner alleges error on the part of the Commissioner (1) in allowing an inadequate value at March 1, 1913, for patterns as a basis for depreciation; (2) in allowing an inadequate value at March 1, 1913, for patents as a basis for depreciation; (3) in computing depreciation of plant and equipment upon a basis less than the cost thereof; (4) in allowing inadequate rates of depreciation in the years 1920 and 1921 on ovens and furnaces, and office furniture and fixtures; (5) in failing to restore to capital account in 1920 both for depreciation and invested capital purposes the cost of patterns, amounting to \$10,025.52, originally charged off by the taxpayer in 1917 but disallowed by the Commissioner; (6) in failing to allow deductions in 1920 for depreciation on the new buildings erected and operated during a part of the year 1920; (7) in failing to allow as a deduction depreciation on various expenditures made during 1920, originally charged to expense but restored to capital account by the Commissioner. The petition originally contained an allegation that the Commissioner erred in refusing to allow a March 1, 1913, value of plant and equipment, as a basis for depreciation, in excess of the cost thereof as shown by the books. This contention was withdrawn by the petitioner at the hearing.

FINDINGS OF FACT.

Petitioner is a corporation, organized under the laws of the State of Missouri, and had its principal office at 7701 Conduit Avenue, St. Louis, Mo. Petitioner engaged in the manufacture and sale of

devices connected with, electrical transmission lines. It was organized about 1902, and for a few subsequent years was engaged in producing castings for the St. Louis Car Co. During 1908 the St. Louis Car Co. became financially involved, resulting in the loss of this business to the petitioner. It therefore became necessary for the petitioner to secure other outlets for its business; in accomplishing this object it manufactured a large number of patterns for the devices which it desired to make in addition to the patterns which it already owned.

At March 1, 1913, petitioner was the owner of the following patents which were issued on the dates indicated:

Patent No.	Issued
905414	Dec. 1, 1908
906003	Dec. 8, 1908
906787	Dec. 15, 1908
908082	Dec. 29, 1908
919840	Apr. 29, 1909
995123	June 13, 1911

The petitioner manufactured devices covered by these patents both prior and subsequent to March 1, 1913, but also manufactured and sold a large number of devices not covered by patents. The book records of the petitioner show the sales of patented and nonpatented articles, as follows:

<i>Sales</i>			
Patented articles	Nonpatented articles	Total sales	Percentage patent sales to total sales
1908	\$178,821.74	\$178,821.74	
1909	\$38,668.65	266,741.37	305,410.02 12.66
1910	43,804.62	421,679.82	465,484.44 9.41
1911	46,574.69	278,909.10	325,483.79 14.31
1912	62,188.97	341,290.95	403,479.92 15.41
1913	96,948.65	460,025.22	556,973.87 17.41
1914	59,900.64	291,177.20	351,077.84 17.06
1915	63,252.12	277,279.85	340,531.97 18.57
1916	97,595.46	473,979.72	571,575.18 17.07
1917	147,717.68	865,644.91	1,013,362.59 14.57
1918	44,402.75	974,370.52	1,018,773.27 4.35
1919	63,973.61	806,359.25	870,332.86 7.35
1920	167,710.81	1,399,486.71	1,567,197.52 10.70
	932,738.65	7,035,766.36	7,968,505.01 11.71

By applying average cost per hundred pounds of petitioner's entire production to ascertain the cost of producing the patented articles, the following result is reflected:

<i>Profit from sale of patented articles compared to net income from</i>		
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<i>entire business</i>						
Year	Weight	Average cost per 100 pounds	Cost of sales	Sales	Profit on patent sales	Total net income for the year as per books
1908						\$57,502.20
1909	\$642,378	\$4.125	\$26,497.69	\$38,668.65	\$12,170.96	5,748.68
1910	583,668	4.000	23,346.72	43,804.62	20,457.90	18,610.08
1911	566,456	4.293	24,307.97	46,574.69	22,266.72	35,444.25
1912	781,303	3.844	28,767.56	62,188.97	33,421.41	42,240.23
1913	1,198,611	4.157	49,826.23	96,948.65	47,122.42	65,399.08
1914	686,643	4.459	30,617.41	59,900.64	29,283.23	26,859.88
1915	770,238	4.510	34,737.55	63,252.12	28,514.57	26,691.38
1916	919,969	4.631	42,603.76	97,595.46	54,991.70	57,877.30
1917	976,099	5.939	57,970.52	147,717.68	89,747.16	174,943.24
1918	304,749	7.948	24,221.45	44,402.75	20,181.30	40,154.02
1919	396,251	8.336	33,031.49	63,973.61	30,942.12	55,399.97
1920	713,444	10.661	76,060.25	167,710.81	91,650.56	317,142.27

The profits prior to 1913 thus attributed to the patented articles have been apportioned to the various patents by the petitioner, as follows:

Patent No.	Years	Total sales	Cost of sales	Profit	Average profit
905414	1909	\$5.00	\$4.62	\$0.38	
	1910	637.72	512.12	125.60	
	1911	760.98	559.51	201.47	
	1912	832.74	644.79	187.95	
		2,236.44	1,721.04	515.40	\$128.85
906003	1909	31,337.48	20,654.13	10,683.35	
	1910	39,215.61	20,926.52	18,289.09	
	1911	42,212.91	21,580.78	20,632.13	
	1912	57,943.79	27,741.57	30,202.22	
		170,709.79	90,903.00	79,806.79	19,951.69
906787	1909	28.26	16.83	11.43	
	1910	43.51	19.84	23.67	
1911	65.12	14.00	51.12		
1912	55.11	30.59	24.52		
		192.00	81.26	110.74	27.68
908082	1909	5,303.92	4,447.25	856.67	
	1910	2,339.77	931.20	1,408.57	
	1911	90.81	32.93	57.88	
	1912	345.21	124.08	221.13	
		8,079.71	5,535.46	2,544.25	636.06
919840	1909	1,993.99	1,374.86	619.13	

Patent No.	Years	Total sales	Cost of sales	Profit	Average profit
	1910	1,568.01	957.04	610.97	
	1911	2,813.98	1,725.36	1,088.62	
	1912	2,154.80	1,032.42	1,122.38	
		8,530.78	5,089.68	3,441.10	860.27
995123	1911	630.89	395.39	235.50	
	1912	857.32	459.82	397.50	
		1,488.21	855.21	633.00	158.25

The fair market value of these patents at March 1, 1913, was \$90,284.94.

During the year 1924 the petitioner engaged the services of an appraisal company to make a retrospective appraisal of its assets as at March 1, 1913. In this appraisal the reconstruction cost at March 1, 1913, of patterns owned by the petitioner on that date has been included. The appraiser visited the vaults in which the patterns were contained and made a more or less superficial inspection. He then took from the books of the petitioner, year by year, the costs of patterns as shown therein, and by a method of calculation and percentage, determined the number of labor hours and cost of material entering into the production of the petitioner's patterns as opposed to patterns manufactured by it but owned by its customers. Having ascertained the number of hours of labor and the cost of material, the appraiser adjusted the costs thereof to a basis of cost at March 1, 1913, including in such adjusted costs 60 per cent for overhead. This 60 per cent for overhead expenses was an estimate which corresponded to the rate the petitioner used in billing patterns to its customers. The appraiser did not take each pattern found in the vaults and storerooms and appraise such pattern in accordance with the method employed in the balance of the appraisal of the petitioner's plant and equipment. The fair market value at March 1, 1913, of the petitioner's patterns was \$33,932.04, the cost thereof as shown by its books.

For the years 1917 and 1918 the Commissioner determined depreciation on the petitioner's plant and equipment by using the amounts determined by the revenue agent in a report dated October 30, 1920. In this report it is shown that the revenue agent took from the books the costs applicable to the various groups of assets and applied depreciation rates thereon, all of which were acceptable to the petitioner with the exception of the rates used on ovens and furnaces. In computing the cost to which these rates should be applied at December 31, 1916, the revenue agent eliminated from the total costs as shown by the books the cost of the assets which, in accordance with the rate of depreciation applied, would have been entirely depreciated prior to that date. This also resulted in a reserve for depreciation on December 31, 1916, of \$93,597.13 in excess of the amount which the petitioner had taken up to that time, which excess if entered in the balance sheet would have resulted in a corresponding reduction of surplus. The Commissioner, in determining the deficiency for the years 1917 and 1918, did not make such deduction in the surplus of petitioner, but left the surplus as shown by the books undisturbed.

For the year 1920 the Commissioner used as a deduction for depreciation amounts determined by the revenue agent as shown in his report dated April 6, 1925. In this report the revenue agent ignored the method employed by the previous revenue agent and, instead of using as a basis the total cost of assets as shown by the books less the items entirely depreciated, started his

computation with the amounts shown in the balance sheet at December 31, 1916, for each of the group of assets, using the same rates of depreciation as in the previous report except in the case of office furniture and fixtures. The balance sheet of the petitioner at December 31, 1916, showed the net value of assets after the sustained depreciation had been deducted from the cost of the asset and no depreciation reserve was set up as a liability. The books of the petitioner reflect the following:

Machine and equipment, December 31, 1916		\$62,968.48
Depreciation which had been credited to the account:		
1912	\$10,000.00	
1913	8,000.00	
1914	2,209.19	
1915	6,875.00	
1916	7,000.00	
Total of depreciation		34,084.19
Adjusted balance in depreciation restored		97,052.67
Buildings, balance, December 31, 1916		104,244.08

Depreciation which had been credited to the accounts prior to December 31, 1916:		
1913	\$5,000.00	
1916	8,000.00	
Total		13,000.00
Adjusted balance, December 31, 1916, with depreciation restored		117,244.08
Tools and flasks, balance December 31, 1916		36,138.47
Depreciation credited to the account in 1912		416.64
Adjusted balance with depreciation restored		36,555.11
Patterns, balance, December 31, 1916		17,165.89
Depreciation credited to the account prior to December 31, 1916:		
1912	\$10,000.00	
1913	8,000.00	
1914	2,300.16	
1915	5,000.00	

1916	5,000.00	
Total depreciation		30,300.16
Adjusted balance December 31, 1916, with depreciation restored		47,433.05
Ovens and furnaces, December 31, 1916		31,305.24
Prior depreciation credited to the account:		
1913	\$3,000.00	
1916	6,000.00	
Total depreciation		9,000.00
Adjusted balance December 31, 1916, with depreciation restored		40,305.24
Office furniture and fixtures, balance December 31, 1916		300.00
Prior depreciation credited to the account:		
1913	\$1,677.36	
1916	291.11	
Total depreciation		1,968.47
Adjusted balance, December 31, 1916, with		2,268.47

depreciation
restored

For the year 1920 the revenue agent also failed to restore to the pattern account the amount of \$10,025.52, which had been disallowed as an expense in 1917 and restored to capital account by the previous revenue agent.

During the year 1918 the petitioner purchased some heating units, consisting of square boxes about 10 by 8 feet, containing motors and fans. This item was added to the building account by the revenue agent in his report for that year.

During the years 1920 and 1921 the petitioner engaged in a new building program, expending \$253,181.62 in 1920 and \$108,120.48 in 1921. The buildings were erected in sections, and one section was completed and put into use in the early part of July, 1920. The total floor area of both sections was 70,715 square feet and that of the section completed in July, 1920, was 38,860 square feet.

During the year 1920 the Commissioner disallowed as deductions for repairs various items aggregating \$11,254.59, and restored such amount to the capital account. The character of the expenditure, the amount spent, and the date when the asset was put into use, were as follows:

Item	Account	Amount	Date put into use
New plumbing in old buildings	Buildings	\$1,856.84	May 15, 1920
New wall, plus salvage value of old brick used	do	4,696.45	Dec. 1, 1920
Moving and re-erecting flask shed and carpenter shop	do	2,201.30	Apr. 1, 1920
New style lights in old building	do	2,500.00	May 1, 1920

OPINION.

LITTLETON:

The first issue is the value at March 1, 1913, of the patterns owned by the petitioner on that date. As set forth in the findings of fact, a value has been assigned to these patterns at March 1, 1913, in the report of the appraisal company which purported to be the reconstruction cost of the patterns then on hand, less its estimate of depreciation sustained prior to that date.

The so-called retrospective appraisal of patterns was at best a rough segregation of the working hours and material applicable to patterns as shown by the petitioner's records into working hours and material applicable to patterns owned by the petitioner and those owned by customers. This was done on a percentage basis by calculating the cost of all pattern labor and materials, adding 60 per cent overhead and 20 per cent profit, and comparing this total amount with the amount actually charged on the books to customers. In order for this calculation to be correct all patterns must be of equal size and weight and of equal ease of manufacture, which, of course, was not a fact.

The appraiser did not take each pattern and determine the reconstruction cost thereof nor did he eliminate obsolete, discarded or worthless patterns, nor did he check over the patterns to ascertain if all of the patterns which were made by the petitioner from 1903 to March 1, 1913, were still in existence. If a large part of the labor and materials on the books of the petitioner had been extravagantly or wastefully spent or wholly wasted, the appraisal would not eliminate such waste, but would magnify the amount by applying increased costs thereto.

Therefore the figures set forth in the appraisal applicable to patterns do not represent an appraisal of patterns but an appreciation of book costs and are therefore of little value in arriving at the fair market value of the petitioner's patterns at March 1, 1913.

The only additional evidence contained in the record as to the value of these patterns was an expression of opinion by Martin B. Hammell, who is secretary and treasurer of the petitioner company. He testified that in his opinion the patterns of the petitioner were worth at least the amount shown in the appraisal company's report. However, it was not shown that Mr. Hammell had ever examined all of the patterns owned by the petitioner, nor had he any personal knowledge of the cost of constructing patterns other than a general knowledge from examining the accounts of the company. We do not feel that Mr. Hammell had a sufficiently intimate knowledge of the patterns owned by the petitioner and the cost or market value thereof at March 1, 1913, to make more than an unsupported guess as to the value. Furthermore, since the petitioner is claiming a value for patents based upon the net profits derived from the manufacture and sale of patented articles, any value in excess of cost of the patterns would be reflected in the value of patents thus determined. In computing the overhead expenses used in determining the cost of producing patented articles, it is not apparent that the petitioner increased the pattern value over cost as shown by the books. From a consideration of all the evidence submitted we approve the Commissioner's determination of the March 1, 1913, value of patterns for the purpose of depreciation deduction.

The next issue is the value of patents owned by the petitioner on March 1, 1913. The average profits ascribed to the various patents by an analysis of the petitioner's records for the years 1911 and 1912 and the remaining life as at March 1, 1913, are as follows:

Patent number	Average profit, 1911 and 1912	Remaining life after Mar. 1, 1913
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		<i>Years</i>
905414	\$194.71	12 3/4
906003	25,417.17	12 3/4
906787	37.82	12 3/4
908082	139.51	12 5/6
919840	1,105.50	13 1/12
995123	316.75	14 1/3

From a consideration of all the evidence, we are of opinion that the fair market value of these patents on March 1, 1913, was as follows:

Patent No.	March 1, 1913, value
905414	\$6,073.78
906003	79,285.46
906787	117.99
908082	438.03
919840	3,349.03
995123	1,020.65
Total	\$90,284.94

These amounts represent the fair market value of petitioner's patents at March 1, 1913, and the amount to which the petitioner is entitled as a deduction for each patent in the years in question is an aliquot part of such value equal to the patent value divided by the years of life remaining after March 1, 1913.

The petitioner alleges error on the part of the Commissioner in computing depreciation for the years 1917 and 1918, by eliminating from the asset account, used as a basis for depreciation, certain amounts representing items of equipment claimed to be wholly depreciated. For example, the total cost of all items of the machinery and fixtures account up to December 31, 1916, as shown by the books of the petitioner, was \$97,052.67. The revenue agent, whose action upon this issue was followed by the Commissioner, reduced this cost to \$43,088.38. The difference is due to the elimination of the earliest purchases which, on the basis of the rates of depreciation used, would be entirely depreciated by December 31, 1916. The petitioner asks that depreciation for 1917 and 1918 be based upon a cost at December 31, 1916, of \$97,152.67 instead of the \$43,088.38 used by the Commissioner. No objection is raised by the petitioner to the rates used by the Commissioner for the prior years, nor is evidence presented to show that repairs or maintenance increased the life of the assets beyond the years indicated by the rates used.

The application of the method proposed by the petitioner would produce results which are inconsistent with the theory of a depreciation charge. Obviously, unless there is error on the part of the Commissioner in the rates of depreciation used, the assets which were fully depreciated at the end of their expected life should not remain in the asset account and be depreciated over years when they are no longer in existence. To do so would be to permit a double recovery of the same assets. Accordingly, on the basis of the evidence presented, we must sustain the action of the Commissioner in computing the depreciation allowance only on assets which his determination showed had not yet been fully depreciated.

The next contention of the petitioner is that the Commissioner, in computing the depreciation for 1920 and 1921, used as a basis the net amounts appearing in the petitioner's balance sheet for December 31, 1916, instead of the total cost of the assets, and also used inadequate rates of depreciation.

An examination of the revenue agents' reports which were followed by the Commissioner shows that in the report for 1917, 1918, and 1919 depreciation was computed on the basis of the total cost of the assets, whereas in the report for 1920 and 1921 depreciation was computed on the balances of the assets as shown by petitioner's books, which balances represented the total costs less the various depreciation charges which the petitioner had made against the assets. In both reports the same rates of depreciation were used, except in the case of office furniture and fixtures where the report for the later years used a lower rate. Under the previous issue we sustained the action of the Commissioner with respect to the basis of depreciation for 1917 and 1918, which action was based on the revenue agent's report for these years and which provided for depreciation on the total cost of the assets, less proper eliminations for fully depreciated assets. We are of the opinion that the same method should be applied for 1920.

An examination of the petitioner's record shows that it did not employ a consistent method of computing depreciation prior to 1917. It took no depreciation whatever prior to 1912, in which year it deducted some \$40,000. In 1914 and 1915 no depreciation was written off except on patterns and on machinery and fixtures. The record further shows that on an investment of \$39,305.24 for furnaces and ovens up to 1916, only \$3,000 was written off as depreciation. In respect to these assets the petitioner introduced testimony to the effect that the proper annual rate of depreciation was 7½ per cent and that the two furnaces purchased in 1903 and a third purchased in 1907 became entirely worthless in 1920. In view of this testimony, it is evident that the asset value of furnaces and ovens, on the books at December 31, 1916, was erroneous and would result in having a large balance still remaining on the books in 1920 when the assets were entirely depreciated. The same appears to be true of other depreciable assets. For example, in the case of patterns, testimony was introduced as to their useful life, including an allowance both for wear and tear and also for obsolescence which agrees with the rates used by the Commissioner. It further appears that no objection is raised to the rates of depreciation used prior to December 31, 1916, the controversy being over the resultant effect of the application of the rates.

In view of the foregoing, the Board is of the opinion that not only should the respective rates of depreciation be applied to total costs of assets, after proper adjustment for assets fully depreciated, for the purpose of determining a reasonable allowance for depreciation in the various years, but also surplus should be adjusted in conformity therewith for all years on appeal.

The application of the foregoing principle also disposes of the issue raised as to \$10,025.52 written off in 1917 on account of obsolete patterns, since the 10 per cent depreciation rate on this class of assets includes an allowance for obsolescence. The foregoing amount was disallowed as a deduction by the Commissioner for 1917 and restored to the asset account for depreciation and invested capital purposes for 1917 and 1918, but the evidence shows that this adjustment was not carried through into 1920, and we are, accordingly, of the opinion that the determination in 1920 with respect to this item should be consistent with the action for 1917 and 1918.

We are also satisfied that the depreciation rate of 10 per cent on office furniture and fixtures which was used by the respondent in the determination of the deficiencies for 1917 and 1918 should likewise be applied in 1920.

During the year 1918 an amount of \$9,879.93 was spent for heating units, consisting of square boxes about 10 feet by 8 feet, containing motors and fans. This item was added to building account by the revenue agent, but should properly have been added to machinery and fixtures account. Therefore, this amount should be excluded from the building account and added to machinery and fixtures account.

The depreciation rate on ovens and furnaces has been established at 7½ per cent. Therefore, that account should be revised beginning with 1903 so as to reflect this rate. The depreciation rates applied to all assets in 1918 and prior years should also be applied in 1920.

During the years 1920 and 1921 the petitioner engaged in a new building program, expending \$253,181.62 in 1920 and \$108,120.48 in 1921, a total of \$381,302.10. The buildings were erected in sections, and one section was completed and put in use in the early part of July, 1920. The cost of the completed section is not shown in the record and evidently was not segregated on the books. The petitioner apparently desires that a segregation be made on the basis of square feet of floor area of the completed section as compared with the total floor area. The petitioner's witness testified that the construction on the two section was the same and that consequently the cost per square foot in each case would be the same. The total floor area of both sections was 70,715 square feet and that of the section completed in July, 1920, was 38,860 square feet.

While this manner of segregating costs is only an approximation and not generally acceptable in determinations of this character, we believe that in this instance we are justified in computing a cost on this basis. It is of general knowledge that building costs reached a peak about the middle of 1920 and thereafter declined to the close of 1921. Consequently, with similar types of construction of the two sections, the second section would not normally have cost more per square foot than the first section, and may have cost less.

We are, therefore, of the opinion that the cost of the first section should be determined on this basis and depreciation be allowed thereon for 1920, beginning with July, 1920.

During 1920 the Commissioner disallowed as deductions for repairs various items aggregating \$11,254.59, on the ground that such expenditures were capital investments, but allowed no depreciation thereon for the year 1920. The evidence shows that these expenditures were made on improvements to buildings and were put into use during 1920.

The petitioner is entitled to depreciation on these assets during 1920 for the portion of the year that they were in use as indicated in the following schedule:

Item	Account	Amount	Date put into use
New plumbing in old buildings	Buildings	\$1,856.84	May 15, 1920
New wall, plus salvage value of	do	4,696.45	Dec. 1, 1920

Item	Account	Amount	Date put into use
old brick used			
Moving and reerectin g flask shed and carpenter shop	do	2,201.30	Apr. 1, 1920
New skylights in old buildings	do	2,500.00	May 1, 1920
		11,254.59	

Judgment will be entered on 15 days' notice, under Rule 50.

Considered by SMITH, TRUSSELL, and LOVE.