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Trusts -- Amortization -- Cost of Life Estate -- Portion Allocable to Tax-Exempt Income -- Manufacturers Hanover Trust Co. v. Commissioner

John M. DeStefano Jr

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CASE NOTE

Trusts—Amortization—Cost of Life Estate—Portion Allocable to Tax-Exempt Income—*Manufacturers Hanover Trust Co. v. Commissioner.*[1]

> *A thing may be within the letter of a statute and not within its meaning, and within its meaning, though not within its letter. The intention of the lawmaker is the law.*[2]

In 1958, one Clarence Dillon assigned 72 percent of his life estate and contingent remainder in a trust created by him in May, 1932,[3] to another trust created by Anne Dillon in June, 1932. In consideration of this transfer, the taxpayer trust, that of June, 1932, paid Clarence Dillon $1,232,030.18.[4] As of November, 1961, the taxpayer trust, using a straight-line method, began amortizing this amount over a projected period of 6.21 years, then Clarence Dillon's life expectancy.[5]

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[1] Manufacturers Hanover Trust Co. v. Commissioner, CCH 1970 Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,508) ¶ 9606 (2d Cir. Sept. 14, 1970).

[2] Smyth v. Fiske, 23 Wall. 347, 380 (U.S. 1874).

[3] Anne Dillon, wife of Clarence Dillon, established a trust in 1923 reserving income to herself for life and providing that upon the grantor's death the corpus of the trust was to go to Clarence Dillion "if he be then living," with a substitutional gift to the children of Anne and Clarence Dillon. Nine years later, Clarence Dillon assigned his entire contingent remainder interest in the 1923 Trust to the May 1932 Trust. The 1958 (72%) transfer was made while Anne Dillon was still alive. The appellees are successor trustees of the June 1932 taxpayer trust. Brief for Appellant at 2, 3, Manufacturers Hanover Trust Co. v. Commissioner, CCH 1970 Stand. Fed. Tax. Rep., U.S. Tax Cas. (70-2, at 84,508) ¶ 9606 (2d Cir. Sept. 14, 1970) [hereinafter cited as Brief for Appellant]. The Second Circuit opinion refers to Anne as Clarence Dillon's daughter. Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,508.)

[4] This amount represented $700 plus 72% of the fair market value as of April 11, 1958, of the assets held by the 1923 Trust multiplied by a factor (.077035) representing the actuarial value of the assignor's interest in the May 1932 Trust. Brief for Appellant at 3.

[5] Anne Dillon died on November 8, 1961 and was survived by Clarence Dillon who was then 79 years old with a life expectancy of 6.21 years. Brief for Appellant at 3. The sale of a life interest in property by the life tenant has in the past produced interesting tax consequences. See generally, Plumb, Tax Effects of Sales of Life Interests in Trusts, 9 Tax L. Rev. 39 (1953). Prior to the Tax Reform Act of 1969, Pub. L. No. 91-172, Dec. 30, 1969, 1 U.S. Code Cong. & Ad. News 509-822 (1969), the transaction was accomplished with the following results. When a life estate and remainder interest in property are acquired by gift, bequest or inheritance, a so-called "uniform basis" rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced and the basis of the remainder interest is increased in the same amount. Hence, the combined basis of the life estate and the remainder interest remains the same from year to year. The life tenant is not permitted to amortize his basis over the length of the life estate and thereby reduce for tax purposes the amount of income he receives. However, where the life tenant sold his right to receive future income, his basis in the property was used to reduce the gain he received on the sale. The purchaser of the life estate, however, is allowed to amortize

The taxpayer trust's share of income from the May, 1932 trust during 1962 was $526,373.05. Of this amount, approximately 11 percent, or $58,291.79 of the total income, was interest wholly exempt from income taxes, "having been derived from tax exempt sources."[6] The balance of the 1932 trust income was reported by the taxpayer as dividends and long-term capital gains. On its 1962 return, the taxpayer trust claimed a section 167(a)(2)[7] amortization deduction, in accordance with the above-described method, in the amount of $198,394.55. The Commissioner disallowed 11 percent, or $21,970.06, of the amortization deduction on the ground that it was allocable, within the terms of section 265(1),[8] to the taxpayer's tax-exempt income of $58,291.79.

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his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

This treatment has the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sold his interest. The life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it and, in addition, the purchaser of the life estate was not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss. See Plumb, supra note 5; Lyon and Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 295, 321-27 (1962). Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947); Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946), cert. denied, 330 U.S. 828 (1947). Cf. Quigley v. Commissioner, 143 F.2d 27 (7th Cir. 1944). Section 516(a) of the Tax Reform Act of 1969 amended § 1001 of the 1954 Code to make the entire proceeds received on the sale of most life estates taxable since the basis acquired by gift, will or transfer in trust is to be disregarded in computing taxable gain. The new rule applies to sales or dispositions after October 9, 1969. Tax Reform Act of 1969, Pub. L. No. 91-172 § 516 (1969).

6 1970 CCH Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,509). The Tax Court described the tax-exempt income-producing property as state and municipal bonds. Manufacturers Hanover Trust Co., 28 CCH Tax Ct. Mem. 692, 693 (1969).

7 Int. Rev. Code of 1954, § 167(a)(2) provides:

(a) General rule.

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)

* * *

(2) of property held for the production of income.

8 Int. Rev. Code of 1954, § 265(1) provides: No deduction shall be allowed for—

(1) Expenses.

Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

The language of the present § 265(1) conforms substantially to the statutory language of § 24(a)(5) of the 1939 Code as amended by the Revenue Act of 1942, ch. 619, § 121(b), 56 Stat. 819 (1942), except that the parenthetical, "(relating to expenses for the production of income)," was added in 1954 to make it clear that expenses relating to the determination, collection or refund of taxes under § 212(3) would not be dis-

He then determined a deficiency in the 1962 income tax of the taxpayer trust in the amount of $19,057.44 and taxpayer petitioned for a redetermination in the Tax Court.[9]

Deciding in favor of the taxpayer, the Tax Court held that an amortization deduction, based upon the cost of a purchased life estate, should not be reduced under section 265(1) by that portion of the deduction which is allocable to tax-exempt interest income.[10] Although he did not dispute that the amortized cost was deductible, if at all, under section 167(a)(2), the Commissioner contended that the portion of the deduction allocable to tax-exempt interest income should be disallowed by section 265(1) as an "amount otherwise allowable under section 212,"[11] or in other words, that section 167(a)(2) amortization should be recognized as the equivalent of a section 212 expense for the purposes of section 265(1). However, the Commissioner conceded on brief that his position *vis a vis* the disallowance of the deduction "[was] inconsistent with the literal terms of section 265."[12] Following its own decision in *Allen M. Early*,[13] a case decided only four days prior to *Manufacturers*, the Tax Court reiterated its position that the second clause of section 265(1) plainly and unambiguously disallows deduction of expenses allocable to tax-exempt interest income only insofar as the expenses are deductible under section 212;[14] although the provisions of section 167(a)(2) may be considered to parallel those of section 212,[15] the absence of a reference to section 167(a)(2) in the second clause of section 265(1) has a controlling effect on the interpretation of the clause.[16] Under these circumstances, the court considered itself bound to interpret and apply section 265(1) literally.[17]

Subsequently, the Commissioner petitioned the Court of Appeals for the Second Circuit for review of the Tax Court's decision. In affirming the decision of the Tax Court, the appellate court set forth

allowed because the expense involved issues related to tax-exempt interest. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. (1954), 3 U.S. Code Cong. and Ad. News 4025, 4196 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954), 3 U.S. Code Cong. and Ad. News 4621, 4855 (1954); cf. Lykes v. United States, 343 U.S. 118 (1952); Estate of Bartholomew, 4 T.C. 349 (1944); Estate of Elsie Weil, 13 CCH Tax Ct. Mem. 653 (1954).

9 Manufacturers Hanover Trust Co., 28 CCH Tax Ct. Mem. 692 (1969).

10 Id. at 694.

11 Int. Rev. Code of 1954 § 212 Provides:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

12 CCH Tax Ct. Mem. at 694.

13 52 T.C. 560 (1969) (as reviewed by the full Tax Court with six dissents); appeal docketed (5th Cir.), 7 CCH 1970 Stand. Fed. Tax. Rep. at 70,714.

14 28 CCH Tax Ct. Mem. at 694.

15 Id. at 694; 52 T.C. at 566.

16 28 CCH Tax Ct. Mem. at 694.

17 Id.

the following reasons for its rejection of the Commissioner's position. First, the court said, an amortization deduction is properly allowable under section 167(a)(2) as "exhaustion . . . of property held for the production of income."[18] Second, amortization, like depreciation, has been traditionally considered and treated by Congress as being outside of "the usual meaning of 'expenses'."[19] Third, the legislative history of section 265(1) provides no indication of why Congress imposed in that section an express limitation on the deductibility of section 212 expenses, while no such limitation was imposed with regard to deductions for section 167 depreciation of non-business property held for the production of income.[20] Rejecting the Commissioner's "policy argument" that the congressional drafting of section 265 must be deemed illogical if strictly construed, the court of appeals determined that the "plain and unambiguous" language of the statute must be given effect.[21]

On the surface, *Manufacturers* appears to be another justifiable addition to a long series of tax cases in which the courts, unable to uncover contrary legislative history, have disregarded significant policy considerations and given effect to the literal meaning of a provision of the Internal Revenue Code.[22] It is the intention of this note, however, to show that careful analysis of the rationale upon which the Second Circuit based its opinion suggests that the court may have either misconstrued or overlooked legislative history which clearly indicates that the allowance of the amortization deduction related to tax-exempt interest in cases like *Manufacturers* may be contrary to congressional intent. Although this area of the tax law has not attracted a significant amount of attention among legal commentators, it has produced substantial disagreement among members of the Tax Court as evidenced by the vigorous dissenting opinion of Judge Tannenwald in *Allen M. Early*.[23] Finally, the case is noteworthy, regardless of the validity of the *Manufacturers* opinion, as an expression of law the consequences of which merit the consideration of taxpayers, tax planners and perhaps even Congress.[24]

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18 The court cites numerous authorities in support of this statement, CCH 1970 Stand. Fed. Tax., U.S. Tax. Cas. (70-2, at 84,509-10).

19 Id. at 84,510. The court cited no authority or legislative history in support of this sweeping generalization.

20 Id.

21 Id.

22 See discussion and cases and other authorities cited in Commissioner v. Beck's Estate, 129 F.2d 243, 245-46 (2d Cir. 1942); Hanover Bank v. Commissioner, 369 U.S. 672, 687-88 (1962); Iselin v. United States, 270 U.S. 245, 250-51 (1926); Stone v. Commissioner, 360 F.2d 737, 740 (1st Cir. 1966); Commissioner v. Oswego Falls Corp., 137 F.2d 173, 176 (2d Cir. 1943); Huntington Sec. Corp. v. Busey, 112 F.2d 368, 370 (6th Cir. 1940); Eaton v. White, 70 F.2d 449, 452 (1st Cir. 1934); Viola E. Bray, 46 T.C. 577 (1966); Mary E. Burrow, 39 T.C. 1080, 1091 (1963), aff'd, 333 F.2d 66 (10th Cir. 1964). See Note, 65 Mich. L. Rev. 571 (1967); Note, 51 Minn. L. Rev. 166 (1966); Rice, Judicial Techniques in Combatting Tax Avoidance, 51 Mich. L. Rev. 1021-023, 1047-048 (1953).

23 52 T.C. at 568.

24 As the appellate court stated, "if the facts of this case demonstrate a tax loophole

Although in both *Manufacturers* and *Early* the Commissioner sought to have the courts ignore, or at least broadly interpret, literal legislative language, he did not insist that they ignore legislative intent.[25] The opinions in both cases, however, demonstrate the traditional reluctance of the courts to fill legislative gaps in statutory language which appears to be clear and unambiguous.[26] In accordance with the well-settled canon of statutory construction, the Tax Court and Second Circuit reached their results by following the rule that where statutory language is plain and unambiguous, legislative history should not control judicial interpretation unless such history demonstrates a clearly contrary congressional intent.[27] Although ultimately concluding that section 265(1) must be held to mean what it plainly expresses, the appellate court in *Manufacturers* did agree with the Commissioner that "the underlying purpose of § 265 is to prevent multiple tax benefits."[28] Certainly, it is the widely recognized purpose of section 265 to deny deductions for expenses and interest relating to tax-exempt income,[29] in order to prevent a taxpayer from having the federal government finance the acquisition of tax-exempt securities through the multiple tax benefits resulting from a simultaneous exclusion of income and deduction of expenses.[30] Since a literal interpretation of section 265(1) as it bears upon the allowance of section 167(a)(2) deductions appears to impede rather than effectuate the clear purpose of section 256(1),

Congress, not the courts, should plug it." CCH 1970 Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,510); cf. Fabreeka Prod. Co. v. Commissioner, 294 F.2d 876, 879 (1st Cir. 1961); Tyler, Disallowance of Deductions on Public Policy Grounds, 20 Tax L. Rev. 665, 696-97 (1965).

[25] Cf. 129 F.2d at 246.

[26] Id. at 245 & n.4.

[27] 369 U.S. at 687-88; 270 U.S. at 250-51: 2 J. Sutherland, Statutes and Statutory Construction §§ 4702, 4706 (3d ed. 1943) [hereinafter cited as Sutherland].

[28] CCH 1970 Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,509).

[29] See generally 4A Merten's Law of Federal Income Taxation § 26.13 (1966). The Revenue Act of 1934 included the first statutory provision [predecessor of the present § 265(1)] disallowing certain deductions allocable to tax-exempt income other than interest. See Revenue Act of 1934, ch. 277, § 24(a)(5), 48 Stat. 580 (1934). Prior to 1934, in the absence of any statute disallowing expenses otherwise deductible and allocable to tax-exempt income, the Tax Court held administrative expenses of an estate to be properly deductible from the income thereof without regard to the fact that a portion of the estate's income was exempt from taxation. Grace M. Knox, B.T.A. 143 (1925). After 1934, see Commissioner v. McDonald, 320 F.2d 109, 111 (5th Cir. 1963); Curtis v. Commissioner, 3 T.C. 648 (1944); Rev. Rul. 62-9, 1962-1 C.B. 35, 36. See also H.R. Rep. No. 704, 73d Cong., 2d Sess. 23 (1934). On the manner of allocating disallowed expenses under § 265(1), see Whittemore v. United States, 383 F.2d 824 (8th Cir. 1967).

With respect to the disallowance of interest deductions under § 265(2), see Denman v. Slayton, 282 U.S. 514, 519-20 (1931); Wynn v. United States, 411 F.2d 614 (3d Cir. 1969); McCollum, Recent Cases Threaten All Interest Deductions for Holders of Tax Exempts, 27 J. of Tax. 194 (1967). The applicability of § 265(2) to banks appears to be somewhat of a problem area in the tax law. See discussion of cases and rulings at Sachs, Recent Developments in the Tax Field With Regard to Commercial Banks, 26 Bus. Law. 89, 95, 96 (1970); see also Rep. No. 558, 73d Cong., 2d Sess. 26-27 (1934).

[30] First Nat'l Bank v. United States, 283 U.S. 142 (1931); 282 U.S. at 519-20; 411 F.2d 614; 383 **F.2d at 834.**

the appellate court in *Manufacturers* considered the legislative history[31] of section 265(1) in an effort to determine whether section 167 *amortization* and section 212 *expenses* incurred in the production of income could be properly "merged," or deemed equivalent in meaning for the purposes of section 265(1).[32] However, the court was of the opinion that the legislative history was "colorless"[33] with respect to why in section 265(1) Congress chose to treat section 212 expenses differently from section 167(a)(2) depreciation deductions for non-business property held for the production of income. By deciding the case in favor of the taxpayer, the court gave little weight to the Commissioner's arguments that there was no *logical* reason for Congress to treat the two types of deductions differently for the purposes of section 265(1) and that a literal interpretation of the statute would "attribute irrationality to the drafters of the provision."[34] In contrast, the court noted that it seemed unlikely that Congress did not have the amortization section of the Code in mind when it amended the predecessor of section 265(1) in the 1942 Revenue Act[35] (hereinafter the 1942 Act) since the first congressional allowance for a depreciation deduction for property held for the production of income was enacted simultaneously and in the same statutory section which specifically disallowed deductions allocable to tax-exempt interest, provided they were otherwise allowable under the predecessor of section 212.[36]

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31 Cf. United States v. Public Util. Comm'n, 345 U.S. 295, 315 (1953); J.C. Penny Co. v. Commissioner, 312 F.2d 65, 68 (2d Cir. 1962); Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir. 1942).

32 CCH 1970 Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,510). Compare with Viola E. Bray, 46 T.C. 577 (1966); Note, 65 Mich. L. Rev. 571 (1967). In *Bray*, the Tax Court held that a disallowance of double deductions under § 642(g) of the Code applies only to statutory deductions. The court rejected the Commissioner's argument that the word "deduction" should be broadly interpreted so as to include "offsets" in order to effectuate the intent of Congress.

33 CCH 1970 Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,510). Both the House Ways and Means Committee and Senate Finance Committee Reports which accompanied the Revenue Act of 1942, ch. 619 § 121, 56 Stat. 819 (1942), employed substantially the same language to describe the inter-relationship between § 23(a)(2) of the 1939 Code [predecessor of the present § 212] and § 24(a)(5) of the 1939 Code [predecessor of the present § 265(1)]:

> Section 24(a)(5) as amended by this section [§ 121], while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allocable to one or more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

H.R. Rep. No. 2333, 77th Cong., 2d Sess. 75 (1942); see also S. Rep. No. 1631, 77th Cong,. 2d Sess. 88 (1942).

34 CCH 1970 Stand. Fed. Tax Rep., U.S. Tax Cas. (70-2, at 84,510).

35 Revenue Act of 1942, ch. 619, § 121, 56 Stat. 819 (1942).

36 Id. § 121. Non-trade or non-business deductions

(a) Deduction for expenses. Section 23(a) (relating to deduction for expenses) is amended to read as follows:

. . . .

(a) Expenses

Although it is true that the predecessors of sections 167(a)(2) [23(*l*)(2) of the 1939 Code] and 212 [23(a)(2) of the 1939 Code] found their origins in the same section[37] of the 1942 Act, the primary objective which led Congress to adopt these provisions reveals much about their interrelation, and their relation with section 265(1), and indicates that all three of these sections must be examined and viewed as a functional whole to effectuate the intent of Congress.[38] The simultaneous enactment of sections 23(a)(2) and 23(*l*)(2), was, in effect, the congressional response to judicial determinations which had denied deductions for expenses incurred in the management of property held for the production of income on the ground that the taxpayers were not engaged in a trade or business.[39] By adoption of these sections, Congress intended to permit deductions related to property held for the production of income regardless of whether or not such property is used by the taxpayer in a trade or business.[40] The commitee reports which

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(2) Non-trade or non-business expenses. In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

(b) Allocable to exempt income. Section 24(a)(5) (relating to items not deductible) is amended by inserting after "this chapter" the following: or any amount otherwise allowable under section 23(a)(2) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this chapter.

(c) Depreciation deduction. The first sentence of section 23(*l*) (relating to deduction for depreciation) is amended to read as follows: A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

[37] See supra note 36.

[38] See J. Sutherland, supra note 27, at § 4706 and cases there cited; cf. Babcock v. Phillips, 372 F.2d 240 (10th Cir.), cert. denied, 387 U.S. 918 (1967); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967), rehearing denied, 389 U.S. 893 (1967); United States v. Sheahan, 323 F.2d 383 (5th Cir. 1963); Fairfield S.S. Corp. v. Commissioner, 157 F.2d 321 (2d Cir. 1946); 126 F.2d at 406: Newman & Co. v. United States, 290 F. Supp. 170 (D.C.N.Y. 1968).

[39] Previously, § 23(a) of the 1939 Code [the predecessor of § 162(a) of the 1954 Code] had permitted only the expenses of "carrying on any trade or business" to be deducted. See Higgins v. Commissioner, 312 U.S. 212 (1941); City Bank Farmers Trust Co. v. Commissioner, 313 U.S. 121 (1941); Ross v. Commissioner, 125 F.2d 767 (3d Cir.), cert. denied. 316 U.S. 685 (1942); Wilcox v. Commissioner, 119 F.2d 899 (6th Cir. 1941); Elliot v. Commissioner, 117 F.2d 1012 (3d Cir. 1941).

[40] This standard was applied to both "expense" and "amortization" deductions in those portions of the committee reports which discuss § 121 of the 1942 Act:

> This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, *whether or not such expenses are paid or incurred in carrying on a trade or business*, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, *whether*

accompanied the 1942 Act make it clear that congressional enactment of section 121 of the original bill[41] was designed to end the tax-deduction inequity which had arisen between business and non-business taxpayers, both of whom were receiving income which was *clearly taxable*:

> The existing [pre-1942] law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute [predecessor of Section 162 of the 1954 Code] and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is *fully subject to tax*. The bill *corrects this inequity* by allowing all of the ordinary and *necessary* expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income.[42] (Emphasis added.)

This same intention to equalize the availability of deductions to taxpayers who had income "subject to tax" through the enactment of section 121 was expressed on the floor of the House prior to the passage of the 1942 Act:

> The Internal Revenue Code provides that expenses incurred in the trade or business of the taxpayer may be deducted in arriving at net income. The law also provides that personal living or family expenses may not be deducted. There is left a great borderland of doubt. Trade or business has received such a narrow interpretation that many meritorious deductions are denied. The Supreme Court, in the case of *Higgins v. Commissioner* (312 U.S. 212 (1941)) held that expenses in connection with a taxpayer's investments in income-producing properties were not deductible, on the ground that making casual investments was not a trade or business. *Since the income from such investments is clearly taxable it is inequitable to deny the deduction of expenses attributable to such investments.*[43] (Emphasis added.)

In view of the preceeding, it seems clear that the 1942 enactment of section 23(a)(2) and section 23(*l*)(2) were straightforward measures

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or not such property is used by the taxpayer in a trade or business. (Emphasis added.)

H.R. Rep. No. 2333, 77th Cong., 2d Sess. 74 (1942); See also S. Rep. No. 1631, 77th Cong., 2d Sess. 87-88 (1942).

41 H.R. 7378, 77th Cong., 2d Sess. § 121 (1942).

42 H.R. Rep. No. 2333, 77th Cong., 2d Sess. 46. On the similarity of purpose of the expense and depreciation deductions, see also Elsie B. Gale, 13 T.C. 661 (1949), aff'd on other grounds, 191 F.2d 79 (2d Cir. 1951); 4A Merten's Law of Federal Income Taxation, § 25A.01 at n.6. (1966).

43 88 Cong. Rec. 6376 (1942) (remarks of Representative Disney).

taken by Congress to equalize tax treatment of income clearly subject to taxation regardless of business or trade status. Thus court treatment of the section 167(a)(2) deductions allocable to income exempt from taxation in *Manufacturers* and *Early*, by sanctioning a deduction related to a property interest held for the production of income which is not subject to tax, conflicts directly with the policy and purpose underlying the above described Code sections. It is suggested here that the court's reliance upon the "literal language" rule in *Manufacturers* may perhaps have had the effect of frustrating and impeding the tax policy to which Congress committed itself in Section 121 of the 1942 Act. This undesirable result could possibly have been avoided by recognizing the fact that according to principles of accounting, economics, and well-established tax law it is not wholly improper to consider amortization as the equivalent of an annual "expense."

That the *Manufacturers'* court did not consider amortization to be the equivalent of an annual section 212 expense is plainly evident:

> . . . it has been traditionally accepted that amortization does not fall within the usual meaning of "expenses," but is considered a *capital outlay* for an asset of limited income-producing duration. If amortization is an "expense," it follows that depreciation would also fall into that category, yet for a half-century Congress has deemed it necessary to provide for depreciation deductions separately from "expense" deductions.[44] (Emphasis added.)

The court is correct in saying that Congress has provided for depreciation deductions separately from "expense" deductions for more than five decades.[45] But that fact does not prove that amortization is or is not an "expense." More significantly, the court's description of amortization as a "capital outlay" demonstrates that the court misconceived a basic tax precept in a manner that is fatal to the court's final determination, and which can be clarified within the context of the Code itself. Section 167(a)(2) allows a deduction for depreciation of property held for the production of income, and, in effect, allows deductions for amortization, which is the commonly accepted way of referring to depreciation of intangible property, such as the life estate in *Manufacturers*. Amortization is derived from the wasting asset concept,[46] which originated in the law of depreciation of tangible property, even though intangible property does not exhaust or waste away in the same manner as does machinery or equipment. The exhaustion of intangible property is a legal fiction found useful in spreading the recovery of capital out-

44 CCH 1970 Stand. Fed. Tax Rep., Tax Cas. (70-2, at 84,510).

45 Amortization as a variant of depreciation has been allowed since at least 1918 as a tax deduction; see, e.g., § 214(a)(8), Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1067 (1918); § 167(a)(2) of the Int. Rev. Code of 1954.

46 Int. Rev. Code of 1954, § 167(a)(1) and Treas. Reg. § 1.167(a)-3 (1956); see Kennecott Copper Corp. v. United States, 347 F.2d 275 (Ct. Cl. 1965); Douglas v. Commissioner, 134 F.2d 762 (8th Cir. 1943), aff'd, 322 U.S. 275 (1944).

lay for an intangible asset over its fixed or useful life.[47] The use or consumption of depreciable or amortizable property over its useful life in the production of income is also generally considered to be a pro-rata sale of the asset[48] or a charge against income of cash expenditures previously made.[49] Amortization is not, as the *Manufacturers'* court said, a capital outlay. Rather, it represents a systematic financial allocation of the cost or other basic value of an intangible asset over its useful life.[50] The portion of the cost allocated to each accounting period is designated as "amortization expense,"[51] and theoretically, even if Section 167 were to be deleted from the Code, one would expect that depreciation and amortization would necessarily be deductible as ordinary and necessary expenses under sections 162 and 212.[52] Such an expectation is logically consistent with the proposition, manifested throughout the entire structure and history of the income tax, that what Congress has always intended to tax is *net* income.[53] In fact, the

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47 According to the regulations only intangible personal property known to be of use in the business or production of income for a limited period may be amortized. Treas. Reg. § 1.167(a)-3 (1956).

48 J. Polk, Depreciation and Replacement, 2 Tax Revision Compendium, House Ways and Means Committee (Committee Print) 921 (1959).

49 G. Kitendaugh, Depreciation Policy for an Expanding Economy, Id. at 841-42.

50 R. Seiler, Elementary Accounting 438 (1963); The Committee on Terminology of the American Institute of Certified Public Accountants has defined depreciation accounting as

> . . . a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year.

Accounting Terminology Bulletin No. 1, American Institute of Certified Public Accountants 25 (1953). Cf. Tierney, The Internal Revenue Code and its Relationship to Generally Accepted Accounting Principles, 48 Marq. L. Rev. 181, 189 (1964). See Parsons v. United States, 126 F. Supp. 552, 554-55 (D.N.J. 1954).

51 R. Seiler, Elementary Accounting, supra note 50, at 452 (1963).

52 Amounts expended by taxpayers which are capital outlays are not deductible in the year they are paid. Int. Rev. Code of 1954, § 263.

53 See generally Griswold, An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943). The net income principle has been observed by Congress for more than three quarters of a century, apparently finding its origins in § 28 of the Act of August 27, 1894, which provided in the case of individuals that "the necessary expenses actually incurred in carrying on any business, occupation, or profession shall be deducted. . . ." Ch. 349, § 28, 28 Stat. 509 (1894). Griswold, Id. at 1145; 50 Cong. Rec. 3849 (1913) (remarks of Senator Williams); Note, 36 Col. L. Rev. 274 (1936); cf. Stewart Dry Goods Co. v. Lewis, 294 U.S. 550 (1935). The concept appears to be widely recognized and has been frequently discussed in cases where the issue has been whether deductions otherwise allowable should be disallowed on public policy grounds. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Tyler, Disallowance of Deductions on Public Policy Grounds, 20 Tax L. Rev. 665, 667-68 (1965); Diamond, The Relevance (or Irrelevance) of Public Policy in Disallowance of Income Tax Deductions, 44 Taxes 803, 805 (1966); Lindsay, Tax Deductions and Public Policy, 41 Taxes 711, 715 (1963). See also Goffman, An Economic Analysis of the Preferential Tax Treatment of Personal Income in Canada and the United States, 17 Tax. L. Rev. 77, 112-13 (1961).

very adoption of the forerunners of Sections 167(a)(2) and 212 of the Code in 1942 serves in itself as evidence of the congressional insistence that the income tax be assessed on net, rather than gross, income. Moreover, the conceptualization of amortization as an item of expense finds further support in several Supreme Court opinions where the Court had occasion to touch upon the purpose,[54] legitimacy[55] and characterization[56] of "depreciation." For example, in *Hertz Corp. v. United States*,[57] the Court stated that

> the purpose of depreciation accounting is to allocate the *expense* of using an asset to the various periods which are benefited by that asset.[58] (Emphasis added.)

Finally, both the Internal Revenue Service and some courts have recognized that certain items could be deductible under more than one section of the Code. The Service has anticipated this possibility and expressly provided in the Regulations under Section 161:[59]

> Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.[60]

Similarly, it has been judicially held that state income taxes paid by an individual may constitute ordinary and necessary expenses of carrying on a trade or business for the purposes of computing a net operating loss deduction under section 172.[61] This is in contrast to the general rule which has traditionally been that state income taxes paid by an individual are not expenses attributable to a trade or business, but personal deductions only.[62] Even the Tax Court in *KIRO, Inc. v. Commissioner*[63] observed that the fact that a deduction might be within section 167 did not preclude a holding that it might also come within

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Depreciation has been viewed as a necessary deduction, allowance of which is required to reduce the amount computed as gross income to what is in fact income, and so lawfully taxable as such. Davis v. United States, 87 F.2d 323 (2d Cir. 1937). See Kaminsky, Are All Deductions a Matter of Privilege?, 37 Taxes 137, 147 (1959); Clark, Can Congress Tax "Gross Income" Under Sixteenth Amendment?, 8 A.B.A.J. 513 (1922); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 254 (1939).

54 Hertz Corp. v. United States, 364 U.S. 122, 126 (1960).

55 Massey Motors v. United States, 364 U.S. 92, 96 (1960).

56 Gambrinus Brewery Co. v. Anderson, 282 U.S. 638, 642-43 (1931).

57 364 U.S. 122 (1960).

58 Id. at 126.

59 Int. Rev. Code of 1954, § 161.

60 Treas. Reg. § 1.161-1 (1958); cf. Treas. Reg. § 1.212-1(o) (1957).

61 Elmer Reise, 35 T.C. 571 (1961), (unanimous decision by the full Tax Court), aff'd, 299 F.2d 380 (7th Cir. 1962); Note, 1961 Duke L.J. 467 (1961); Note, 22 U. Pitt. L. Rev. 793 (1961). Cf. Bayou Verret Land Co., 52 T.C. 971, 982 (1969); Baker v. Commissioner, 38 T.C. 9, 13 (1962); McNutt-Boyce Co. v. Commissioner, 38 T.C. 462, 465-66 (1962), aff'd per curiam, 324 F.2d 957 (5th Cir. 1963).

62 Wilma Aaron, 22 T.C. 1370 (1954); Rev. Rul. 58-142, 1958-1 Cum. Bull. 147; I.T. 3951, 1949-1 Cum. Bull. 84.

63 51 T.C. 155 (1968).

section 162 as an ordinary and necessary trade or business expense deduction.[64] Since Code Sections 162 and 212 are coextensive and correlative in scope and application,[65] it follows that the fact that a deduction might be within Section 167 should not preclude a holding that it might also come within Section 212 as an ordinary and necessary expense incurred for the production of income.[66]

Besides serving as authority for the proposition that taxpayers are entitled to deduct the portion of the amortized cost of a purchased life estate which is allocable to interest income received from tax-exempt sources, *Manufacturers* and its rationale may be applied in the resolution of other tax questions. Thus, the decision could resolve doubts as to whether section 265(1) has any effect upon the deductibility of state taxes paid on interest income exempt from income tax. In the past, the Internal Revenue Service has held that the portion of state taxes allocable to tax-exempt interest income is an allowable deduction.[67] *Manufacturers* is consistent with and buttresses that position in the taxpayer's favor since it does not recognize a specific statutory deduction, which by its own terms is closely related to the production of income, as a section 212 expense for section 265(1) purposes. Although it is unlike the deduction for amortization, section 164 exclusively qualifies certain state taxes for deduction regardless of whether the taxes are incurred for the production of income.[68] Similarly, though dependent upon a significant assumption,[69] *Manufacturers* seems to indicate that certain taxpayers may be able to deduct interest paid on funds used to

[64] Id. at 167-68; see also B. Bittker, Federal Income Estate and Gift Taxation, 204 (3d ed. 1964); 4A Merten's Law of Federal Income Taxation § 25.05 (1966); Compare Treas. Reg. § 1.162-11(a) (1958) with Treas. Reg. 1.212-1 (o) (1957). On the interchangeability between § 162 and § 167 from a deduction standpoint see Baker v. Commissioner, 38 T.C. 9, 13 (1962); between § 162 and § 163 see 38 T.C. 462, 465-66. But see Douglas H. Tanner, 45 T.C. 145 (1965).

[65] Trust of Bingham v. Commissioner, 325 U.S. 365, 374 (1945); Petschek v. United States, 335 F.2d 734, 735-36 (2d Cir. 1964); Ditmars v. Commissioner, 302 F.2d 481, 487 (2d Cir. 1962); Trent v. Commissioner, 291 F.2d 669, 671 (2d Cir. 1961); Commissioner v. Macy, 215 F.2d 875, 877 (2d Cir. 1954).

[66] Compare with notes 63, 64 and related text supra.

[67] Rev. Rule 61-86, 1961-1 Cum. Bull. 41; cf. Rev. Rul. 70-429, 1970 Int. Rev. Bull. No. 34, at 71, which superseded and restated I.T. 3234, 1938-2 Cum. Bull. 145. Though not applicable to exempt interest income, in Hawaiian Trust Co. v. United States, 291 F.2d 761 (9th Cir. 1961), the Ninth Circuit considered the issue of whether territorial taxes, paid on § 337 "nonrecognized gains" realized pursuant to a plan of complete corporate liquidation, could be classified as "expenses" within the meaning of § 265(1). However, the court did not have to decide the question in view of its holding that "nonrecognized gains" under § 337 did not constitute income "wholly exempt" within the meaning of § 265. 291 F.2d 761, 773. Accord Commissioner v. McDonald, 320 F.2d 109 (5th Cir. 1963).

[68] Treas. Reg. 1.164-1(a) as amended by T.D. 6780 (1964).

[69] The assumption required here is that interest deductions under § 163 of the Code will be treated as personal (non-§ 162, non-§ 212) deductions for the purposes of § 933(1) which disallows deductions allocable or chargeable against amounts excluded from gross income (i.e., Puerto Rican source income) under § 933 of the Code. Int. Rev. Code of 1954, §§ 163, 933. Cf. Jon F. Hartung, 55 T.C. No. 1, 39 U.S.L.W. 2200 (Tax Court, October 1, 1970).

purchase or carry some types of bonds the interest on which is exempt from taxation because excludable from gross income. For example, a bona fide resident of Puerto Rico, who is also a U.S. citizen, who borrows funds in order to purchase industrial bonds of a Puerto Rican corporation, could conceivably claim a section 163 interest deduction (for interest paid on the loans) against U.S. source income. Simultaneously, he would be receiving tax-exempt interest income derived from Puerto Rican sources under Section 933 of the Code[70] from the industrial obligations. Section 265(2),[71] which disallows deductions for interest paid or accrued to purchase or carry tax-exempt bonds, would probably not prohibit the deduction since that section seems to apply only to interest income derived from government, state and municipal obligations or "tax-exempts."[72] Alternatively, it might be contended that section 265(1) should disallow the interest expense deduction. However, the first clause of section 265(1) disallows deductions only where the tax-exempt income is other than tax-exempt interest and would therefore be inapplicable. The second clause of section 265(1) would effectively disallow the claimed interest deductions only if they were deemed to constitute amounts otherwise allowable under section 212. *Manufacturers*, *Early*, and a number of Revenue Rulings[73] lend much support to the argument that since interest exclusively qualifies for deduction under section 163, regardless of whether or not incurred for the production of income, it should not be classified as a deductible amount otherwise allowable under section 212 for the purposes of section 265(1) disallowance.

As it now stands, *Manufacturers* may lead to legislative reappraisal of section 265(1). This is particularly unfortunate since the loophole which the Tax Court and the Second Circuit have brought to light may not have existed at all. Existence of the double tax benefit seems at least dubious when weighed against the substantial amount of authority which indicates that the courts' literal interpretation of section 265(1) may be inconsistent with congressional intention, basic tax, economic and accounting principles, and pertinent characterizations of depreciation by the Supreme Court as an item of expense. If allowance of the portion of the amortization deduction allocable to tax-exempt income is, as is submitted herein, an unintended and unnecessary allowance of multiple deductions, then the court may have inadvertently "transcended the Judicial function"[74] just as surely as if it had undertaken to rewrite section 265(1) to conform to the Commis-

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70 Int. Rev. Code of 1954, § 933.

71 Int. Rev. Code of 1954, § 265(2).

72 Treas. Reg. § 1.265-2(a) as amended by T.D. 6927 (1967). This regulation lists as examples of tax-exempt bonds, municipal bonds, Panama Canal Bonds, and certain obligations of the United States. See 4A Merten's Law of Federal Income Taxation § 26.13 (1966); First Nat'l Bank of Chicago v. United States, 38 F.2d 925 (Ct. Cls. 1930), aff'd, 283 U.S. 142 (1931).

73 See note 67 supra.

74 1970 CCH Stand. Fed. Tax. Rep., U.S. Tax Cas. (70-2, at 84,510).

sioner's policy arguments. Clearly, disallowance of the double deduction appears to be not only justifiable, but actually required in accordance with the rule that the Code should not be interpreted so as to allow "the practical equivalent of a double deduction . . . absent a clear declaration of intent by Congress."[75] In effect, the courts in both *Early* and *Manufacturers* may have created a tax loophole which high bracket taxpayers will find especially attractive. The decisions in these cases, therefore, are perhaps not only unfair to the government, but also to millions of taxpayers who deserve a fair apportionment of the tax burden.[76] The achievement of this fair apportionment should not be thrown back needlessly onto the draftsmen of the statutes; the task of the draftsmen, as one commentator once wrote, "can be greatly simplified to the benefit of us all by a more sympathetic and organic approach to the problems of construing tax statutes."[77] Although it is wise to avoid the judicial absolutism which obtains when courts are free to interpret statutes in reliance upon the vague contours of policy considerations,[78] the court should exercise great diligence in searching out all possible judicial alternatives that may reasonably preclude the necessity of remedial legislative action.

JOHN M. DESTEFANO, JR.

[75] United States v. Skelly Oil, 394 U.S. 678, 684 (1969); cf. Massey Motors v. United States, 364 U.S. 92, 101 (1960).

[76] Griswold, 56 Harv. L. Rev. at 1147; Rice, 51 Mich. L. Rev. at 1023-024.

[77] Griswold, 56 Harv. L. Rev. at 1147; Lewyt Corp. v. Commissioner, 349 U.S. 237, 240 (1955); 366 F.2d 874, 879; 323 F.2d 383, 385; Commissioner v. Hopkinson, 126 F.2d 406, 411 (2d Cir. 1942); 290 F. Supp. 170, 175; cf. 372 F.2d 240, 243. See also J. Sutherland, supra note 27, at § 4706.

[78] 51 Mich. L. Rev. at 1023.