

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA



In the Matter of the Appeal of
FIFTH STREET BUILDING

Appearances:

For Appellant: C. J. Milliron, Attorney; Dr. Thurston H. Ross, Chairman of the Department of Management, University of Southern California
For Respondent: Chas. J. McColgan, Franchise Tax Commissioner

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Fifth Street Building, a corporation, to a proposed assessment of an additional tax in the amount of \$1,210.60 for the year 1932 based upon its return for the year ended December 31, 1931.

The Appellant holds certain lots in the City of Los Angeles under leases running continuously from January 1, 1921 until January 1, 1941, for which Appellant is required to pay an annual rental of \$100,000.00 until September 1, 1941 and \$70,000.00 per annum thereafter. Pursuant to provisions in the leases, Appellant erected an eleven story and basement, steel frame and concrete convertible department store building, equipped with elevators, machinery, etc. upon the lots so leased by it. The property has been leased to another corporation as a department store for a term from January 1, 1921 to March 1, 1952 at a rental of \$290,000.00 per annum. The tenant agreed to pay all taxes, assessments and insurance and to maintain the building without cost to the Appellant.

In its Federal income tax return for the year ended December 31, 1931, Appellant claimed a deduction for depreciation upon its building, equipment and leasehold, computed upon the basis of the cost thereof. As so computed, the deduction for depreciation amounted to \$68,824.13. In its franchise tax return for said year, however, Appellant claimed a deduction for depreciation of its property computed upon the basis of the fair market value thereof as of January 1, 1928. As so computed, the deduction amounted to \$103,248.49 or \$34,424.36 more than claimed for Federal income tax purposes.

The Commissioner allowed a deduction for depreciation computed upon the basis employed for Federal income tax purposes but disallowed the additional amount on the grounds that Appellant had not satisfactorily established the fair market value of its property as of January 1, 1928.

Appeal of Fifth Street Building

Section 8(f) of the Act, as it read during the year for which the additional assessment in question was proposed, provided that depreciation may be computed either upon the basis employed for Federal income tax purposes or upon the basis provided in Section 19 of the Act. Section 19 provided, in the case of property acquired prior to January 1, 1928, that the basis should be the fair market value of the property as of said date.

In view of these provisions, it would seem that Appellant was entitled to compute depreciation upon the basis of the fair market value of its property as of January 1, 1928, provided that value can be established.

Appellant contends that the Commissioner is not in a position to question the values as of January 1, 1928 asserted by it inasmuch as he approved those values in computing Appellant's tax liability for a prior year and that such approval is binding upon him. In support of this contention, Appellant has cited a number of cases, a careful review of which reveals that the one most directly in point is *Woodworth vs. Kales* (C.C.A. 6th) 26 Fed. (2d) 178. In that case it was held that after the Commissioner of Internal Revenue had determined a taxpayer's liability for a certain period and had acted upon the facts fully before him and exercised his best judgment thereon, he could not years later change his judgment as to those facts and apply such changed judgment to those facts.

It appears, however, that this case has not been generally followed. Thus in *Baumgartner vs. Commissioner* (C.C.A. 9th) 51 Fed (2d) 472, *Certiorari denied* 284 U. S. 674, the court held that the determination by the Commissioner of Internal Revenue of a deficiency upon the basis of certain facts did not prevent the Commissioner from making another additional assessment upon the basis of the same facts. The court stated that the yardstick by which Federal taxes are measured is the U. S. Revenue Laws and not the act of the government officers and that until the tax liability fixed by law is fully settled, a deficiency may be assessed at any time within the statutory period of limitation.

Again in *McIlhenny vs. Commissioner*, (C.C.A. 3rd) 39 Fed (2d) 356, in which the taxpayer relied on *Woodworth vs. Kales*, it was held that the determination by the Commissioner of Internal Revenue of a taxpayer's liability for a particular year did not bar the Commissioner from reopening the matter and redetermining the facts.

The court in the following cases likewise refused to follow Woodworth vs. Kales:

Holmquist vs. Blair 35 Fed (2d) 13,
Austin Co. vs. Commissioner (C.C.A. 6th) 35 Fed (2d) 910,
Oak Worsted Mills vs. United States, 36 Fed (2d) 529,
38 Fed (2d) 699, and
Page vs. Lafayette Worsted Co. (C.C.A. 1st) 66 Fed (2d) 339.

Appeal of Fifth Street Building

In the following cases the court either approved the rule laid down in the McIlhenny case or established a rule contrary to that of Woodworth vs. Kales:

Burnett vs. Porter, 283 U.S. 230,
Prentis vs. Atlantic Coast Lines, 211 U.S. 210,
223-225, and
Laher Auto Spring Co. vs. United States, 5 Fed. Supp. 38

Inasmuch as the weight of authority appears to be contrary to Appellant's contention, we must hold that the Commissioner was not precluded from questioning the values asserted by Appellant in determining Appellant's tax liability for the year 1932. Accordingly, we must determine whether the Appellant has satisfactorily established the values asserted by it.

Appellant contends that its building had a fair market value as of January 1, 1928 of \$1,691,408.82 and that its machinery and equipment had a fair market value as of that date of \$351,191.68. These values were determined upon the basis of the reproduction cost new, less depreciation, of the property.

It appears, however, that the total fair market value of the building, machinery and equipment as of the first Monday in March 1928, computed upon the basis of the amount for which the property was assessed for taxation by the County of Los Angeles during the year 1928, assuming that it was assessed at 47.31% of its actual fair market value, the average amount at which property was assessed in Los Angeles County during that year (See p. 28 of the Board's report for 1927-28), was but \$1,068,248.44. In this connection, it is to be observed that although the amount for which property is assessed for local taxation may not be technical evidence of the fair market value of the property, we have held in prior appeals that it is a factor which may be considered by us in determining the fair market value (See appeal of The Richard Corporation, decided by us on April 14, 1934, and appeal of American Dredging Company, decided by us on April 23, 1934.) Furthermore, it appears from a document filed by Appellant with the Corporation Commissioner, that the building had a value on December 31, 1928 of but \$1,069,230.25 and that the machinery and equipment had a value on said date of but \$133,878.58.

In view of these conflicting values and in view of the fact that the reproduction cost new, less depreciation, of property, alone considered, is not conclusive evidence of the fair market value of the property, we must conclude that Appellant has not satisfactorily established that its building, machinery and equipment had as large a fair market value on January 1, 1928 as claimed by Appellant.

Thus there remains for our determination only the question as to whether Appellant has satisfactorily established the fair market value as of January 1, 1928 of its leasehold.

Appellant claims that its leasehold had a fair market value as of January 1, 1928 of \$731,106.16 over and above the amount of rent which Appellant agreed to pay for such leasehold.

Appeal of Fifth Street Building

In arriving at this value, Appellant first estimated the total amount of income which it expected to derive from its property during the period of its leasehold, and then deducted from this income the rent which it had to pay, depreciation on its building, machinery and equipment and a reasonable return on its investment in such building machinery and equipment. The balance of the income Appellant concluded, was attributable to the leasehold. This income capitalized at 8% produced a value for the leasehold as of January 1, 1928 of \$731,106.16.

This method appears to be a proper one for arriving at the value of a leasehold (See Blinn Lumber Co. vs. Los Angeles County, 216 Cal. 468, 474). Furthermore, it appears that the various assumptions and calculations made by Appellant were fair and reasonable. Accordingly, we see no reason for questioning the value of the leasehold as of January 1, 1928 asserted by Appellant. Consequently, we must hold that the Commissioner erred in disallowing a deduction for depreciation of Appellant's leasehold computed upon the basis of a value of \$731,106.16.

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, that the action of the Franchise Tax Commissioner in overruling the protest of Fifth Street Building against a proposed assessment of an additional tax in the amount of \$1,210.60 for the year 1932 based upon the net income of said corporation for the period ended December 31, 1931, be and the same is hereby modified. Said action is reversed insofar as the Commissioner failed to allow a deduction for depreciation of a leasehold of Fifth Street Building computed upon the basis of the fair market value thereof as of January 1, 1928 in the amount of \$731,106.16. In all other respects said action is sustained. The correct amount of the tax to be assessed to the Fifth Street Building is hereby determined as the amount produced by means of a computation which will include the allowance of a deduction for depreciation of a leasehold of said corporation computed upon the basis of the fair market value thereof as of January 1, 1928 in the amount of \$731,106.16 in the calculation thereof. The Commissioner is hereby directed to proceed to conformity with this order and to send Fifth Street Building a notice of the assessment revised in accordance therewith.

Done at Sacramento, California, this 21st day of May, 1934, by the State Board of Equalization.

R. E. Collins, Chairman
Fred E. Stewart, Member
Jno. C. Corbett, Member
H. G. Cattell, Member

ATTEST: Dixwell L. Pierce, Secretary