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Federal Income Taxation: Depreciation Deduction: Useful Life and Salvage Value Under The Declining Balance Method

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exercised in aid of the state's administration of justice, not to defeat or needlessly embarrass it.

Under the particular facts of this case a strong argument can be made in favor of affirming the action of the district court. The dissent of Judge Finnegan does just that. As the record clearly shows the petitioner filed a notice of appeal and requested a verbatim record immediately after his conviction. Through no fault of his own he was prevented from further prosecuting the appeal. The matter was before the State Supreme Court on at least three separate occasions[11] when action could have been taken to grant a new trial. It would seem that during the ten year period preceding the present case the state had already had a reasonable time in which to take corrective action and that now law and justice would require the prisoner to be discharged.

Aside from the final disposition of the case, there is a question of the propriety of the order of the district court discharging the prisoner in view of the request by the state attorney general that the prisoner be not released pending appeal. In *O'Brien v. Lindsey*[12] the following comment was made:

> Weighing the relevant considerations of policy, it is by no means clear that as a matter of right and routine a state prisoner should be set at large pending review in a court of appeals of a federal district court order discharging the prisoner on *habeas corpus.*

Considering here the fact that the district judge certified that there existed probable cause for appeal[13] and also the attorney general's request, it would appear that the discharge should have been delayed pending the appeal.

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Federal Income Taxation: Depreciation Deduction—Useful Life and Salvage Value Under the Declining Balance Method—Taxpayer corporation is engaged in the business of renting automobiles. On an average, during the tax years in issue, new cars were held by the taxpayer for a period of 26 months and then sold, although, generally, such autos had a useful life to someone of four years. Taxpayer contended that it should be allowed to depreciate the cars on the declining

[11] 1951—Westbrook, appearing *pro se,* prosecuted a writ of error to the Illinois Supreme Court, contending the sentence imposed was improper. The Court held that the sentence was not for an indeterminate period and remanded the the case for imposition of a proper sentence. He was resentenced to 30-50 years imprisonment. People v. Westbrook, 411 Ill. 301, 103 N.E. 2d 494 (1952). 1952—Illinois Supreme Court affirmed a denial of petition for a hearing under the Illinois Post Conviction Hearing Act, ILL. REV. STAT. 1953, C. 38, §§26-832. 1956—Petition for writ of *habeas corpus* dismissed. See 259 F. 2d at 217.

[12] 202. F. 2d 418, 420 (1st Cir. 1953).

[13] See 28 U.S.C.A. §2253.

balance method, using four years as the useful life of the asset. In this connection, it further contended that Treas. Reg. §1.167(a)-1(b) is an erroneous interpretation and expansion of Section 167(b) (2) of the Internal Revenue Code of 1954. This regulation holds that, for purposes of depreciation under Section 167 of the Code, "useful life" of an asset is the useful life of that asset to a particular taxpayer and not the inherent overall useful life of that asset to someone. If this regulation was correct, the taxpayer in the instant case could not depreciate its autos by the declining balance method since under Section 167(c) this method can be used only with an asset which has a useful life of 3 years or more.

Held: Under Section 167 of the code "useful life" of an asset for purposes of depreciation is the useful life of that asset to the particular taxpayer. Examination of the reports of the Committee of both Houses of Congress indicates a congressional intent that the declining balance method shall be a realistic method which allows depreciation on the basis of actual economic usefulness. To achieve this result it is essential that useful life as well as salvage value be based upon the actual life and salvage value of the asset to the particular taxpayer in question. This is a much more realistic approach than using the actual life of the asset, computed on the basis of its economic value to someone; or salvage value based on the value of the asset when it is no longer economically useful to someone.

Thus, the taxpayer in the instant case can not depreciate its autos on the declining balance method as they have a useful life of only 26 months.[1] Section 167(c) was designed to prevent an unnaturally fast writeoff of short term assets by providing assets with useful life of less than 3 years cannot be depreciated through the declining balance method. This Section is not to be circumvented by placing a useful life of 4 years upon an asset which has an actual useful life to the taxpayer of only 26 months. *Hertz Corporation v. U.S.*, 165 F. Supp. 261 (D. Del. 1958)*.

If the principal case is correct in its interpretation, an incongruous result arises which was clearly never intended by Congress. To illustrate, let us take the example of a corporate asset acquired by a taxpayer with a basis of $10,000.00. This asset has an overall useful life of 10 years but will be retained by the taxpayer for use in his business for only four years. Under the doctrine of the principal case, the useful life of the asset for purposes of depreciation will be 4 years. The rate of depreciation to be applied under the declining balance method will be 50 percent of the unexpended balance per year (200 percent

[1] This regulation was held inapplicable retroactively and thus the taxpayer could use the declining balance method for years prior to the adoption of the regulation.

* [Appeal authorized by Solicitor General, P-H 1959 FED. TAXES. §56,355 *Ed.*]

of the straight line rate which on a four year asset is 25 percent per year). Ignoring the actual salvage value but applying the salvage value inherent in the declining balance method, at the end of four years the taxpayer will have deducted $19,375.00 from ordinary income for depreciation and the asset will have a basis of $625.00. On sale of the asset the taxpayer will pay capital gains on the excess of the amount realized over basis, thus realizing a considerable tax saving. It is thus apparent that under the doctrine of the instant case an avenue for tax avoidance is opened to the taxpayer. He can hold an asset for much less than its actual useful life and take accelerated depreciation which he deducts from ordinary income otherwise taxable at a 52 percent rate.[2] Then, upon sale, he pays the 25 percent capital gains rate on the amount recovered in excess of basis. This tax saving device will be somewhat limited, in that, if the taxpayer holds the asset for less than 3 years he will be precluded from using the declining balance method under Section 167(c) of the Code. In the case of assets with a useful life of 3 years or more, however, the taxayer may rely upon this method.

Clearly, Congress never intended to allow such unnaturally fast depreciation which would result in an unnaturally low basis at the time of sale. Thus, in discussing the declining balance method of depreciation, the House Ways and Means Committee states:

> This method concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresonding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles.[3]

The report of the Finance Committee indicated a philosophy identical to that of the House.[4] Both reports indicate an intent to have depreciation reflect actual economic decline in value and not to allow unnaturally fast write-offs with a resulting basis which is much below actual value.

This contention is further borne out by Amendment No. 50 as proposed by the Senate and adopted as Section (167(c) of the Code. Under this provision the declining balance method cannot be used with assets which have a useful life of less than 3 years. In proposing this amendment the Finance Committee stated:

> The use of the 200 percent declining balance rate in the case of short-lived properties would result in extremely fast write-offs. For example, in the case of an asset with a 2 year service life, the doubling of the 50 percent straight-line rate would be

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[2] The corporate rate on the first $25,000.00 of income would be 30 per cent.
[3] H. R. REP. No. 1337, 83d Cong., 2d Sess. 23 (1954).
[4] S. REP. No. 1622, 83d Cong., 2d Sess. 25 (1954).

> equivalent to expensing the cost in the year of acquisition. These properties would retain substantial value and could be resold subject to capital gain rates.
>
> To prevent unrealistic deductions and resulting tax avoidance, your committee has provided that the liberalized methods be made available only with respect to assets with useful lives of 3 or more years.[5]

Thus, the Committee clearly expresses an intent to disallow unrealistic writeoffs and goes so far as to provide that the declining balance method cannot be used with short term assets when such would be the result. It seems incongruous that the Congress would specifically exclude assets with a useful life of less than 3 years to prevent unrealistic writeoffs and yet intend that this result can be accomplished with assets which have a useful life of over 3 years by applying a concept of useful life to the taxpayer plus an artificial salvage value. The principal case relies heavily upon the above quoted language from both the House and Senate in support of its contention that useful life to the individual taxpayer is the useful life contemplated in Section 167 of the Code. However, when one couples this useful life concept with the court's opinion that actual salvage value can be ignored under the declining balance method, the result achieved will be the very type of unrealistic depreciation which Congress is seeking to avoid.

Realistic depreciation plus an accurate basis at the end of depreciation can be achieved under the declining balance method in one of two ways. If useful life of an asset is defined as the inherent useful life of the asset to someone, the taxpayer will not be able to take as great an amount of depreciation. If he sells the asset before its useful life is complete his basis will thus be greater. Taking the example used previously of a $10,000.00 asset with overall life of 10 years, the taxpayer could depreciate the asset at the rate of 20 percent per year. At the end of four years he would have charged off $5,904.00 as depreciation and the asset would have a basis of $4,096.00. In the alternative, the useful life of the asset could be determined as the useful life to the individual taxpayer but it could be held that, under the declining balance system, the asset may not be depreciated below the reasonable salvage value of the asset at the time the taxpayer normally disposes of assets of this type. Under this system, however, when one is dealing with an asset which has a long inherent life but which has a useful life to the taxpayer of only limited duration, all depreciation may be concentrated in the first year or two of the life of the asset with the salvage value being reached at this time. Thus, there will be no depreciation allowable during the further life of the

[5] *Id.* at 29.

asset to the taxpayer. Clearly, this result does not conform to sound accounting principles. The instant case rejects the concept of using actual salvage value under the declining balance method.

A perusal of the reports of the House and Senate indicates that Congress did not intend true salvage value to be a limit on the amount deductable under the declining balance method. Thus, the Senate Finance Committee in considering the declining balance method states:

> The salvage value is not deducated from the basis prior to applying the rate, since under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value.[6]

Likewise, the Staff of the Joint Committee on Internal Revenue Taxation in referring to the declining balance system in its *Summary of the New Provisions in the Internal Revenue Code of 1954* states at page 17:

> However, due to the nature of the declining balance method, some 10 to 13 percent of the cost of a property (which may be either more or less than salvage value) remains unrecovered at the end of its service life....

In addition, the Senate clearly recognized that the amount to be used as salvage under this method was not to be actual salvage when it proposed Amendment 51 which was adopted as Section 167(e) of the Code. Under this section a taxpayer is permitted to change from the declining balance method to the straight line method. In discussing this amendment the Senate Finance Committee indicated that, because of the nature of the declining balance method, the sum left as a basis at the end of depreciation might be larger than actual salvage values. By allowing the taxpayer to switch to the straight line method he would be allowed to depreciate the asset down to its actual salvage value. In referring to this conversion from declining balance to straight line the committee states:

> The straight-line rate would be based on the realistic estimate of remaining life of the property at the time of the switch. Moreover, the rate would thereafter be applied to the depreciated balance of the account at the time of the switch, less a realistic estimate of salvage value.[7]

All of these reports indicate that under the declining balance method actual salvage value is not a limiting factor.

Thus, the only conclusion that can be reached is that Congress intended useful life to be the actual inherent useful life to anyone. This is the only interpretation which will adequately effectuate the Congressional intent that depreciation is to have a reasonable economic basis.

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[6] *Id.* at 201.
[7] *Id.* at 27.

The principal case rejects this concept on the ground it is not intended by Congress, but the alternative which is set forth is even more violative of the express Congressional intent. Nowhere does Congress define useful life, but the only logical inference is that it means the entire useful life inherent in the asset. It is true that under this theory the taxayer in the instant case could depreciate his cars on the declining balance method. However, this does not seem to circumvent Section 167(c) as that section is directed at assets which have such a short life they will be totally depreciated in the year of acquisition. This is the example that is used by the Senate Committee in discussing this section.[8] In the instant case the total life of the asset will be 4 years and thus the taxpayer will be limited to depreciation of 50 percent per year.

To effectuate the congressional intent that the declining balance method be a realistic system based on sound accounting principals the only logical interpretation is that useful life is the inherent useful life of the asset to someone. The interpretation of the principal case would seem to result in a distorted system of depreciation under the declining balance method.

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[8] *Id.* at 29