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Restoration and Recapture:

The Auditor's Responsibility

IN THE FUTURE, the preparation of federal income tax returns for audit clients will require additional work to insure that transactions involving restoration of the investment credit and recapture of depreciation are properly reflected in the returns. Audit engagements in which the responsibility for the preparation of the federal income tax return has been retained by the client will require consideration of restoration and recapture because of the effect which the operation of these new rules will have on a client's tax liability.

Although the tax department ultimately may have to be consulted regarding various possible applications of the rules, the audit staff will have responsibility for recognizing transactions which may be subject to restoration and recapture. Close client relationships of the audit staff will require a degree of familiarity with restoration and recapture in order fully to understand the problems incident to significant acquisitions or disposals of operating assets which may be undertaken by clients.

Restoration and recapture are required by Sections 47 and 1245 of the Internal Revenue Code. Both sections were added to the Code by the Revenue Act of 1962. Section 47 provides for the restoration of an investment credit previously derived from the acquisition of property included within the definition of Section 38 property.¹ Restoration is required if Section 38 property is disposed of, ceases to be Section 38 property, or is converted to public utility property. Section 1245 provides for the recapture, as ordinary income, of depreciation taken after December 31, 1961, on property included within the

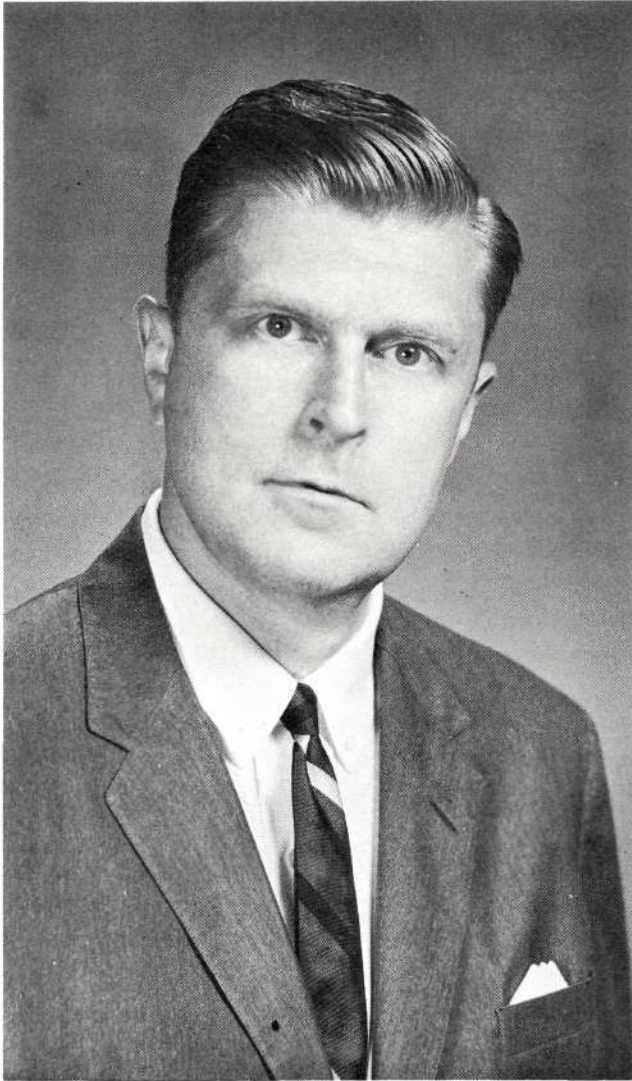
definition of Section 1245 property.² The recapture provision pertains only to dispositions occurring in years beginning after December 31, 1962.

Section 47 was enacted to complement the basic investment credit provision of the Code.³ The purpose of the Section is to prevent taxpayers from deriving multiple investment credits merely by turning over a fixed investment in Section 38 property.⁴

The purpose of Section 1245 is to prevent the conversion of ordinary income into capital gain upon the disposition of property in those instances in which depreciation has been taken at a faster rate than the actual decline in value of the property.⁵ This approach is clearly in conflict with the basic accounting concept of depreciation as a method of allocating the cost of property over its expected useful life without regard to its value. The enactment of Section 1245 was spurred by the advent of the liberalized depreciation rules⁶ which would have increased the amount of capital gain to be realized upon the sale of depreciable property and the investment credit incentive which was designed to encourage the acquisition of depreciable property.⁷

The principle of recapture expressed in Section 1245 is not unique in the Code. Section 1238, which was enacted as part of the Revenue Act of 1950, requires ordinary income treatment of amortization in excess of depreciation taken on an emergency facility which is subsequently recovered as gain on disposition of the facility.

Restoration of the investment credit is required upon disposition or cessation of status as Section 38 property.⁸



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by JOHN D. HEGARTY

However, restoration will be necessary only if the actual useful life of the property terminates before the end of the estimated useful life used in determining the amount of the credit. That is, if a taxpayer who acquires Section 38 property adopts an estimated useful life of four years in determining the amount of the investment credit and he later disposes of the property in the sixth year, restoration of the credit will not be required. The credit is not increased if the property is used for a period longer than its estimated useful life.

With respect to Section 38 property held by partnerships, Subchapter S corporations, trusts, and estates, disposition includes a sale or exchange of a partnership interest, Subchapter S stock, or a beneficial interest in a trust or estate.⁹ A lease of Section 38 property will not require restoration of the investment credit by the lessor unless the lease arrangement is undertaken merely for the purpose of avoiding the application of Section 47 in a situation in which the lessor would ordinarily dispose of the property by sale or exchange.¹⁰ Termination of a bonafide lease with respect to which the lessor elected to treat the lessee as a purchaser of the property will constitute a disposition unless the lessee acquires the property upon termination of the lease.¹¹

Simply stated, the amount of the investment credit to be restored is the difference between the credit computed by using the actual useful life of the property and that computed from the estimated useful life.

Termination of useful life as Section 38 property will

most commonly occur upon a disposition of property. However, the loss of Section 38 characteristics by any property on which the investment credit has been taken also will invoke the restoration provision.

Section 38 property

Section 38 property¹³ does not lend itself to a simple definition. It includes tangible personal property (other than livestock) and real property (other than buildings and structural components) on which depreciation, or amortization in lieu of depreciation, is allowable. If it is real property, it also must be used as an integral part of manufacturing, production, or extraction, or of furnishing various utility services, or as a research or storage facility used in connection with any of these functions. Its useful life must be four years or more. During its useful life, it must be used predominantly in the United States, but not predominantly in furnishing non-transient lodging. In addition, it cannot be leased to a governmental unit and, if leased to or acquired by a tax-exempt organization, it will be treated as Section 38 property only if it is used predominantly in a trade or business which is subject to tax because it is unrelated to the tax-exempt purposes of the organization.

Conversion to public utility property

Conversion of Section 38 property to public utility property requires partial restoration of the original investment credit.¹⁴ In any year in which property is used predominantly in furnishing various utility services, an adjustment will be required.¹⁵ The reason for the reduction is that public utility property qualifies for only 3/7 of the investment credit. The amount of the credit to be restored is the difference (between—and—) in the credit computed by reducing the investment in Section 38 property to 3/7 for the remainder of the estimated useful life of the property after conversion.^{16a} Restoration of the credit is permanent, subsequent use predominantly as nonpublic utility property is ignored.¹⁷

Manner and year of restoration

Restoration of the investment credit is accomplished by an increase in tax liability for the year of disposition, cessation, or conversion.¹⁸ Recomputation of tax for the year in which the credit was originally taken is unnecessary. To the extent a restored credit is reflected in an unused investment credit carry-over, such carry-over must be reduced accordingly.¹⁹ A reduction in a carry-over to any year which is attributable to a disposition, cessation, or conversion occurring in the same year is to be taken

into account in determining the amount of carry-over to that year.²⁰ A restored credit reflected in a carry-back which has been utilized in a prior year is treated as an increase in tax for the year of restoration rather than for the earlier year.²¹ Although overpayments of tax resulting from investment credit carry-backs will yield interest from the end of the year in which the carry-back arises,²² repayment of the credit or credits which gave rise to the carry-back occurs only in the year of restoration and is made without liability for interest.²³

Adjustment to basis in year of restoration

In order to compensate for the basis of property giving rise to an investment credit being reduced in the year of acquisition by the amount of the credit, the basis of the property is increased in an equal amount in the year of restoration.²⁴ The increase in basis occurs immediately before the event giving rise to restoration of the credit, thereby eliminating the necessity of recomputing depreciation for prior years.²⁵ The reduction in depreciation for these years which resulted from the lower basis of the property is offset by a correspondingly higher basis upon disposition. The higher basis thus reduces the amount of depreciation which is taxable as ordinary income under Section 1245.

In the case of leased property, rental deductions taken in prior years will be reduced to reflect investment credits which the lessor has elected to pass through to the lessee. The amount of prior decreases in rental deductions will be deductible in the year of restoration.

Legislation pending in Congress would retroactively revoke the requirement that the basis of property subject to the investment credit be reduced by the amount of the credit.^{25b} Final enactment of this change would eliminate the adjustment to basis in the year of restoration.

Exceptions to restoration

There are only a few exceptions to the restoration rule, 26 and for various reasons these have been held to a minimum. The amount of the credit available to the taxpayer after restoration is no less than the credit which would have been available to him if the useful life of the property as Section 38 property had been estimated accurately.²⁷ Because the adjustment is made in the year of restoration, interest is not due from the taxpayer on the credit restored and, presumably, the credit is given up by the taxpayer without financial burden.²⁸ In those instances in which the taxpayer immediately reinvests the proceeds of a disposition, he will be entitled to a new investment credit to replace the surrendered credit.

Transfers of property by reason of death are excluded from the operation of Section 47.²⁹ All property held by a decedent at the time of his death is deemed, in effect, to be held by the decedent for the useful life originally estimated by him in computing outstanding investment credits.³⁰ Death transfers include those made by way of survivorship in the case of a joint tenancy or tenancy by the entirety.³¹

Transfers of property in transactions to which Section 381(a) applies are also excepted.³² Briefly, these transactions would include liquidations of controlled subsidiaries in which the basis of the subsidiary's assets carries over to the parent company and to certain tax-free corporate reorganizations involving the acquisition of assets. Section 381(c) (23) complements the exception by providing that an acquiring corporation must recognize items required to be taken into account for purposes of the investment credit, including restoration of credits on acquired property subsequently disposed of by the acquiring company.

A mere change in the form of conducting a business will not result in restoration under Section 47.³³ However, the exception applies only if three conditions are met: (1) the business in which the Section 38 property was used, as well as the property itself, is transferred;³⁴ (2) the property is retained in the business after the transfer; and (3) the transferor retains a substantial interest in the business. A determination of whether or not a substantial interest has been retained must be made after the initial change in form of conducting the business and also after each disposition of a portion of the transferor's interest.³⁵ If the percentage of the transferor's interest in the business after a change in form remains exactly the same as his interest prior to the change, the transferor will be considered to have retained a substantial interest.³⁶

While this exception is stated in broad terms, its application may be limited because of the requirement that the business in which the property is used must be transferred with the property. Also, retention of less than an identical percentage of ownership will create considerable uncertainty as to whether or not a substantial interest has been retained.

For example, if Messrs. Jones and Smith decide to engage in business together under corporate form, their retained interests in specific Section 38 property transferred by them to the corporation will always be less than their previous ownership. If they are equal shareholders, their retained interests in the property will be only 50%. In any event, as Jones and Smith each transferred Section 38 property to the corporation, they may find it difficult

to demonstrate that they each transferred an identifiable business in which the property was used.

A further exception relates to dispositions attributable to casualty losses or thefts.³⁷ Restoration of the investment credit is inapplicable in these instances if the property is replaced and the reduction in the basis of the replacement property, which is required under Section 46(c) (4), is equal to or greater than the decrease in qualified investment in Section 38 property resulting from the casualty loss or theft. Section 46(c) (4) becomes operative if Section 38 property is acquired to replace other property, including property which is not Section 38 property, and which is destroyed or damaged by casualty, or stolen. In this situation, the basis of the replacement property for purposes of computing the investment credit is to be reduced by the lesser of the adjusted basis of the property replaced or the insurance (or other compensation) received. For example, assume that property which originally cost \$90,000 is destroyed by fire and replaced with property purchased for \$100,000. Assume that the portion of original cost of destroyed property which represented qualified investment in Section 38 property was \$30,000; the adjusted basis after deductions for depreciation was \$45,000; and the insurance received was \$55,000. The reduction in the basis of the replacement property required by Section 46(c) (4) would be \$45,000. As the reduction is greater than the \$30,000 decrease in the qualified investment in Section 38 property, restoration of the investment credit taken on the destroyed property would not be required. The overall effect of the two provisions is to require restoration of the credit only if both the adjusted basis of the property replaced and the insurance proceeds are less than the reduction in qualified investment in Section 38 property which was caused by the casualty loss or theft. Operating together, the two provisions limit the application of the investment credit to the acquisition of Section 38 property which represents an additional investment by the taxpayer.

Nature of restored credits

Restored investment credits are treated as tax in the year of restoration for all purposes, except in applying the limitations imposed on the amount of the various allowable credits against tax which are measured by the amount of tax liability for the year.³⁸ For example, the aggregate amount of investment credits restored in a year would not be considered as tax for purposes of applying the foreign tax credit or the basic \$25,000 limitation on investment credits which may be taken in a year.

Effect of restoration on cost of used Section 38 property

Dispositions resulting in the loss of the investment credit which are followed by reinvestment of the proceeds in used Section 38 property permit the taxpayer to claim a higher basis for the used property acquired in computing the investment credit.³⁹ As a general rule, taxpayers who acquire used property either through trade-in or to replace property similar or related in service or use must reduce the basis of the replacement property by an amount equal to the adjusted basis of the property replaced.⁴⁰ The rule applies whether or not the property replaced is Section 38 property. The reduction in basis is required in order to insure that the investment credit is obtained solely for new investment. However, if an investment credit applicable to the replaced property is restored by virtue of Section 47, the basis of the Section 38 property is determined in the traditional manner.⁴¹

RECAPTURE UNDER SECTION 1245:

Disposition defined

The recapture of depreciation as ordinary income applies to dispositions of Section 1245 property in years beginning after December 31, 1962.⁴² Except for specific statutory exceptions, recapture applies to any disposition of Section 1245 property. However, the Senate Committee Report indicates that it does not include gain incident to a normal retirement from a multiple asset account.⁴³

A sale or exchange is not a prerequisite to the operation of Section 1245. If a sale or exchange is not present, the amount realized by a taxpayer is imputed from the fair market value of the property at the date of disposition.⁴⁴

Depreciation subject to recapture

The maximum amount subject to recapture, or in other words, the Section 1245 potential, cannot exceed the gain on disposition of Section 1245 property.⁴⁵ The gain is measured in the usual manner. It is the difference between the amount realized, whether actual or imputed from fair market value, and the adjusted basis of the property.⁴⁶ The amount of recapture will be less the gain if the recomputed basis of the property is less than the amount realized.⁴⁷ Recomputed basis is nothing more than the adjusted basis of the property, increased by depreciation taken after December 31, 1961.⁴⁸ Fortunately, Section 1245 gain lends itself to a reasonably concise definition. It is the lesser of the gain realized on a disposition, or the sum of all depreciation deductions taken after December 31, 1961. In the case of an actual sale or exchange, if the gain

is greater than the prior depreciation, the excess will qualify as gain from the sale or exchange of a capital asset or Section 1231 property.

Recomputed basis, which determines the Section 1245 potential, includes only depreciation (and amortization of emergency facilities) allowed as a deduction.⁴⁹ Taxpayers, however, must demonstrate that the amount of depreciation allowed them was less than the amount allowable.⁵⁰ Depreciation is included in recomputed basis even though it did not produce tax benefit in an earlier year. Section 1245 makes no exception in this circumstance. Rather, it specifically provides that depreciation reflected in the adjusted basis of property must be included in determining recomputed basis.⁵¹ A prior reduction in the basis of property which was required to reflect the investment credit is not treated as depreciation in arriving at recomputed basis.⁵²

Is the recapture provision limited to depreciation under Section 167 (which includes additional first-year depreciation under Section 179).⁵³ It would appear that, for purposes of recapture, depreciation does not include amortization of leasehold improvements in those instances in which the useful life of the improvement is longer than the term of the lease. The Regulations under Section 167 indicate that such amortization is in lieu of depreciation and deductible under Section 162 rather than under Section 167.⁵⁴

Section 1245 property

The statutory definition of Section 1245 property is generally broader than that of Section 38 property.⁵⁵ It includes property which is, or has been, property of a character subject to depreciation under Section 167. As previously noted, with depreciation limited to that provided for by Section 167, the definition of Section 1245 property would not include leasehold improvements on which amortization in lieu of depreciation is taken. (This is, of course, in contrast to the definition of Section 38 property which includes leasehold improvements subject to amortization.⁵⁶)

Section 1245 property encompasses intangible as well as tangible personal property. The same categories of real property which qualify as Section 38 property are included. With respect to such real property, recomputed basis includes only depreciation allowed while the property was an integral part of (or research or storage facility used in connection with) the various qualifying activities in which the property must be employed. The relatively numerous limitations imposed on Section 38 property are not applicable in the case of Section 1245 property. The

requirements relating to continuous use as depreciable property, useful life, predominant use inside of the United States or in furnishing only transient lodging, and other limitations are not present.

Exceptions to recapture

Section 1245 generally does not operate in the context of certain transfers in which the transferor's basis for the property disposed of carries over either to the same property in the hands of the transferee or to other Section 1245 property received by the transferor.⁵⁷

The statutory exceptions include transfers of property incident to the following occurrences:⁵⁸

1. Gifts (other than charitable contributions).
2. Death (except that gain realized on the disposition of Section 1245 property prior to death which constitutes income in respect of a decedent is not included within the exception. It should be noted that the exception with respect to transfers of property at death does not fit within the general rule which excludes transfers in which the transferee takes the property with a carry-over basis).
3. Liquidation of a controlled subsidiary in which the basis of the subsidiary's assets carries over to the parent company (Section 332).
4. Exchanges for stock or securities in a controlled subsidiary (Section 351).
5. Corporate reorganizations involving transfers of assets (Section 361).
6. Reorganizations pursuant to receivership and bankruptcy proceedings (Section 371).
7. Certain railroad reorganizations (Section 374).
8. Exchanges for partnership interests (Section 721).
9. Prorata distributions by a partnership to a partner (Section 731).
10. Wholly or partially tax-free exchanges of like-kind business or investment property and involuntary conversions (Sections 1031 and 1033).
11. Sales or exchanges to implement policies of the FCC or exchanges in obedience to SEC orders (Sections 1071 and 1081).

Limitations imposed on exceptions to recapture

Section 1245 gain will be recognized, however, in transactions included within the exceptions to the extent gain would be otherwise recognized without regard to the section.⁵⁹ For example, transfers of assets for stock and securities pursuant to a tax-free corporate reorganization will result in taxable gain to the transferor corporation if it also receives, and retains, boot in exchange for

its assets.⁶⁰ Ordinary income would be recognized to the extent of such gain without regard to the exception for corporate reorganizations under Section 1245.

Although included among the exceptions to the operation of Section 1245, like-kind exchanges under Section 1031 and involuntary conversions under Section 1033 will produce ordinary income if property other than Section 1245 property is acquired. However, if the receipt of such property otherwise results in gain in the same transaction under Section 1031 as boot or under Section 1033 as unreinvested compensation, it will not give rise to further gain. Similar treatment, in accordance with Treasury Department regulations, is provided for sales or exchanges made to effectuate policies of the FCC or exchanges made in obedience to SEC orders under Sections 1071 and 1081, respectively.⁶² The limitation imposed with respect to these exceptions is designed to prevent deferment of Section 1245 gain where there is no possibility of its recapture upon a later disposition of substituted property.

Carry-over of Section 1245 potential

In those instances in which the recognition of Section 1245 potential is deferred under the various statutory exceptions the basis of property transferred (other than at death) carries over. As a result, the recomputed basis, or Section 1245 potential, of the transferred property also carries over to the same property in the hands of the transferee or to other Section 1245 property received by the transferor.⁶³

The basis of Section 1245 property distributed by a partnership to a partner carries over to the partner whether or not the basis of the property does in fact carry-over as a result of the distribution.⁶⁴ As a result, the recomputed basis of the property also carries over to the partner.⁶⁵ However, the ordinary income potential which carries over is limited to the Section 1245 gain which would have been realized if the partnership had sold the property at its fair market value immediately before the distribution.⁶⁶ The carry-over of ordinary income potential to a partner includes depreciation taken by a partner prior to transferring the property to the partnership.⁶⁷ Consequently, a partner could receive a distribution of ordinary income-potential property attributable to another partner who originally had contributed the property to the partnership.

Although transfers at death are included among the statutory exceptions, Section 1245 potential does not carry over with property transmitted at death inasmuch as the recipient takes the property with a stepped-up basis.⁶⁸

An interesting situation is presented by a gift of Section 1245 property made during a decedent's lifetime which also is included in his gross estate at death. If disposition by gift controls, the Section 1245 potential of the property will carry over to the donee. On the other hand, if the transfer did not take place until death, a carry-over of such potential may be avoided under the exception for transfers at death. The more plausible result is that the disposition is a gift and that the ordinary income potential carries over with the property.

Section 1245 potential which would otherwise carry over with property transferred by way of gift will be reduced by the amount of gift tax incurred by the donor. The basis of the property in the hands of the donee must be increased by the gift tax attributable to it (but not beyond the fair market value of the property at the date of gift.)⁶⁹ As a result, the Section 1245 potential is correspondingly reduced. If the gift tax rate of the donor is high, all or a substantial portion of the ordinary income potential may be dissipated by the increase in basis attributable to the gift tax.

Creation of income under Section 1245

Section 1245 treats as taxable events certain dispositions which were previously tax free. Income is attributed to a transferor in those cases in which Section 1245 gain would escape taxation forever unless taxed upon disposition of the property to which it relates. The dispositions involved are those in which the transferee receives a new basis for the property as a result of a taxable transaction.

Specifically, these situations are:

1. Distributions of property by corporations as dividends or in partial or complete liquidation.⁷⁰
2. Sales or exchanges of property by corporations within the provisions of Section 337.⁷¹
3. Distributions of installment obligations by corporations under Section 334(b)(2) or Section 337.⁷²

Prior to the enactment of Section 1245, gain deferred under the installment method of accounting was not accelerated on distributions of installment obligations in liquidations under Section 334(b)(2) or 337. Under present law, this rule remains in effect to permit distributions of installment obligations in these liquidations without acceleration of deferred gain, but only to the extent Section 1245 gain is not involved.

The requirement that Section 1245 gain must be recognized on installment obligations distributed in a Section 337 liquidation was adopted in recognition of the

fact that a liquidating corporation is free to elect the installment method of reporting gain on the sale of its assets. In order to place it on an equal footing with a similarly situated corporation which does not elect this method and is, therefore, subject to tax on Section 1245 gain realized on the sale of its assets, the deferred Section 1245 gain represented by installment obligations distributed is accelerated at the time of liquidation to the extent of the fair market value of the obligations.

Recapture of depreciation on partnership property

Section 1245 potential attributable to partnership property is treated as an unrealized receivable.⁷⁴ Thus, in a distribution to a retiring partner or a successor in interest of a deceased partner;⁷⁵ a sale or exchange of a partnership interest;⁷⁶ or a distribution by a partnership to a partner of Section 1245 property which results in the partner giving up or receiving more than his prorata share of such property,⁷⁷ amounts realized with respect to Section 1245 property are treated as ordinary income.

A problem may arise in determining gain in a nonprorata distribution of several items of Section 1245 property because the properties distributed will not have identical amounts of ordinary income potential. However, the approach taken by existing regulations with respect to unrealized receivables is to allocate a portion of the gain on all of the partnership's unrealized receivables to those given up by either the partner or the partnership.⁷⁹ Presumably, the same technique will be applied to Section 1245 property as it is included within the definition of unrealized receivables.

Adjustment to basis for depreciation recaptured

Section 1245 provides for adjustments to the basis of property, in accordance with Treasury Department regulations, to reflect gain recognized under the section.⁸⁰ The adjustments contemplated are those necessary to prevent double taxation of the same Section 1245 gain. Adjustments will generally be required in those transactions in which gain is recognized on the disposition of property and the basis of the property carries over either to the same property in the hands of the transferee or to other Section 1245 property received by the transferor.

With the exception of property received by a partner in a nonprorata distribution, the adjustments are to be made by increasing the basis of the property received rather than by reducing the recomputed basis which carries over intact.⁸¹ As a result, basis generally will be the same for all purposes. However, in those cases in which the basis of the property must be reduced (without re-

gard to Section 1245) by the amount of cash received, as in like-kind exchanges under Section 1031 and involuntary conversions under Section 1033(a)(1), the basis of the property for purposes of Section 1245 will be different from its basis for the other provisions of the Code. The difference in basis will exist to the extent that the cash received reflects gain recognized on the disposition. Thus, although Section 1245 gain will be recognized to the extent of the cash received (thereby requiring an increase in basis), the reduction in basis which also is required for the cash received will eliminate the adjustment to basis for the Section 1245 gain recognized. Unless the property is given a higher basis for Section 1245 purposes, the same Section 1245 gain may be taxed again on a subsequent disposition.

The following illustrate transactions in which an adjustment to basis may be required in order to reflect recognized gain:

1. Distributions of property by corporations to corporate distributees as dividends or in partial or complete liquidation. (An amendment to Section 301(d) specifically provides for an increase in the basis of property received by a corporate distributee equal to the Section 1245 gain recognized.)
2. Exchanges for stock or securities in a controlled subsidiary (Section 351).
3. Corporate reorganizations involving transfers of assets (Section 361).
4. Reorganizations pursuant to receivership and bankruptcy proceedings (Section 371).
5. Certain railroad reorganizations (Section 374).
6. Partially tax-free exchanges of like-kind business or investment property and involuntary conversions (Sections 1031 and 1033).
7. Sales or exchanges to effectuate policies of the FCC or exchanges in obedience to SEC orders (Sections 1071 and 1081).

The adjustment to basis for gain recognized in a nonprorata distribution by a partnership to a partner is accomplished by reducing the Section 1245 potential which carries over with the property received by the partner, rather than by the general technique of increasing the adjusted basis of the property.⁸² This method is employed in recognition of the fact that, although the recomputed basis of property carries over in a nonprorata distribution to a partner, the basis of the partnership for the property does not carry over.⁸³ The peculiar result of this refinement is that the ordinary income potential of property received by a partner in excess of

his prorata share is reduced by the gain taxed to the partnership. A similar adjustment would not be required if the partner took less than his prorata share of Section 1245 property, as the recomputed basis of the property would not carry over to the partnership.

Charitable contributions

Charitable contributions of Section 1245 property are accorded special treatment. The amount of any deduction for a charitable contribution of such property is reduced by the Section 1245 gain which would have resulted from a sale of the property at its fair market value at the time of the contribution.⁸⁴

Effect of recapture on percentage depletion

The limitation of percentage depletion to 50% of the taxable income from depletable property has been modified to reflect the ordinary income treatment now accorded recaptured depreciation.⁸⁵ Section 613 has been amended to take into account the fact that depreciation recovered with respect to Section 1245 property used in working a mineral interest may have decreased taxable income in the year it was deducted, thereby reducing the limitation on percentage depletion. As modified, Section 613 provides that expenses of mining reflected in taxable income for a year in which Section 1245 property is disposed of are to be reduced by the amount of depreciation recovered. The adjustment is to be made whether or not the recaptured depreciation resulted in a reduced deduction for percentage depletion in an earlier year.

Scope of Section 1245

Section 1245 specifically provides that it is to take precedence over all other provisions of the Code.⁸⁶ That is, it overrides any nonrecognition provision which is not specifically designated as an exception to its operation. In addition, it is not affected by any income-characterizing provisions of the Code.⁸⁷ Broad application of the section will require closer examination of transactions which traditionally have not resulted in income or in income taxable only as capital gain.

LIBERALIZATION OF SALVAGE VALUE REQUIREMENTS AND OPTIONAL DECELERATION OF DEPRECIATION:

Accompanying and directly related to the passage of Section 1245, there are two changes dealing with depreciation. For depreciable personal property (other than livestock) with a useful life of three years or more, sal-

vage value up to 10% of basis may be ignored in determining depreciation.⁸⁸ This change applies only to property acquired after October 16, 1962, and only to taxable years ending after that date. Real property included within the definition of Section 1245 property is not encompassed by the liberalized salvage value rule.

The second amendment will permit a taxpayer to change from any accelerated method of depreciation to the straight-line method, but only for the first taxable year beginning after December 31, 1962.⁸⁹ The methods from which a taxpayer may change are not limited to 200% declining balance and sum of the years-digits methods of depreciation. A taxpayer employing the 150% declining balance method of depreciation — or any other accelerated method — may change to the straight-line method of depreciation.

The opportunity to change from accelerated depreciation methods may have special appeal to taxpayers who have adopted multiple asset accounting for depreciable property in conjunction with the guideline lives published by the Treasury Department.⁹⁰ Many taxpayers who have changed to multiple asset accounting have found that annual depreciation deductions were substantially increased after the change, even in those cases in which the guideline lives generally were longer than the lives used earlier. The increase in depreciation could be assigned to the presence of a high percentage of fully depreciated assets in multiple asset accounts being depreciated under the straight-line method. By switching multiple asset accounts presently on an accelerated method of depreciation to the straight-line method, further increases in annual depreciation charges may be achieved.

While this certainly was not the result intended by Congress in granting permission to change, it appears to be within the right of any taxpayer to secure this advantage. Predictably, the Internal Revenue Service will closely scrutinize the mechanics of change. However, the possibility of lower tax rates in later years and the desirability of emerging from the three-year grace period (in which the reserve ratio is considered to be met for all taxpayers) with as high a reserve ratio as possible, in order to facilitate the task of moving toward the appropriate reserve ratio range during the remainder of the guideline life adopted, would appear to be sufficient motives to risk the discomfiture of the Internal Revenue Service. (The reserve ratio problem may be aggravated, however, if asset additions and retirements in years following the grace period are inadequate to achieve annual decreases in the reserve ratio.)

Under existing regulations, a change in method must be made with respect to all of the assets in a particular account.⁹¹ Thus taxpayers using multiple asset accounts rather than item accounts will be required to change their method of accounting for all assets in a particular multiple asset account. They will not be permitted to make the change only with respect to those account assets fully depreciated or approaching that status.

IMPACT OF RECAPTURE ON REVENUE RULING 62-92:

Revenue Ruling 62-92,⁹² which was adopted in response to the favorable holding in the Cohn⁹³ case, provides that depreciation in the year depreciable property is sold cannot include any portion of the undepreciated basis of the property at the beginning of the year which is recovered in the proceeds of the sale. If the proceeds are equal to or greater than the undepreciated basis of the property at the beginning of the year, no depreciation at all may be taken in the year of sale. In years beginning after December 31, 1962, Section 1245 will make it unnecessary for the Internal Revenue Service to apply Revenue Ruling 62-92 in disallowing depreciation taken on Section 1245 property in the year of sale.

MUTUALITY OF SECTIONS 47 AND 1245:

Instances in which the restoration and recapture rules operate in harmony are somewhat limited. The lack of uniformity is attributable, in part, to differences in the kinds of property covered and differences in the exceptions to operation of the rules. And the exceptions themselves cannot be applied unequivocally in every case. The exception which most frequently recurs under Section 47 relates to transfers accompanied by continuity of business and ownership in the context of a mere change in form of doing business. As the exception contemplates a transfer of a business intact with a substantial interest therein retained by the transferor, the scope of the exception is difficult to predetermine without reference to a particular transaction. In the case of Section 1245, the exceptions to its operation are modified by the limitation that ordinary income is always recognized in any transaction to the extent gain would be recognized without regard to Section 1245.

For the purposes of comparison, however, a broad analysis of the operation of the two sections is useful. Assuming that gain otherwise taxable in a particular transaction may be Section 1245 gain, the application of Sections 47 and 1245 to certain common transfers of assets is as follows:

TRANSACTION	CODE SECTION	APPLICATION OF SECTION	
		47	1245
Gifts	2501	Yes	No
Charitable contributions. (Section 1245 applies as a reduction in the amount deductible. Section 170(e))	170	Yes	Yes
Transfers by reason of death. (Section 1245 applies to the extent gain constitutes income in respect to a decedent. Section 1245(b)(2))	2001	No	No
Leases of assets. (Assuming absence of a sham transaction to avoid application of the sections)		No	No
Sales, exchanges, or other dispositions of corporate stock	61	No	No
Sales, exchanges, or other dispositions of Subchapter S corporation stock	61	Yes	No
Dividend distributions by a corporation	301	Yes	Yes
Distributions in partial or complete liquidation of a corporation	336	Yes	Yes
Liquidation of a controlled subsidiary. (Both sections would apply if the basis of the property distributed is determined under Section 334(b)(2))	336	No	No
Sales, exchanges, or other dispositions of corporate assets in a 12-month liquidation	337	Yes	Yes
Transfers in exchange for stock or securities of a controlled corporation. (Section 47 would not apply to a transfer accompanied by continuity of business and ownership. Section 47(b))	351	Yes	No
Transfers of assets in corporate reorganizations. (Section 47 would apply in a D reorganization in which the transferor does not transfer substantially all of its assets or is not completely liquidated. Sections 381(a) and 354(b)(1)(A) and (B))	361	No	No
Transfers of assets among affiliated corporations. (Section 1245 would not apply to a transfer made pursuant to Section 351. In addition, it should not apply to gain which is not recognized on transfers among affiliated corporations which have elected to file a consolidated return. Section 47 will not apply to a transfer during a consolidated return period if the investment credit arose during a year for which a consolidated return had been filed for the same group. Regulations Section 1.1502-51(c)(2))	61	Yes	Yes
Transfers in exchange for interests in a partnership. (Section 47 would not apply to a transfer accompanied by continuity of business and ownership. Section 47(b))	721	Yes	No
Sales, exchanges, or other dispositions of partnership interests	741	Yes	Yes
Distributions by a partnership to a partner. (Section 47 would not apply to a distribution accompanied by continuity of business and ownership. Section 47(b). Section 1245 would apply to a distribution which is not pro rata. Section 751(b) and (c))	731	Yes	No
Wholly or partially tax-free exchanges of business or investment property. (Section 1245 would apply to the extent of the fair market value of non-Section 1245 property received in the exchange which is not otherwise reflected in recognized gain. Section 1245(b)(4)(B))	1031	Yes	No
Involuntary conversion. (Section 47 applies either to restore the investment credit or to reduce the basis of replacement property. Sections 46(c)(4) and 47(a)(4). Section 1245 would apply to the extent of the fair market value of non-Section 1245 property acquired as replacement property which is not otherwise reflected in recognized gain. Section 1245(b)(4)(B))	1033	Yes	No
Sales, exchanges, or other dispositions of beneficial interests in a trust or estate	61	Yes	No

INFLUENCE OF RESTORATION AND RECOVERY PROVISIONS ON BUSINESS ACQUISITIONS AND DISPOSITIONS:

The restoration and recapture provisions may have a pronounced effect on the shape of future business acquisitions and dispositions. Advantages once enjoyed by sellers and purchasers may be altered or even eliminated.

In particular, the interests of sellers and purchasers of corporate stock or assets will become more difficult than ever to reconcile. Because of Sections 47 and 1245, the shareholders of a corporation will find it advantageous to sell their stock rather than to arrange for a sale of corporate assets followed by a complete liquidation of the corporation under Section 337. Except for shareholders of Subchapter S corporations, a sale of stock will not result in restoration or recapture. On the other hand, a sale of corporate assets under Section 337 will invoke, in many cases, restoration and recapture with respect to a substantial portion of the corporation's operating assets. Further, Section 1245 gains in a Section 337 liquidation cannot be offset against unrecognized losses on the sale of other property which may have an adjusted basis in excess of its fair market value.

Purchasers seeking assets will prefer direct asset acquisitions rather than a purchase of stock in order to avoid the operation of the restoration and recapture provisions in the case of a Section 334(b)(2) liquidation. A purchaser of assets also will be entitled to the investment credit (to the extent of the \$50,000 limitation on used property) with respect to Section 38 property which may be acquired.

Even if a seller can be persuaded to sell assets, there will be further conflict of interest in allocating the purchase price to Section 1245 property. In the past, the interests of a seller and a purchaser in regard to allocation were generally compatible because of the seller's ability to obtain capital gain treatment on the sale of depreciable property under Section 1231.

A further subject for negotiation between seller and purchaser will be the desirability of a taxable versus a nontaxable asset acquisition. Presumably, purchasers will choose to avoid acquiring property with Section 1245 potential in a nontaxable acquisition whenever possible. In any event, it seems likely that future informed purchasers will bargain for an adjustment in the purchase price whenever they must assume the burden of restoration or recapture.

The effect of recapture in a Section 337 liquidation may be minimized, or at least postponed, if the selling corporation elects the installment method of reporting

gain on the sale of Section 1245 property. Section 1245 gain would be accelerated, of course, upon distribution to the shareholders of the installment obligations received by the corporation. Acceleration would occur to the extent the fair market value of the obligations was in excess of the corporation's basis for the obligations. However, if the fair market value was depressed at the date of distribution because of the credit status of the purchaser or other unfavorable circumstances, the ordinary income to be recognized by the corporation would be correspondingly reduced. The shareholders, on the other hand, would be faced with receipt of ordinary income if the obligations subsequently were paid in full.

A partner disposing of his interest in a partnership always will be confronted with the possibility of subsequent challenge by the Internal Revenue Service as to the fair market value which he has determined for his allocable share of Section 1245 property held by the partnership. As any Section 1245 gain (based on its fair market value at the date of disposition) attributable to the partner is treated as an unrealized receivable, a withdrawing partner will undergo a period of uncertainty as to the nature of all or part of his gain until the statutory period of limitations has expired. In those instances in which a partnership is to be terminated, it may be preferable to dispose of substantially appreciated Section 1245 property prior to termination. This course of action would eliminate the problems of establishing and defending the fair market value of the property at the date of termination.

CHARITABLE CONTRIBUTIONS UNDER THE RESTORATION AND RECOVERY RULES:

A contribution of depreciable property to a charitable organization is a disposition for purposes of Sections 47 and 1245. Applied in concert, these sections may eliminate the tax benefit of charitable giving and even result in tax liability for the donor. If the charitable contribution is a premature disposition of Section 38 property, it will increase the donor's tax liability by all or a portion of the original investment credit. If the tax benefit arising from the deduction for the charitable contribution (after the deduction has been reduced by the amount of any Section 1245 gain recognized) is less than the amount of the investment credit restored, the donor actually will have increased his taxes through his gift to charity.

This unfortunate circumstance would most likely occur in the case of a bargain sale of depreciable property to a charitable organization in which the contribution element is minimized. The possibility that the donor will incur tax on making a charitable contribution will be stronger if

accelerated depreciation has been taken and if the contribution of property is made prior to four years from the

date of acquisition by the donor, thereby resulting in the maximum amount of restoration and recapture.

- ¹ IRC Sec. 48(a), (b), and (c).
- ² IRC Sec. 1245(a)(3).
- ³ IRC Sec. 38.
- ⁴ S. Rep. No. 1881, 87th Cong., 2d Sess. 18.
- ⁵ S. Rep. No. 1881, 87th Cong., 2d Sess. 95.
- ⁶ Rev. Proc. 62-21, 1962-2 Cum. Bul. 418.
- ⁷ S. Rep. No. 1881, 87th Cong., 2d Sess. 95.
- ⁸ IRC Sec. 47(a)(1).
- ⁹ S. Rep. No. 1881, 87th Cong., 2d Sess. 149.
- ¹⁰ Ibid.
- ¹¹ Ibid.
- ¹² IRC Sec. 47(a)(1).
- ¹³ IRC Sec. 48(a), (b), and (c).
- ¹⁴ IRC Sec. 47(a)(2).
- ¹⁵ S. Rep. No. 1881, 87th Cong., 2d Sess. 149.
- ¹⁶ IRC Sec. 46(c)(3).
- ^{16a} S. Rep. No. 1881, 87th Cong., 2d Sess. 18.
- ¹⁷ S. Rep. No. 1881, 87th Cong., 2d Sess. 150.
- ¹⁸ IRC Sec. 47(a)(1) and (2).
- ¹⁹ IRC Sec. 47(a)(3).
- ²⁰ S. Rep. No. 1881, 87th Cong., 2d Sess. 153.
- ²¹ S. Rep. No. 1881, 87th Cong., 2d Sess. 151 (Example).
- ²² IRC Secs. 6601 and 6611(f)(2).
- ²³ S. Rep. No. 1881, 87th Cong., 2d Sess. 18, 151 (Example).
- ²⁴ IRC Sec. 48(g)(2).
- ²⁵ Ibid.
- ^{25a} Revenue Act of 1963.
- ²⁶ IRC Sec. 47(b).
- ²⁷ S. Rep. No. 1881, 87th Cong., 2d Sess. 18.
- ²⁸ Ibid.
- ²⁹ IRC Sec. 47(b)(1).
- ³⁰ S. Rep. No. 1881, 87th Cong., 2d Sess. 152.
- ³¹ Ibid.
- ³² IRC Sec. 47(b)(2).
- ³³ IRC Sec. 47(b).
- ³⁴ S. Rep. No. 1881, 87th Cong., 2d Sess. 152.
- ³⁵ Ibid.
- ³⁶ Ibid.
- ³⁷ IRC Sec. 47(a)(4).
- ³⁸ IRC Sec. 47(c) and S. Rep. No. 1881, 87th Cong., 2d Sess. 153.
- ³⁹ IRC Sec. 48(c)(3)(B).
- ⁴⁰ Ibid.
- ⁴¹ Ibid.
- ⁴² IRC Sec. 1245(a)(1).
- ⁴³ S. Rep. No. 1881, 87th Cong., 2d Sess. 281.
- ⁴⁴ IRC Sec. 1245(a)(1).
- ⁴⁵ Ibid.
- ⁴⁶ Ibid.

- ⁴⁷ Ibid.
- ⁴⁸ IRC Sec. 1245(a)(2).
- ⁴⁹ Ibid.
- ⁵⁰ Ibid.
- ⁵¹ Ibid.
- ⁵² S. Rep. No. 1881, 87th Cong., 2d Sess. 97.
- ⁵³ IRC Sec. 1245(a)(2).
- ⁵⁴ Reg. Sec. 1.167(a)-4.
- ⁵⁵ IRC Sec. 1245(a)(3).
- ⁵⁶ IRC Sec. 48(a)(1).
- ⁵⁷ S. Rep. No. 1881, 87th Cong., 2d Sess. 282, 283.
- ⁵⁸ IRC Sec. 1245(b).
- ⁵⁹ IRC Sec. 1245(b)(3), (4), and (5).
- ⁶⁰ IRC Sec. 361(b)(1)(B).
- ⁶¹ IRC Sec. 1245(4)(B).
- ⁶² IRC Sec. 1245(b)(5).
- ⁶³ IRC Sec. 1245(a)(2).
- ⁶⁴ IRC Sec. 1245(b)(6)(A).
- ⁶⁵ S. Rep. No. 1881, 87th Cong., 2d Sess. 284.
- ⁶⁶ IRC Sec. 1245(b)(6)(B)(i).
- ⁶⁷ S. Rep. No. 1881, 87th Cong., 2d Sess. 99.
- ⁶⁸ IRC Sec. 1014(a).
- ⁶⁹ IRC Sec. 1015(d).
- ⁷⁰ IRC Sec. 1245(a)(1).
- ⁷¹ Ibid.
- ⁷² IRC Sec. 453(d)(4)(A) and (B).
- ⁷³ Ibid.
- ⁷⁴ IRC Sec. 751(c).
- ⁷⁵ IRC Sec. 736.
- ⁷⁶ IRC Sec. 741.
- ⁷⁷ IRC Secs. 731 and 751(b).
- ⁷⁸ Deleted.
- ⁷⁹ Reg. Sec. 1.751-1(g) Example (3)(e)(1) and Example (4)(e)(1).
- ⁸⁰ IRC Sec. 1245(c).
- ⁸¹ S. Rep. No. 1881, 87th Cong., 2d Sess. 285.
- ⁸² IRC Sec. 1245(b)(6)(B)(ii).
- ⁸³ Reg. Sec. 1.751-1(g) Example (3)(d)(2).
- ⁸⁴ IRC Sec. 170(e).
- ⁸⁵ IRC Sec. 613(a).
- ⁸⁶ IRC Sec. 1245(d).
- ⁸⁷ S. Rep. No. 1881, 87th Cong., 2d Sess. 285.
- ⁸⁸ IRC Sec. 167(f).
- ⁸⁹ IRC Sec. 167(e)(2).
- ⁹⁰ Rev. Proc. 62-21, 1962-2 Cum. Bul. 418.
- ⁹¹ Reg. Sec. 1.167(e)-1(a) and (b).
- ⁹² 1962-1 Cum. Bul. 29.
- ⁹³ 259 F.2d 371.
- ⁹⁴ IRC Sec. 453(d)(4)(B).
- ⁹⁵ Rev. Rul. 58-402, 1958-2 Cum. Bul. 15.