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Internal Revenue Code Section 1250, in a limited way, does for building, and leaseholds of buildings, what Section 1245 I.R.C. did for personal property. The basic rules are:

a. There is no recapture at all on buildings held for at least 10 years.

b. There is no recapture at all on buildings held for more than 1 year—if you have used straight-line depreciation.

c. Property sold within the first year—all post 1963 depreciation—would be recaptured and treated as ordinary income.

d. Disposition after one year is taxed as follows—ordinary income on profit covered by difference between accelerated method and straight-line method for period between 13th and 20th months. After 20th month the amount taxed as ordinary income is the same, as discussed in the 13th to 20th months, except that the excess depreciation is reduced by 1% per month. After 10 years the figure is zero, and so no recapture.

Bear in mind that in the case of property held more than one year, the only depreciation subject to recapture is the excess of accelerated depreciation over straight-line depreciation claimed for any period after December 31, 1963. In other words, the excess of the amount of depreciation determined under the 200 per cent declining-balance method, or the sum-of-the-years-digits method over the amount of depreciation that would have been allowable under a straight-line method is potentially subject to recapture.

The following example will show the operation of the above rules:

Assume building constructed January 1, 1962 at cost of $1,000,000.00, exclusive of land. Rate used—40 years double declining-balance method. Building was sold January 1, 1966 for $1,200,000.00.

Depreciation taken 1/1/62–1/1/64	$97,500.00	
Depreciation taken 1/1/64–1/1/66	87,963.97	
Straight-line depreciation 1/1/64–1/1/66	50,000.00	
Excess depreciation after 1/1/64		37,963.97

Building was held 48 months. This is 28 months more than the 20 month period discussed, so excess depreciation is reduced by 28% (1% per month over 20 months). The balance 100% less 28% or 72% is taxed as ordinary income. The total profit on the sale is as follows:

Sale price	$1,200,000.00
Basis ($1,000,000.00 less depreciation of $185,463.97)	814,536.03
Profit	$ 385,463.97

The problem is to determine how much of this profit is subject to ordinary income and how much capital gain:

Ordinary Profit (72% of excess depreciation of $37,963.97)	$ 27,334.05
Balance—Taxed as capital gains	$358,129.92

Recapture applies not only to taxable sales and exchanges, but also to any other disposition with certain exceptions. For example, there is recapture if a corporation distributes a building in kind to its stockholders as an ordinary or liquidating dividend (Sec. 337), on a sale during the one month liquidation period under Section 333, and on a liquidation of a newly acquired subsidiary corporation under Section 334(b) (2). Some exceptions are: no recapture on a tax free swap or involuntary conversion except as to "boot" received or proceeds not reinvested. The untaxed potential continues in new property.

Unlike the Revenue Act of 1962, the new Revenue Act does not grant any new election to change to a more conservative method of depreciation applicable to Section 1250 property. This means that in the case of a building or other Section 1250 property a taxpayer cannot, with two exceptions, change from one of the accelerated methods of depreciation to the straight-line method *without first obtaining the Commissioner's consent.* He may change from the 200% declining-balance method to the straight-line method by the right given him under Section 167(e) (1). Further, a taxpayer has an automatic right to change from the 150% declining-balance method to the straight-line method with respect to new property acquired in 1954 and later years, but not with respect to new property acquired prior to 1954 or used property acquired at any time.

In the case of major improvements the "recapture formula" is computed separately from the building. For example, assume a gain of $100,000 on a building held for 72 full months, with major improvements over the 36-month period preceding sale of $75,000. The depreciation taken in excess of straight-line amounts to $60,000 for the building and $20,000 for improvements.

Since the gain is more than the excess depreciation, the amount recaptured or taxable as ordinary income would be—(a) 48 per cent [100 less (72-20%)] of $60,000 or $28,800 plus (b) 84 per cent [100 less (36-20%)] of $20,000 or $16,800, making a total of $45,600 taxable as ordinary income, with the balance of $54,-400 taxable at capital gains rates.

The recapture formula is applied to major improvements separately, provided they are substantial and were made over a 36-month period. Improvements in any tax year that cost $2,000 or less or not more than 1 per cent of the original cost are completely disregarded. The improvements are substantial if the cost exceeds whichever is the greater of the following: (a) $5,000, (b) 25 per cent of the adjusted basis at the beginning of the 36-month period, or (c) 10 per cent of the unadjusted basis.

Now that you have read the preceding, let me enlighten you by some clear (?) and concise language (?) as used in the Code:

"EXCEPTIONS AND LIMITATIONS—

Certain Tax-free Transactions.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of Section 332, 351, 361, 371(a), 374(a), 721 or 731, then the amount of gain taken into account by the transferor under subsection (a) (1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in Section 521) which is exempt from the tax imposed by this chapter."

Internal Control of Cash

(continued from page 6)

In restaurants, prenumbered tickets written by the waitress provide control over the cashier. For more complete control, however, a third person should perform all of the three following steps:

1. Total the tickets collected by the cashier.
2. Account for all the prenumbered tickets issued since the previous day.
3. Inspect the tickets for alteration.[12]

A movie theatre can use prenumbered tickets which are accounted for. The ticket taker tears the stub in half for control. There must be collusion between the ticket taker and cashier to palm tickets and return them for resale.[13]

A common device used to control cash sales is a cash register which has locked-in totals (cannot be cleared by anyone without a key). The visible total showing at the top of the machine and the printed receipt allows the customer to help with this control. It is important to use the machine correctly by segregating duties. Not knowing how much he should have, the sales clerk counts the cash drawer at the end of the day and turns the cash and records over to the office or cashier. "Someone who has no contact with the cash 'reads' the cash register by inserting a key which is necessary to print the cumulative or daily total."[14] The machine is then cleared, the tape removed and compared to the clerk's cash record. A running record should be kept of shortages or overages to see that there is no "borrowing" of funds.[15]

When a cash register is not financially feasible, another mechanical device is a machine which holds and automatically feeds a three copy prenumbered form into an open writing space. The information, which may include the customer's signature, is completed on the form. By a turn of a crank, two copies are released—one for the clerk and one for the customer. The third copy goes into a locked compartment, opened only by key.

Internal control can exist regardless of the size of the firm. In a small office, the owner can provide internal control by using as many of the above controls as possible, through his intimate knowledge of his business, and by observation of the procedures being used. The gamut can be run to the large firm which uses an independent internal control department which reviews the actual use of the above internal control principles and also uses independent auditing procedures.

Footnotes

[1&2]R. K. Mautz and R. Schlosser, "Internal Control Techniques," *Journal of Accountancy*, October 1957, p. 45-47.

[3]W. B. Jencks, *Auditing Principles*, p. 113.

[4]C. A. Stewart, "Nature and Prevention of Fraud," *Journal of Accountancy*, February 1957, p. 42.

[5]*Ibid.*, p. 43.

[6]Cutley and Bauer, *Auditing*, p. 84.

[7]Howard F. Stettler, *Auditing Principles*, p. 192.

[8]*Ibid.*

[9]*Ibid.*

[10]Jencks, *op. cit.*, p. 118.

[11]*Ibid.*, p. 115.

[12]Stettler, *op. cit.*, p. 193-4.

[13]*Ibid.*

[14]*Ibid.*

[15]*Ibid.*, p. 192.

(See page 10 for Bibliography)