[Florida Law Review](https://scholarship.law.ufl.edu/flr)

Volume 16 | Issue 1 Article 4

June 1963

Depreciable Property: Tax Policy and Economic Effects

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The question which might now validly be raised is whether our examination has been merely a chronicle of a brief era in our judicial history. But hopefully that examination has fulfilled a didactic purpose and will have a salutary effect. Hopefully our review has furnished us with a renewed sensitivity to the problems confronting our lawyers and trial judges when faced with motions for new trial, and our appellate courts when reviewing the trial judge's dispositions made thereon.

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DEPRECIABLE PROPERTY: TAX POLICY AND ECONOMIC EFFECTS

The substantial revision of the treatment of property used in a trade or business that is embodied in the Revenue Act of 1962 represents the culmination of a gradual liberalization of this treatment over the years. The purpose of this note is to examine the Congressional and administrative manifestations of this liberalization in light of a policy of maximum stimulation of economic growth.

TAX TREATMENT OF DEPRECIABLE PROPERTY PRIOR TO THE REVENUE ACT OF 1962

Treatment of the Sale of Depreciable Property

Because of the exigencies of wartime, and a desire to accelerate the replacement of aging machinery and equipment by industry, Congress, in the Revenue Act of 1942,[1] added section 117(j) to the Internal Revenue Code of 1939.[2] Before the adoption of this provision, gain or loss from the sale of property used in a trade or business was treated as

1. 56 Stat. 798 (1942).
2. 56 Stat. 846 (1942) (now INT. REV. CODE OF 1954, §1231).

ordinary gain or loss, and either taxed as, or deducted from, ordinary income. To an appreciable extent, this treatment inhibited the disposition of depreciable property at a gain and in many cases created undue hardship.[3] Although the section applies also to involuntary conversions of property used in a trade or business,[4] for our purposes we are concerned only with sales or exchanges of such property. Section 117(j), and its successor, section 1231, treated gains from the aggregate of transactions affecting property used in a trade or business and held for a period of more than six months, as capital gains, and losses from the aggregate of such transactions as ordinary losses. Thus, any net gain from the sale of depreciable property was taxed at a maximum rate of twenty-five per cent, whereas any net loss was deductible in full from ordinary income, the tax on which could be at rates as high as fifty-two per cent in the case of a corporation.

Consequently, by enacting section 117(j), Congress provided substantial incentive to the rapid disposition of equipment and machinery and frequent modernization of industrial facilities. Moreover, in a period during which it was almost universally felt that the statutory and administrative allowances for depreciation were inadequate, the treatment of gains from the sale or exchange of depreciable property as capital gains provided a type of rough justice in the area of capital recovery.[5]

Depreciation Reform Under the 1954 Code

In spite of any incentive provided by section 117(j), the country experienced a mild recession in 1953 and 1954, which, in the minds of many people, including the administration and Congress, was attributable to a reluctance on the part of the business and industrial community to dispose of their existing machinery and equipment and modernize their facilities.[6] It was believed that tax-free recovery of equipment costs was of critical importance in the decision of management to incur risks. The depreciation allowances before 1954 under the Code,[7] especially in light of the interpretations placed on them by the commissioner,[8] made the recovery of such costs grossly inadequate. Under the

3. H.R. REP. No. 2333, 77th Cong., 2d Sess. 53-54 (1942). The hardship was especially marked in situations in which equipment that had been held for a long period was disposed of at a gain. To treat such gains as ordinary income did violence to the theory of special tax treatment of capital gains.

4. Int. Rev. Code of 1939, §117(j), 56 Stat. 846.

5. *Hearings on H.R. 10650 Before the Senate Committee on Finance,* 87th Cong., 2d Sess. 687 (1962).

6. See 100 CONG. REC. 570 (1954).

7. Int. Rev. Code of 1939, ch. 1, §23 (*l*), 53 Stat. 14.

8. Treas. Reg. 118, §39.23(*l*) (1953).

regulations, the taxpayer was generally allowed to compute his depreciation allowance only by the straight-line method, which produces a gradual rather than accelerated recovery of costs. In the exceptional situations in which permission was granted by the commissioner to use the declining-balance method, the taxpayer was limited to a maximum rate of one hundred fifty per cent of that allowable under the straight-line method. There was considerable evidence that the existing policies on depreciation acted as a barrier to investment in fixed assets, and that the slow rate of write-off permitted under the 1939 Code tended to discourage modern replacement practices.[9] Although there was some dissent to "arguments that accelerated depreciation would encourage investment, promote growth, meet the problem of inflation, or accomplish some other presumably worthy social purpose,"[10] there was virtual unanimity among those appearing before Congress that considerable liberalization was necessary to maintain adequate economic growth.[11] On the basis of such testimony Congress enacted section 167.[12] In this provision, the allowance of the straight-line method, which had previously been permitted by the regulations, was codified[13] and the use of three other methods that were designed to result in much more accelerated depreciation allowances was specifically authorized.[14] Moreover, section 167 was clearly designed to encourage the replacement of old property by acquisition or construction of new assets, because the new and more liberal methods were applicable only to that portion of the basis of property with a useful life of three years or more, that was attributable to acquisition, construction, reconstruction, or erection after December 31, 1953.[15] The statutory introduction of these new methods resulted in a more realistic depreciation policy, allowing a more rapid deduction in the early years of the useful life of the property. Moreover, since the provisions applied only to new property, the intended effect was that of a stimulant on the acquisition and modernization of capital equipment. Another result contemplated by Congress in the passage of the act[16] was a reduction of disputes with the commissioner and a greater flexibility concerning useful life and depreciation rates, two subjects provoking frequent litigation.[17] The enactment of section 167 was

9. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 22 (1954).

10. Papers Submitted by Panelists Appearing Before the Subcommittee on Tax Policy, 84th Cong., 1st Sess., Joint Committee on the Economic Report 403 (Comm. Print 1955).

11. *Id.* at 495.

12. Int. Rev. Code of 1954, §167.

13. Treas. Reg. 118, §39.23(*l*) (1953).

14. Int. Rev. Code of 1954, §167(b)(2)-(4).

15. Int. Rev. Code of 1954, §167(c)(1)-(2).

16. Int. Rev. Code of 1954, §167(d).

17. *E.g.*, Pohlen v. Commissioner, 165 F.2d 258 (5th Cir. 1948); Commissioner

a statutory recognition of depreciation policies that were considerably more realistic in light of actual business practices. However, because the underlying concepts of "salvage value" and "useful life"[18] remained substantially unchanged by the 1954 Code, there was still much to be desired from the standpoint of maximum economic growth.

First-Year Depreciation Bonus

In 1958, testimony before Congress indicated that even as liberalized by the 1954 provision[19] and its accompanying regulations,[20] the depreciation allowances were still not adequate, especially from the standpoint of small business, to produce sufficient reserves for expansion and modernization.[21] Consequently, a bill was introduced that would further increase the initial write-off of depreciable property, thus encouraging capital investment.[22]

Section 179 provides, with respect to specified types of property, that the taxpayer has an election to deduct an amount equal to twenty per cent of the cost of such property in the first taxable year in which it is subject to a depreciation deduction.[23] Although not expressly limited to businesses of any particular size, the provision has a greater impact upon small business because of the limitation that it applies only to property costing not more than $10,000, or $20,000 in the case of a joint return.[24] To be affected by this provision, the property must be tangible personal property, depreciable under section 167, acquired by purchase after December 31, 1957, and have a useful life of at least six years.[25] The additional first-year allowance is determined without reference to salvage value, although the basis of the property is reduced by the amount of the allowance for purposes of computing future depreciation deductions, including those for the first year.[26]

Notwithstanding these liberalizations, which were effected expressly to stimulate capital investment and economic growth by means of more

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v. Philadelphia Coke Co., 130 F.2d 87 (3d Cir. 1942), *cert. denied* 317 U.S. 685 (1942).

18. Salvage value and useful life are concepts which must enter into the actual computation of any depreciation deduction.

19. INT. REV. CODE OF 1954, §167.

20. Treas. Reg. §1.167 (1956).

21. H.R. REP. No. 2198, 85th Cong., 2d Sess. 5 (1958).

22. INT. REV. CODE OF 1954, §179.

23. INT. REV. CODE OF 1954, §179(a). A recent ruling has indicated that the deduction might not be allowed for the year of acquisition if the property is purchased late in that year. See Rev. Rul. 63-30, 1963-10 I.R.B. 6.

24. INT. REV. CODE OF 1954, §179(b).

25. INT. REV. CODE OF 1954, §179(d).

26. H.R. REP. No. 2198, 85th Cong., 2d Sess. 13-14 (1958).

realistic depreciation allowances, as late as 1960 there remained serious impediments to that goal in the form of inflation and technological obsolescence. Although section 167 expressly provides that reasonable allowances for obsolescence be included in the deduction of depreciation,[27] the Treasury's concept of useful life was not sufficiently realistic in light of business replacement practices to make the provision effective.[28] Although the useful lives announced in Bulletin "F" were not conclusive, it was heavily relied upon by revenue agents in their determination whether to disallow depreciation deductions.[29] This fact was emphasized in testimony before the Senate Committee on Small Business:[30]

> [W]hereas machine tools today under Treasury tax depreciation policy are being written off on the average in about 15 to 20 years, it is perfectly evident simply in terms of technological obsolescence that the writeoff of machine tools should be from 6 to 10 years, and that from now on we will not have very much modern, first-line productive equipment in this country that is more than 6 years old.

With the possible exception of the amortization of emergency facilities, available only in specified circumstances under section 168,[31] there had been virtually no provision which permitted recovery of losses occasioned by technological obsolescence of the magnitude faced by modern business.

The problems resulting from inflation had been neglected to an even greater extent. This is possibly attributable to the fact that the effects of such problems are less capable of precise measurement and prediction than those resulting from obsolescence. Nevertheless, it is generally recognized that inflation is largely responsible for a distortion in income which results in under-depreciation, in a real sense, of property used in a trade or business.[32] The primary reason is that the formula for comput-

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27. INT. REV. CODE OF 1954, §167(a).

28. U.S. TREASURY DEP'T, INCOME TAX DEPRECIATION AND OBSOLESCENCE, ESTIMATED USEFUL LIVES AND DEPRECIATION RATES (Bulletin "F") (1948). Bulletin "F" was the announced position of the Treasury on the average guidelines to be employed in determining useful life.

29. See *Panel Discussion on Income Tax Revision Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 445 (1959).

30. *Hearings on Tax Depreciation Allowances on Capital Equipment Before the Senate Committee on Small Business*, 86th Cong., 1st Sess. 1, 25 (1959).

31. INT. REV. CODE OF 1954, §168. Generally, §168 permits the tax amortization of emergency facilities over a sixty-month period, without regard to ordinary concepts of "useful life." See also Stephens, *Tax Amortization Is the Key to the Stable Door*, 5 U. FLA. L. REV. 261 (1952).

ing depreciation deductions under section 167 is based on historical cost. In an inflationary situation, the real value of the dollars with which the property was initially purchased is higher than the real value of the current dollars deducted as depreciation allowances.[33] This often results in a considerable loss in real income. (The amount of such loss increases as the useful life, determined by the Treasury, increases.) At least one source has estimated that an approximate annual capital consumption of $6 billion is caused by under-depreciation in this form.[34] In 1959, the Senate Committee on Small Business conducted extensive hearings on the question of tax depreciation allowances on capital equipment.[35] Appearing before it were businessmen, economists, and tax attorneys, from whom considerable testimony was elicited concerning the effect of technological obsolescence and inflation on the economy in light of existing depreciation policies. On the basis of these hearings, the committee made the following recommendations:[36]

> Current depreciation policies should be reviewed and all of the practical proposals for (a) shortening the period for depreciating property, (b) permitting greater depreciation in the years immediately after the purchase of the property, and (c) depreciating on a basis other than cost, to reflect the inflation factor, should be considered.

Soon after the release of this report the Kennedy Administration commenced performance of its promise to "get the country moving again."

Developments Under the Revenue Act of 1962[37]

Beginning with the President's 1961 message to Congress on the federal tax system,[38] the administration and Congress have seriously considered the question of major revision and reform of the federal income tax. Much of this activity has been directed toward the revision of the treatment of depreciable property used in a trade or business.[39]

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32. See *Panel Discussion Before the Committee on Ways and Means, supra* note 29, at 419.

33. See S. Rep. No. 1017, 86th Cong., 2d Sess. 5 (1960). It should be noted that, like most economic theories, this view is not universally entertained and has been questioned by some authorities. In this connection, see Papers Submitted by Panelists Appearing Before the Subcommittee on Tax Policy, *supra* note 10.

34. *Hearings Before Senate Committee on Small Business, supra* note 30, at 56.

35. *Hearings Before Senate Committee on Small Business, supra* note 30.

36. S. Rep. No. 1017, 86th Cong., 2d Sess. 11 (1960).

37. 76 Stat. 960.

38. 107 Cong. Rec. 6377 (1961).

39. *Id.* at 6377, 6380.

The Investment Credit

Perhaps the most widely heralded statutory change was the so-called investment credit provision, recommended by the President in his message to Congress on April 20, 1961.[40] This plan as finally adopted is embodied in section 38 of the Code.[41] The provision permits a credit against tax liability of seven per cent of the taxpayer's qualified investment in tangible personal property, or other tangible property (not including buildings and their structural components) used as part of manufacturing, production, extraction, or furnishing transportation and communications (for example, oil or gas pipelines), or constituting a research or storage facility in one of the above activities.[42] The credit is qualified according to the useful life of the property,[43] and is not available for investments in property having a useful life of less than four years.[44] With minor differences in application, the credit is available for investments in either new or used property acquired by the taxpayer after December 31, 1961, although in the case of used property, the amount constituting a qualified investment cannot exceed $50,000. The credit is allowed against the first $25,000 of tax liability in any one taxable year, plus one-fourth of the tax liability in excess of $25,000. However, a carry-back and carry-over provision prevents the loss of unused credit.[45] Although the credit does not reduce the basis of the property for purposes of computing the twenty per cent bonus allowed in the year of acquisition by section 179, it does reduce the basis for the purpose of computing further depreciation deductions.[46]

Testifying before the Senate Finance Committee, Secretary of the Treasury Dillon discussed the existing situation in regard to the acquisition of depreciable property:[47]

> Machinery and equipment expenditures—the type of business capital expenditure which is basic to the creation of new products and which also makes the most direct contribution to cost-

40. *Id.* at 6377-78.

41. INT. REV. CODE OF 1954, §38.

42. INT. REV. CODE OF 1954, §48(a)(1).

43. INT. REV. CODE OF 1954, §46(c)(2). For property having a useful life of eight years or more, the taxpayer is allowed a credit of seven per cent of the full investment; if the useful life is at least six but less than eight years, the credit of seven per cent is applied to only two-thirds of the investment; and with a useful life of at least four but less than six years, the credit is applied only to one-third of the investment.

44. INT. REV. CODE OF 1954, §46(c)(2).

45. INT. REV. CODE OF 1954, §46(b).

46. INT. REV. CODE OF 1954, §48(g)(1).

47. *Hearings on H.R. 10650 Before the Senate Committee on Finance,* 87th Cong., 2d Sess. 79, 80 (1962).

> cutting, productivity, and efficiency—constitute a smaller percentage of gross national product in the United States than in any major industrial nation in the world.

The extent to which the investment credit would, by itself, alter this situation is questionable when the various costs incident to its use, such as reductions in the event of early disposition, inability to use the full credit, additional bookkeeping, and legal and accounting fees, are considered.[48] Moreover, the introduction of the credit was generally regarded by business representatives and some Congressmen as a "gimmick" or loophole to be closed by a future Congress,[49] and as a subsidy which was an inadequate substitute for a realistic depreciation policy designed to accomplish the same goals.

Furthermore, the investment credit, clearly an incentive approach to increasing economic growth, is subject to the objection that it is a prospective victim of legislative whim and political caprice, whereas realistic depreciation would involve no subsidy for incentive purposes, and thus, theoretically at least, would possess more stability.[50]

Nevertheless, the investment credit provision was apparently designed to complement a thorough administrative revision of the tax treatment of depreciable property, and as such, its influence should be more strongly felt.[51]

The New Depreciation Guidelines

The revision of the treatment of depreciable property that will probably have the most far-reaching effect on business replacement practices and the economy is embodied in the new "Guidelines and Administrative Procedures" promulgated by the Treasury on July 23, 1962.[52] This is the first comprehensive revision of the useful life concept since 1942. The new guidelines, which replace the long outdated Bulletin "F,"[53] represent an attempt by the Treasury to modernize its position on depreciation allowances, making it reasonably consistent with current replacement practices.

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48. See Rosbe, *The Investment Credit,* 40 TAXES 1067, 1073 (1962).

49. See H.R. REP. No. 1447, 87th Cong., 2d Sess. B5 (1962).

50. See PAPERS SUBMITTED BY PANELISTS APPEARING BEFORE THE SUBCOMMITTEE ON TAX POLICY, 84TH CONG., 1ST SESS., JOINT COMMITTEE ON THE ECONOMIC REPORT 542 (Comm. Print 1955).

51. H.R. REP. No. 1447, *supra* note 49, at 8; *Hearings on H.R. 10650 Before the Senate Committee on Finance,* 87th Cong., 2d Sess. 83 (1962).

52. Rev. Proc. 62-21, 1962-30 CUM. BULL. 6.

53. U.S. TREASURY DEP'T, INCOME TAX DEPRECIATION AND OBSOLESCENCE, ESTIMATED USEFUL LIVES AND DEPRECIATION RATES (Bulletin "F") (1948).

The methods used to effect this goal are threefold. First, the average useful lives set out in the guidelines are from thirty to forty per cent shorter than those in Bulletin "F."[54] This will enable the taxpayer to recover his costs at a much faster rate in the initial years of an asset's life, when the actual decline in value is greatest. Furthermore, this provision will mitigate considerably the adverse effects of technological obsolescence. Second, the new guideline lives are less complex and easier to utilize, thereby reducing bookkeeping costs and controversies as to interpretation between the taxpayer and the commissioner. Instead of the approach utilized in Bulletin "F," of determining useful lives on an item-by-item basis, the new guidelines adopt seventy-five broad, industry-wide classifications,[55] by which the average useful lives being employed in such an industry may be determined. Third, the new guidelines will be easier to administer, and will thus help avoid frequent disputes with the taxpayer. This is achieved by an objective method of determining whether the deductions taken by the taxpayer are consistent with his actual replacement policies.[56] The guideline lives represent *average* replacement practices within the industry. If the replacement practices of an individual taxpayer involve shorter useful lives than those represented by the guidelines, he may continue to deduct for depreciation on the basis of his own experience. However, after the first three years under the system,[57] he must be prepared to substantiate his deductions by use of the "reserve ratio" test, whereby, through arithmetical computations of various factors regarding the relationship between replacement practices and depreciation reserves, the determination whether his deductions are appropriate will be relatively objective.

Whether the revisions in the treatment of depreciable property comprising the investment credit and depreciation guidelines will provide adequate answers to the problems of economic growth remains to be seen. Nevertheless, the Treasury estimates that the combined impact of these innovations will have a definite stimulative effect on the economy.[58]

New Treatment of the Sale of Depreciable Property

In his Budget Message of April 20, 1961, President Kennedy proposed that Congress revise the effect of section 1231,[59] which treats gains

54. See *Hearings on H.R. 10650 Before the Senate Committee on Finance, supra* note 47, at 81.

55. For example, "Aerospace Industry," "Apparel and Fabricated Textile Products," "Cement Manufacture."

56. Rev. Proc. 62-21, *supra* note 52, at 19.

57. *Id.* at 27.

58. See H.R. REPORT No. 1447, 87th Cong., 2d Sess. 4 (1962).

59. INT. REV. CODE OF 1954, §1231. The application of this section was dis-

from the sale of certain depreciable property as capital gains:[60]

> Our capital gains concept should not encompass this kind of income. This inequity should be eliminated, and especially so in view of the proposed investment credit. We should not encourage through tax incentives the further acquisition of such property as long as this loophole remains.

The inequity to which the President referred arose from the fact that under section 1231 at that time, the taxpayer was able to write off the cost of an asset against income otherwise taxable at ordinary rates, and then, if the asset were sold at a gain, such gain would be taxed at capital gains rates. Whether this result was in fact so inequitable has provoked considerable debate.[61]

In any event, the belief that such treatment was inequitable, coupled with the fact that the release of the new depreciation guidelines was at least partially contingent upon a change in this area of the law, prompted Congress to enact section 1245.[62] Generally, the effect of this section is that gains on the sale of certain depreciable property are taxed as ordinary income, rather than capital gains, to the extent of depreciation deductions taken after 1961.[63] The provision is applicable primarily to personal property that is depreciable under section 167.[64] It is significant that the provision does not apply to buildings or their structural components, even though the President and Secretary Dillon specifically recommended that it apply to improved real estate.[65] This omission was probably attributable to the combined factors that such property was not included in the investment credit,[66] and certain economic aspects to be discussed below.

Technically, the tax at ordinary income rates is applied to the lesser of the following amounts:

> (1) the amount by which the recomputed basis (determined by adding to adjusted basis all post-1961 depreciation or amortization deductions), exceeds the adjusted basis,[67] or,

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cussed in the first part of this note during the consideration of its predecessor, §117(j) of the Int. Rev. Code of 1939, 56 Stat. 846.

60. 107 Cong. Rec. 6380 (1961).

61. See Bryson, *Capital Gain on Sale of Depreciable Assets is Fully Justified: No Give-Away*, 10 J. Taxation 71 (1959).

62. Int. Rev. Code of 1954, §1245.

63. Int. Rev. Code of 1954, §1245(a)(1).

64. Int. Rev. Code of 1954, §167.

65. *Hearings on H.R. 10650 Before the Senate Committee on Finance, supra* note 47, at 88.

66. Int. Rev. Code of 1954, §48(a)(1).

67. Int. Rev. Code of 1954, §1245(a)(1)(A).

(2) the difference by which the amount realized (or in the case of a disposition other than a sale, exchange, or involuntary conversion, the fair market value) exceeds the adjusted basis of the property.[68]

Since amounts equal to prior depreciation deductions are now taxed at ordinary income rates, the effect of this provision is the virtual emasculation of the benefits previously received under section 1231, although any gain in excess of the amounts deducted as depreciation allowances since 1961 is still subject to capital gains treatment under section 1231.[69] Furthermore, by the enactment of this provision, Congress has to some extent reduced the utility of the depreciation allowance as a means of effecting increased modernization and capital goods replacement because of the natural tendency of a businessman, knowing he will later be taxed on the amount of his deductions at ordinary income rates, to be overly conservative in his determination of those deductions.

To complement section 1245, Congress also passed two amendments to section 167, that will partially alleviate the possible harsh effects upon the sale of depreciable property. The first of these allows the taxpayer, for the first taxable year after December 31, 1962, to change his method of depreciation from one of the more accelerated methods to the straight-line method.[70] This will permit the taxpayer to mitigate the eventual impact of section 1245 when the property is disposed of at a gain. However, this raises the question whether the effect of this amendment is to discourage the utilization of the liberalized depreciation deductions. Seemingly, Congress did not consider this a determining factor.

Secondly, the taxpayer is permitted to reduce the salvage value, which is used in determining the depreciation allowance, by ten per cent of the original cost or other basis of the property. This provision applies to personal property with a useful life of three years or more.[71] It is seemingly intended to increase the amounts which may be deducted in the early years of the life of the asset, and reduce the number of disputes over salvage value between the taxpayer and the revenue agents.

Conclusion

Since 1942 the executive and legislative branches of the federal government have been engaged in a process of increased liberalization of the treatment of property used in a trade or business, with the policy reaching its culmination in the broad reforms of the Revenue Act of

68. Int. Rev. Code of 1954, §1245(a)(1)(B).
69. Int. Rev. Code of 1954, §1231(a).
70. Int. Rev. Code of 1954, §167(e).
71. Int. Rev. Code of 1954, §167(f).

1962.[72] The primary goal of this policy has been to induce the business community to utilize modern replacement practices and expansion in order to maintain a fairly rapid rate of economic growth. Considered in the abstract, section 1245 is inconsistent with that policy. Clearly, in the instances that section 1245 was designed to remedy[73]—when the useful life being employed by the taxpayer was unjustifiably short, or the particular method of depreciation being utilized yielded excessive deductions in the early years—the taxation as capital gains of the net gains from disposition of the property under section 1231 was inequitable. The question remains whether the device used by Congress to remedy this inequity sacrifices too much in terms of promoting economic growth. Arguably, the appropriate remedy for such a situation is more effective administrative regulation, such as that provided by the reserve ratio test of the new guidelines, rather than such a far-reaching revision as that embodied in section 1245. Apparently, however, the somewhat harsh effects of section 1245 are the price that had to be paid for the investment credit and the new liberalized administrative treatment of depreciable property.

The new depreciation guidelines[74] will probably be an effective remedy for the problem of technological obsolescence and its effect upon capital recovery. However, the equally important problem of inflation has not been adequately solved by the current treatment of depreciable property. We are still operating under a system which is fundamentally based on considerations of historical cost; therefore, to say that amounts which would have been given capital gains treatment under section 1231 really represent ordinary income is not completely true, because part of these amounts represents an increase in the value of the property due to the inflated value of the current dollar. This is essentially why, in spite of the recommendations of the administration, Congress failed to include real estate in the application of section 1245.[75] If the President and Secretary Dillon are successful with Congress in their continued efforts to have real estate included,[76] the harmful effects on capital recovery will be intensified considerably because the gain incident to a sale of such property is primarily attributable to the increased value of the remaining property, not that represented by

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72. 76 Stat. 960 (1962).

73. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 67 (1962).

74. Rev. Proc. 62-21, 1962-30 Cum. Bull. 6.

75. H.R. Rep. No. 1447, *supra* note 73.

76. Both President Kennedy and Secretary Dillon have urged Congress to extend the application of §1245 to depreciable real estate as part of the income tax reforms proposed for the Revenue Act of 1963. See *Hearings on the President's 1963 Tax Message Before the House Committee on Ways and Means*, 88th Cong., 1st Sess. pt. 1 (rev.) 25, 57 (Comm. Print 1963).