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Taxation—Recapture of Income—Depreciating an Asset in the Year of Sale.— Fribourg Nav. Co. v. Commissioner.

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cases. The act would not violate the first amendment, just as section 9(h) did not, because it would not prevent or criminally punish affiliation with any organization, or the holding of any belief.[50]

BARRY E. ROSENTHAL

Taxation—Recapture of Income—Depreciating an Asset in the Year of Sale.—*Fribourg Nav. Co. v. Commissioner*.[1]—The taxpayer purchased a cargo ship in December, 1955, for $469,000. He had previously secured a letter-ruling from the Internal Revenue Service advising that a straight-line method of depreciation over a useful life of three years with a salvage value of $54,000 would be acceptable. This estimate was reasonable at the date of purchase, but the Suez crisis of 1956-57 caused a scarcity of ships, which, in turn, greatly inflated their market value. As a result, the taxpayer was able to sell his ship for $695,000 in December, 1957. The taxpayer, according to his depreciation schedule, took his depreciation allowance for that portion of the tax year 1957 during which he held the ship, and reported a capital gain of about $500,000. The Commissioner did not attempt to readjust the depreciation allowances taken in 1955 and 1956,[2] but he did disallow the entire depreciation deduction taken in 1957. He declared that a taxpayer cannot depreciate an asset in the year in which it is sold at a gain. The Tax Court[3] upheld the Commissioner's position. On appeal, HELD: the Internal Revenue Code of 1954, Section 167(a),[4] provides for a "reasonable allowance" for depreciation and it would be unreasonable to allow what would be a fictional deduction when the asset has not cost the taxpayer anything during the tax year, but rather has appreciated in value.

Depreciating an asset in the year of a favorable sale will usually result in the conversion of ordinary income into capital gains. The taxpayer's ordinary income is reduced by the amount of the depreciation deduction, and his capital gain is increased by a like amount. His saving will be the difference between the rate at which his ordinary income is taxed and the capital gains rate. In the instant case, the taxpayer's saving would be more substantial than in the usual case. He was proceeding under a plan of complete liquidation within the ambit of Section 337 of the Internal Revenue Code[5] which provides that gains derived from the sale of section 337 assets shall not be recognized. The taxpayer's ship is a section 337 asset and thus

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50 American Communications Ass'n v. Douds, supra note 11, at 402.

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1 335 F.2d 15 (2d Cir. 1964), cert. granted, 33 U.S.L. Week 3262 (U.S. Feb. 2, 1965) (No. 679).

2 Apparently, the Commissioner felt that he was precluded from going back to prior years because of the holding in Cohn v. United States, 259 F.2d 371 (6th Cir. 1958), which disallowed only the depreciation in the year of sale.

3 21 CCH Tax Ct. Mem. 1533 (1962).

4 Int. Rev. Code of 1954, § 167(a): "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."

5 Int. Rev. Code of 1954, § 337.

by depreciating it in the year of sale, the result would be the conversion of ordinary income into a non-taxable gain.

To recapture the tax losses resulting from the transmutation of ordinary income into a capital gain, or no gain at all, the Commissioner utilized two approaches. The first was to define salvage value and useful life more precisely, so as to limit the losses resulting from "padding" depreciation schedules.[6] The second was to disallow a depreciation deduction in the year a depreciable asset was sold at a gain.[7] The instant case and *United States v. Motorlease Corp.*,[8] decided on the same day by the second circuit, sanction the latter approach.

Two recent cases,[9] decided since the instant case, however, disapprove of the use of this latter approach, as a general means of recapturing income. After examining the legislative history,[10] which includes many rejected proposals to recapture these tax losses, both courts conclude that congressional inaction tacitly sanctioned the existing practice of depreciating an asset in the year of sale. With this in mind, these two courts narrowly interpret *Cohn v. United States*[11] according to its somewhat unusual factual situation. In that case the taxpayer properly estimated the useful life of his assets

[6] See Massey Motors, Inc. v. United States, 364 U.S. 92 (1960) and Hertz Corp. v. United States, 364 U.S. 122 (1960).

[7] The first case in which the Commissioner used this approach successfully was Wier Long Leaf Lumber Co., 9 T.C. 990 (1947), rev'd on other grounds, 173 F.2d 549 (5th Cir. 1949), acq., 1948-1 Cum. Bull. 3, (but see 1962-1 Cum. Bull. 5 in which the Commissioner withdrew his acquiescence). This case is interesting because the court disallowed the depreciation deduction in the year for one asset and allowed it for others. The rationale the court used in coming to opposite conclusions is not altogether clear. Because of this lack of clarity, the court in Cohn v. United States, infra note 11, which relied substantially on this case in reaching its conclusion, misinterpreted it. See Note, 37 Texas L. Rev. 787 (1959) for a discussion of this misinterpretation.

[8] 334 F.2d 617 (2d Cir. 1964). For a well-reasoned decision stating that the depreciation deduction should have been allowed in the year of sale, see the district court's opinion in Motorlease Corp. v. United States, 215 F. Supp. 356 (D. Conn. 1963). See 18 J. Taxation 330 (1963) for a discussion of the district court's holding.

[9] Macabe Co., 42 T.C. 1105 (1964). The taxpayer built a building and, expecting to use it for its entire economic life, depreciated it over a 33-year period. He unexpectedly sold the building after nine years, realizing a substantial gain. The court rejected the rule adopted in the principal case and held that the taxpayer could depreciate the asset in the year of sale, because the gains were derived solely from changes in the market, and the taxpayer's original estimates of useful life and salvage value were reasonable when made. United States v. S & A Co., 14 Am. Fed. Tax R.2d 5964 (8th Cir. 1964). In this case the taxpayer purchased all the assets of an outboard motor business intending to use them for their entire economic life. He unexpectedly sold the entire business while the assets were in mid-life, realizing a substantial gain because of market changes. The court examined the entire problem in detail and concluded that the holding of the principal case was erroneous and the reasoning of *Macabe* was sound. The court therefore held that the taxpayer could depreciate the assets in the year of sale.

[10] For an excellent summary of the earlier legislative history see Evans v. Commissioner, 264 F.2d 502 (9th Cir. 1959), rev'd 364 U.S. 92 (1960). For a complete list of citations to the legislative history see United States v. S & A Co., supra note 9, at 5968.

[11] 259 F.2d 371 (6th Cir. 1958). This case has become perhaps the most important decision in the area, primarily because it was the first important case disallowing depreciation in the year of sale. The court relied on Wier Long Leaf Lumber Co. v. Commissioner, supra note 7, and Treas. Reg. § 1.167(a)-1 in its decision. See 1962-1 Cum. Bull. 29 in which the Commissioner wrote the holding of the case as a general rule of law.

but did not make any estimate of salvage value. Near the end of the useful life of these assets the taxpayer sold them, realizing a profit, partly because of wartime shortages and price increases. The Commissioner disallowed the depreciation deduction in the year of sale and the court upheld the Commissioner. The *Macabe* and *S & A Co.* courts concluded that the *Cohn* case reaches the right result because the assets were not sold in mid-life, but rather near the end of their useful life. The result of the *Cohn* case can also be explained by the taxpayer's failure to compute any salvage value originally. In either instance it is reasonable to equate salvage value with sales price. In the former instance the disparity between sales price and salvage value near the end of useful life may indicate an improper computation from the beginning, while in the latter, the sales price is the most reasonable indication of salvage value. In any instance, according to the *Macabe* and *S & A Co.* rationale, the recomputation must be tempered by the realization of a distinction between gains derived from market appreciation and those derived from a basis lowered by excess depreciation.[12] By making this distinction these cases differ from the instant case. The *Macabe* and *S & A Co.* courts would apparently allow the Commissioner to readjust salvage value only when the gains derived from a sale are attributable to factors other than a change in market price. The second circuit, in the instant case, does not make this distinction. It would readjust salvage value in all instances in which the sales price exceeds the adjusted basis at the beginning of the year of sale, even if the gains could be attributed solely to the market.

One reason that it is not clear when the Commissioner can readjust salvage value is that the Regulations do not conclusively deal with the problem. In the instant case the court relies essentially on Regulation 1.167(b)-O(a) which provides,

> The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made.[13]

Regulation 1.167(a)-1 likewise indicates that when there is a redetermination of useful life and salvage value, "facts known at the time of such redetermination . . ."[14] shall be taken into consideration. It is also provided that a reasonable allowance for depreciation

> is that amount which should be set aside for the taxable year . . .

12 "The concepts of depreciation through the process of exhaustion, on the one hand, and of appreciation or depreciation because of market conditions, on the other hand, are mutually exclusive." Macabe Co., supra note 9, at 1109. "Depreciation and capital gain or loss are separate concepts in the income tax law although, of course, the one necessarily affects the other. The former in theory rests on a base independent of market fluctuations. The latter is aimed at those fluctuations. This dichotomy is inherent in the statute. It is defeated and ignored if depreciation is inevitably to be tied to sale price. The two concepts are easily confused for we tend to use the word 'depreciation' not only in the sense of consumption but, as well, in the sense of a downward market fluctuation." United States v. S & A Co., supra note 9, at 5975.

13 Treas. Reg. 1.167(b)-0(a) (1956).

14 Treas. Reg. 1.167(a)-1(c)(1) (1964).

> so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. . . .[15]

The *Macabe* and *S & A Co.* courts, however, point to other provisions of the Regulations to support their conclusion that salvage value cannot be adjusted to equal sales price whenever there is a favorable sale. They point to the provision which states:

> useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination.[16]

Also,

> Salvage value is the amount (determined at the time of acquisition) which is estimated . . . . [It] shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life . . . salvage value may be redetermined based upon facts known at the time of such redetermination of useful life.[17]

In further support of this position is the provision that:

> The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service.[18]

Moreover, the Regulations specifically recognize that there can be a gain or loss from the sale of depreciable property.[19]

The *Macabe* and *S & A Co.* cases thus emphasize that salvage value is an estimate which should not be adjusted "merely because of changes in price levels," and it is the amount "determined at the time of acquisition."[20] Applying this rule to the principal case, the courts would conclude that whereas the taxpayer reasonably estimated salvage value at the time of acquisition and the estimation was ultimately incorrect, only because of a change in price levels, the Commissioner cannot readjust the salvage value. The court in the instant case, however, does not regard these provisions as applicable to the year of sale. The court's position is that estimates need not be relied upon when the actual salvage value is known. The court implies that the Regulation prohibiting adjustment of salvage value because of mere price changes is only for administrative convenience, so that during the useful life of the asset every change in the market will not require constant recomputation of depreciation schedules. The court's rationale is

[15] Treas. Reg. 1.167(a)-1(a) (1964).

[16] Treas. Reg. 1.167(a)-1(b) (1964).

[17] Treas. Reg. 1.167(a)-1(c)(1) (1964).

[18] Treas. Reg. 1.167(a)-10(b) (1956).

[19] Treas. Reg. 1.167(a)-8(a)(1) (1956): "Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of section 1002, 1231 and other applicable provisions of law."

[20] Treas. Reg. 1.167(a)-1(c)(1) (1964).

that once there is a final sale, the problems of administrative red tape disappear, as the original estimation may be corrected by one adjustment. The court's argument in the instant case is thus based essentially on the provision which states that the ultimate determination of salvage value shall be based on conditions existing at the end of the tax year.[21] The court's argument in *Macabe* and *S & A Co.* is based essentially on the provision stating that an asset shall be depreciated until it is sold.[22] These provisions are contradictory and therefore the only proper conclusion is that which was made by the district court in the *Motorlease* case: "neither the Code nor the regulations are dispositive of the issue."[23] To attempt to justify the result of the instant case or that of the *Macabe* and *S & A Co.* cases in terms of the Regulations alone would thus be rationalizing a result which has not been accounted for within the framework of the existing Regulations.

Another reason that these three cases do not agree on when the Commissioner can readjust salvage value is the inconclusiveness of the prior cases. *Cohn v. United States*[24] did not discuss the problem in terms of whether there is a distinction between gains derived solely from market appreciation and gains derived from a basis lowered by excess depreciation. The cases between *Cohn* and the instant case were decided essentially in terms of whether the *Cohn* decision should be regarded as a general rule of law or should be applied only to similar factual situations.[25] In none of these cases was there a gain which was so clearly derived from a change in market conditions as in the present case. Thus in these cases, as in the *Cohn* case, the courts did not have to face squarely the problem of whether depreciation should be allowed when the gain is clearly attributable to the market. Therefore, to interpret the *Cohn* case as stating a general rule of law disallowing depreciation in the year of sale even when the gain is solely the result of market appreciation is an interpretation which can not be supported by any prior cases with similar factual situations.[26] This interpretation can only be justified negatively because no other case has specifically prohibited the Commissioner from disallowing a depreciation deduction under similar circumstances. This reasoning is tenuous especially in the light of the Regulations' inconclusiveness. The court's broad interpretation

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21 Treas. Reg. 1.167(b)-0(a) (1956).

22 Treas. Reg. 1.167(a)-10(b) (1956).

23 United States v. Motorlease Corp., supra note 8, at 618.

24 Supra note 11.

25 Seven cases disallowed the depreciation deduction in the year of sale: R. S. Killebrew, 14 Am. Fed. Tax R.2d 5565 (E.D. Tenn. 1964); W. P. Ison, 22 CCH Tax Ct. Mem. 1620 (1963); L. C. Roberts, 22 CCH Tax Ct. Mem. 1261 (1963); Contra Costa Trucking Co., 22 CCH Tax Ct. Mem. 1018 (1963); J. W. Brown, 40 T.C. 861 (1963); Randolph D. Rouse, 39 T.C. 70 (1962); and Edward V. Lane, 37 T.C. 188 (1961). Five cases allowed the depreciation deduction: Wyoming Builders, Inc. v. United States, 227 F. Supp. 534 (D. Wyo. 1964); S & A Co. v. United States, 218 F. Supp. 677 (D. Minn. 1963) aff'd, 14 Am. Fed. Tax R.2d 5964 (8th Cir. 1964); Kimball Gas Prod. v. United States, 12 Am. Fed. Tax R.2d 5105 (W.D. Tex. 1962); and Wasner v. United States, 10 Am. Fed. Tax R.2d 6162 (E.D. Wash. 1962).

26 The Commissioner attempted to establish this interpretation in 1962-1 Cum. Bull. 29.

of *Cohn* in the instant case is thus undesirable because of the lack of precedent, and difficult to understand because the court applies the holding of the case broadly without making it clear that it is doing so despite significant factual distinctions.

Considering the inconclusiveness of the Regulations and the lack of precedent for the decision in the instant case, it still must be determined whether other policy reasons required the result that was reached. The principle of this case is that in the year of a favorable sale only the amount by which the adjusted basis at the beginning of the year exceeds the sales price will be allowed as a depreciation deduction. The principle of the *Macabe* and *S & A Co.* cases is much narrower: when there is an unanticipated sale, in mid-life, of an asset whose salvage value and useful life have been reasonably computed so that if the sale had not been made the depreciation would have been allowed, it will be allowed in the year of sale. These two principles bring the theories of depreciation and capital gains into direct conflict. If the theory of depreciation, to "replace the original investment,"[27] is to be strictly adhered to, the rule of the instant case should be adopted so that a taxpayer will not be able to regain more than his original cost. If the theory of capital gains is to be strictly adhered to, the latter rule should be adopted so that gains derived from market appreciation are taxed at capital gains rates and not at ordinary income rates.

The conflict between the theory of capital gains and depreciation was resolved indirectly by Congress when it enacted sections 1245[28] and 1250.[29] In the case of section 1245 property (which would include the

[27] Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943). See also Mr. Justice Brandeis' definition of depreciation in United States v. Ludey, 274 U.S. 295, 300-01 (1927).

[28] Int. Rev. Code of 1954, § 1245, added by 76 Stat. 1032 (1962). This section applies only to depreciable personal property and certain limited types of real property. Essentially, it provides that upon disposition of § 1245 property the amount by which the lower of:

(a) Recomputed basis (adjusted basis plus all previous adjustments) exceeds the adjusted basis,
(b) Amount realized in a sale, exchange, or involuntary conversion, exceeds the adjusted basis,
(c) Fair market value upon any other disposition, exceeds the adjusted basis, shall be treated as ordinary income rather than capital gain.

For an excellent discussion of this section see Schapiro, Recapture of Depreciation and Section 1245 of the Internal Revenue Code, 72 Yale L.J. 1483 (1963).

[29] Int. Rev. Code of 1954, § 1250, added by 78 Stat. 100 (1964). This section is analogous to section 1245 and applies to depreciable real property not included under section 1245. It only applies to property depreciated by an accelerated method. Its recapture provisions are not as extensive as section 1245, for when the property is held for more than 20 months, only 100% minus one percentage point for each additional month of the amount which exceeds the adjusted basis is taxable as income. Thus, when section 1250 property is held for over ten years, the entire gain derived from a sale is taxed at capital gains rates, and not at ordinary income rates. The provisions of section 1250 are not as extensive as section 1245 also because the maximum amount which will be recaptured is the difference between the accelerated depreciation allowance and the amount which would have been allowed had a straight-line method of depreciation been used.

asset in the principal case had the transaction occurred after 1962)[30] the result produced by section 1245 is the same as would be produced if the depreciation deduction were not allowed. In either instance, a capital gain is converted into ordinary income. Thus, if section 1245 had applied in the instant case, the question of whether a depreciation deduction should have been allowed in the year of a favorable sale would have been academic. Whether the taxpayer depreciated the asset or not, the ultimate tax would have been the same.[31] Though this question is now academic when section 1245 property is involved, it is not academic in all cases involving section 1250 property. This latter section does not apply when a straight-line method of depreciation is used and so does not convert capital gains into ordinary income in that situation, or when the asset is held for a certain period of time.[32] Nor does it convert more than that portion of the gain which is the difference between the accelerated depreciation allowance and what would have been permitted had a straight-line method been used. Thus, the problem of the present case must still be resolved in many cases which will arise when section 1250 is applicable.

The court in the instant case has accomplished essentially what Congress sought to accomplish by sections 1245 and 1250. This result does not, however, justify the court's decision. Sections 1245 and 1250 represent the culmination of nearly twenty years of numerous congressional attempts to recapture tax losses resulting from the conversion of ordinary income into capital gains by the sale of depreciable property. The legislative history[33] of these attempts, starting with Section 117(j)[34] of the 1939 Code to the passage of sections 1245 and 1250, clearly reveals that although Congress realized that losses were occurring it failed to act. It was this failure of Congress to act which led the Commissioner to utilize his own methods of recapture. The method of disallowing a depreciation deduction in the year of sale goes beyond the scope of what the Commissioner can properly do

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30 Section 1245 is only applicable to taxable years after 1962.

31 The reason for this may be simply illustrated. An asset costs $300,000, and is depreciated over three years using the straight-line method of depreciation. At the end of the second year, the asset is sold for $600,000. At the beginning of the tax year the adjusted basis of the asset was $200,000. If the depreciation deduction is taken for the second year the taxpayer's other income is reduced $100,000 by the deduction, but it is increased by $100,000 because the gain is treated as ordinary income. The taxpayer is thus left in the same position as if he had not taken any depreciation deduction for the year of sale.

32 See supra note 29.

33 See supra note 10.

34 Int. Rev. Code of 1939, § 117(j). This was the first provision to tax gains from the sale of depreciable property at capital gains rates, rather than at ordinary income tax rates. Thus, until this time, it made no difference whether depreciation was allowed in the year of sale. Either way, the ultimate tax would be the same, for the amount by which a larger deduction reduced gross income would be offset by the corresponding larger gain derived from the sale of the asset. Section 117(j) of the 1939 Code was the predecessor of Section 1231 of the 1954 Code. Prior to the enactment of section 117(j) in 1942, the Commissioner took the position that a taxpayer had to depreciate an asset in the year it was sold. See Even Realty Co., 1 BTA 355 (1925). See also United States v. S & A Co., supra note 9, at 5971 (8th Cir. 1964) for an extensive list of pre-1942 cases which take this position.

without congressional sanction. The inconclusiveness of the Regulations, the lack of precedent, and this congressional inaction are the factors which should have induced the court in the instant case to allow the depreciation deduction in the year of sale.

MICHAEL L. ALTMAN

Transportation—Federal Motor Carrier Act—Statutory Interpretation.—***Baggett Transp. Co. v. United States.***[1]—This action was brought by a protesting motor common carrier to set aside an order of the ICC granting the applicant, H. Messick, Inc., a permit to operate as a motor vehicle contract carrier, transporting dangerous explosives and related articles, while under contract with the Hercules Powder Co. The Commission found[2] that Messick met the requirements of Section 203(a)(15) of the Interstate Commerce Act, by proposing to serve a limited number of shippers and to assign motor vehicles to the exclusive use of the shipper for a continuing period of time. Messick proposed distinctive and specialized services which the Commission evaluated in light of the criteria enumerated in section 209(b) of the act. The ICC concluded that, after balancing these factors, the permit should be granted. The district court, setting aside the order of the Commission and remanding the case for further action, HELD: the Commission erroneously assumed the criteria enumerated in section 209(b) could be weighed in the same manner as an algebraic equation. The court concluded that the method of attaching equal weight to every criterion was an improper standard for the Commission to use.

In 1935, Congress enacted legislation designed to foster sound economic conditions in the motoring industry in order to prevent further destructive proliferation of motor transport concerns and ruinous competition.[3] Part II of the Interstate Commerce Act[4] was federal regulatory legislation designed to promote the policy inherent in prior state-controlled regulation of motor carriers,[5] i.e., to promote the economic welfare of the carriers, shippers and the public by advocating a policy of preserving existing common carriage transportation against the inroads of contract carriage transporation.[6] Regulation was designed as an alternative to completely free-entry competition. Although competition was not wholly eliminated, entrance into the industry was limited by strict controls.[7]

The act distinguished between common carriers by motor vehicle ("any person which holds itself out to the general public to engage in transportation by motor vehicle. . . .")[8] and contract carriers ("any person which

1 231 F. Supp. 905 (N.D. Ala. 1964).

2 H. Messick, Inc., 92 M.C.C. 293 (1963).

3 Filing of Contracts by Contract Carriers by Motor Vehicle, 20 M.C.C. 8 (1939).

4 49 Stat. 543 (1935), as amended, 49 U.S.C. §§ 301-27 (1958).

5 See Hale & Hale, Competition or Control III: Motor Carriers, 108 U. Pa. L. Rev. 775 (1960).

6 See C. & D. Oil Co., 1 M.C.C. 329, 332 (1936).

7 Hale & Hale, supra note 5, at 776.

8 49 Stat. 544 (1935), as amended, 49 U.S.C. § 303(a)(19) (1958).