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FEDERAL INCOME TAX—DEDUCTIBILITY OF DEPRECIATION IN YEAR OF SALE WHERE SALE PRICE EXCEEDS ADJUSTED BASIS OF ASSET—Plaintiff sold all the assets used in its business, in the middle of a fiscal year, at a price in excess of their depreciated cost at the beginning of the year. When plaintiff purchased the assets in question, it intended to use them until they became scrap. The assets were sold as part of a going concern years before plaintiff originally intended to dispose of them. A depreciation deduction claimed in the year of the sale was disallowed. An additional assessment was paid, a claim for refund was denied, and this suit was instituted. *Held,* judgment for plaintiff. Depreciation is deductible even though assets are sold during the taxable year at a price in excess of their depreciated cost

at the beginning of the year. *S & A Co. v. United States*, 218 F. Supp. 677 (D. Minn. 1963).

Reasonable allowances for the exhaustion of property used in a trade or business or held for the production of income are permitted in the form of depreciation deductions.[1] The purpose of these allowances is to permit recovery of the cost or other basis of a depreciable asset by means of annual deductions during the useful life of the asset.[2] The proper allowance is that amount which should be set aside each taxable year, in accordance with a reasonably consistent plan, so that the total set aside over the useful life of the asset will equal its cost or other basis less its salvage value.[3] To determine depreciation deductions by use of the straight line method, it is necessary to estimate both useful life and salvage value. Prior to 1954, useful life referred to the physical life of an asset; today, it refers to the period during which an asset is expected to be useful to the taxpayer in his business.[4] Estimated remaining useful life is subject to modification by reason of conditions known to exist at the end of a taxable year, but changes in useful life are not to be made unless there is a clear and convincing basis for redetermination.[5] Salvage value is an estimate of the amount which will be realized upon disposition of an asset. It may be altered if useful life is redetermined, but it may not be altered merely to reflect changes in price levels.[6]

In the principal case, the court refused to redetermine useful life and salvage value.[7] However, such a redetermination was made in the similar case of *Cohn v. United States*.[8] In both cases the assets in question were sold before their estimated useful lives in the taxpayers' businesses had expired. However, in the principal case the assets were sold as part of a going concern, while in the *Cohn* case the sale took place as the business was about to terminate. In *Cohn* the court redetermined salvage value to equal the actual sales price of the assets. With this new salvage value, depreciation deductions in the year of the sale were not permitted because the depreciated cost of the assets at the beginning of the year was less than their redetermined salvage value.[9] In the principal case salvage value was not changed, and although depreciated cost at the beginning of the year was

[1] INT. REV. CODE OF 1954, § 167(a).

[2] Rev. Rul. 53-90, 1953-1 CUM. BULL. 43.

[3] Treas. Reg. § 1.167(a)-1(a) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL 91.

[4] Treas. Reg. § 1.167(a)-1(b) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL. 91; see Hertz Corp. v. United States, 364 U.S. 122 (1960); Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).

[5] Treas. Reg. § 1.167(a)-1(b) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL. 91.

[6] Treas. Reg. § 1.167(a)-1(c) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL. 91.

[7] 218 F. Supp. 677, 682 (D. Minn. 1963).

[8] 259 F.2d 371 (6th Cir. 1958). This case arose under the Internal Revenue Code of 1939, but it applies equally to the 1954 Code. Rev. Rul. 62-92, 1962-1 CUM. BULL. 29, 30.

[9] Treas. Reg. § 1.167(a)-1(a) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL. 91. Assets may not be depreciated below their salvage value under any method of computing depreciation.

below the sale price, deductions for depreciation were allowed because depreciated cost was still above the originally estimated salvage value.

Since the principal case was decided by a district court in the Eighth Circuit, it could not overrule the *Cohn* decision, which was rendered by the Court of Appeals for the Sixth Circuit. However, the principal case does seem to indicate that the *Cohn* ruling should not apply to cases in which assets are sold as part of a going concern. The importance of deductibility of depreciation in the year of sale makes this limitation on *Cohn* highly significant. Total gain before taxes is the same whether or not a deduction is allowed, but if the deduction is allowed, a greater part of the gain will come under section 1231[10] and be taxed at the lower capital gains rate. It should be noted, however, that under section 1245,[11] which the Revenue Act of 1962 added to the Code, the tax on gains from the disposition of "section 1245 property"[12] sold in a taxable year beginning after December 31, 1962, is the same whether or not a depreciation deduction is permitted in the year of sale. Despite the addition of this section to the Code, deductibility of depreciation in the year of sale is still of vital importance in many instances. Although there is a considerable degree of overlap between depreciable property and "section 1245 property," the overlap is not complete.[13] For example, buildings and their structural components are not "section 1245 property." In addition, deductibilty of depreciation in the year of sale is still significant with respect to present cases arising out of sales in a taxable year beginning prior to December 31, 1962. As a result, despite the addition of section 1245, detailed examination of the reasoning and conclusions of both *Cohn* and the principal case seems warranted.

Some of the conclusions reached by the courts in these two cases appear to be of doubtful validity. In the principal case, both estimated useful life and salvage value should have been changed. The Government contended that the decisions in *Massey Motors, Inc. v. United States*[14] and *Hertz Corp.*

10 Gains from compulsory or involuntary conversions, sales, or exchanges of property used in the trade or business are taxed as gains from the sale or exchange of capital assets held for more than six months. INT. REV. CODE OF 1954, § 1231.

11 If § 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the adjusted basis of the property is less than the lower of (1) the amount realized in the case of a sale, exhange or involuntary conversion, or the fair market value in the case of any other type of disposition or (2) the recomputed basis of the property, is taxable as ordinary income. The term "recomputed basis" refers to the adjusted basis of the property plus deductions from the adjusted basis for depreciation and amortization attributable to periods after December 31, 1961. INT. REV. CODE OF 1954, § 1245(a).

12 Section 1245 property is any property, other than livestock, which is or has been subject to the allowance for depreciation provided in § 167 and is either personal property or other property (not including a building or its structural components), but only if such other property is tangible and has an adjusted basis which reflects deductions for depreciation or amortization. INT. REV. CODE OF 1954, § 1245(a)(3).

13 See Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 YALE L.J. 1483, 1497-1502 (1963).

14 364 U.S. 92 (1960).

v. United States[15] required a redetermination.[16] The court properly rejected this contention by pointing out that those cases were distinguishable on the facts. In both *Massey* and *Hertz* the taxpayers had at the outset improperly determined the useful life of each of the assets in question by estimating physical useful life rather than useful life in the taxpayer's business. This was done despite the fact that estimated useful life in the business was much shorter than estimated physical useful life because the assets were purchased with an intent to dispose of them before they became scrap. An improper determination of this sort was not possible in the principal case because, at the time of acquisition, the taxpayer intended to retain the assets until they became scrap. As a result, in the principal case, anticipated useful life in the taxpayer's business and anticipated physical useful life were identical. However, the court also concluded that the plaintiff did not come within the letter or spirit of section 1.167(a)-1(b) of the Treasury Regulations.[17] This conclusion seems erroneous. Section 1.167(a)-1(b) provides:

> "[E]stimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful *to the taxpayer* in *his* trade or business. . . . The estimated remaining useful life may be subject to modification by reason of conditions *known to exist at the end of the taxable year* and shall be redetermined *only* when the change in the useful life is *significant* and there is a *clear and convincing basis* for redetermination."[18]

Plaintiff's estimates of useful life were reasonable as originally determined, but at the end of the taxable year in which the sale took place plaintiff knew the exact life, with relation to its business, of each of its assets and knew that its original estimates had been highly inaccurate. As a result, the estimated useful life of each of plaintiff's assets should have been redetermined. This redetermination would have been quite significant because a shortening of useful life would have necessitated a change in salvage value.

Concerning the redetermination of salvage value, however, the method adopted by the *Cohn* decision was not sound. The court in that case was justified in making a redetermination, but the method employed was improper. By adjusting salvage value to equal sales price,[19] and by permitting deductions in the year of sale only to the extent that the depreciated basis of an asset at the beginning of the year exceeded its sales price, the court in *Cohn* denied the possibility of a capital gain unless the depreciated

[15] 364 U.S. 122 (1960).

[16] 218 F. Supp. 677, 681 (D. Minn. 1963).

[17] *Id.* at 682.

[18] Treas. Reg. § 1.167(a)-1(b) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL. 91. (Emphasis added.)

[19] See Motorlease Corp. v. United States, 215 F. Supp. 356, 362-63 (D. Conn. 1963), for what appears to be an erroneous interpretation of the holding in the *Cohn* case, with respect to redetermination of salvage value.

basis of an asset at the beginning of the year of the sale was below its sales price. Such a decision seems contrary to the spirit of section 1231 of the 1954 Code[20] and section 1.167(a)-8(a)(1) of the Treasury Regulations,[21] both of which allow capital gains treatment of income resulting from the disposition of depreciable assets. A redetermination which equates salvage value with sale price does not completely eliminate the possibility of a capital gain: deductions in years prior to the sale will not be disallowed even if it becomes apparent that they reduced the basis of the asset below the price at which it was sold.[22] However, in cases in which the depreciated cost of the asset at the beginning of the year of sale exceeds the sales price, a capital gain is not possible; and in cases in which the sale price exceeds depreciated cost, the difference between basis and sale price may not be increased in the year of sale. In effect, a redetermination which equates salvage value and sale price prevents any reduction in basis in the year of sale which would give rise to a capital gain or increase a capital gain already caused by depreciation deductions of previous years. It seems illogical to argue that Congress intended to limit the capital gains treatment of depreciable assets in this way.[23]

In conclusion, it seems that the same rules of law ought to have been operative in both *Cohn* and the principal case. In both instances, the disposition took place before the end of the assets' useful lives as originally estimated. Therefore, in both cases, each asset's estimated useful life should have been redetermined to conform to its known life in the taxpayer's business. It seems quite irrelevant that in one of the cases the assets were disposed of as part of a going concern, and in the other the sale took place as the business was about to terminate. With respect to salvage value, the facts in each of the cases should have been considered, and redeterminations should have been made to correct for that part of the difference between the initial estimated salvage value and the sale price which was due to error in estimation rather than appreciation in value. This should have been done by reverting to the time of acquisition and making new estimates of salvage value, taking into consideration all facts known at acquisition, the now known physical condition of each asset at the time of disposition, and the now apparent useful life of each asset. In making these new estimates, the market at the date of acquisition should have been consulted, but appreciation in value between acquisition and sale should have been ignored. In the principal case, the assets in question were sold years before the plaintiff had originally intended to sell them. In all probability, the difference between sale price and estimated salvage value was

20 INT. REV. CODE OF 1954, § 1231.

21 Where an asset is retired by a sale at arm's length, recognition of gain or loss will be subject to the provisions of §§ 1002, 1031, 1231, and other applicable provisions of law. Treas. Reg. § 1.167(a)-8(a)(1) (1956).

22 See 4 MERTENS, FEDERAL INCOME TAXATION § 23.47 (1960).

23 This limitation is quite different from that imposed by § 1245 and is seemingly foreclosed by § 1231.

almost completely due to the fact that the plaintiff was selling relatively new assets after having estimated salvage value on the assumption that the assets would be disposed of in the form of scrap. As a result, the difference between estimated salvage value and sales price was primarily due to error in estimation; thus salvage value should have been redetermined to approximate sales price. On the other hand, in the *Cohn* case the assets in question were sold near the end of their estimated lives, and a significant part of the difference between the price they brought and their salvage value was due to appreciation in value as a result of rising wartime prices.[24] This being the case, salvage value probably should have been redetermined, but not to equal or even approximate sale price. In this way, capital gains treatment would be afforded only for true appreciations, because depreciation deductions would be allowed in the year of sale only to the extent that they reduced basis to the properly redetermined salvage value.

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24 See Cohn v. United States, 259 F.2d 371, 374 (6th Cir. 1958).