William & Mary Law Review

Volume 5 (1964)
Issue 1

Article 7

January 1964

Federal Taxation - Depreciation of Assets in the Year of Disposal

FEDERAL TAXATION

Depreciation of Assets in the Year of Disposal

The Commissioner of Internal Revenue has held various views concerning the amount received by a taxpayer upon disposal or sale of an asset which exceeds the undepreciated and salvage value of the asset as carried on the taxpayer's books.[1] The Commissioner has continuously stated, however, that a taxpayer should not take a deduction for depreciation for an asset in the year of disposal if a gain would result, notwithstanding the fact that the asset sold for more than its estimated salvage value.[2] Recently three Federal District Courts allowed taxpayers to recognize capital gains upon disposal of assets when the amounts exceeded the combined undepreciated value and salvage value.[3]

In *S & A Company* v. *United States*,[4] the taxpayer was a going concern with a business year ending on August 31st. On April 1, 1956, S & A sold its assets to McCulloch Corporation, who in turn assumed S & A's liabilities. McCulloch continued to run the company under much the same policy and work force as did the taxpayer. The consideration for the sale of the assets exceeded the undepreciated basis of the assets at the close of the 1955 business year; however, S & A, in their 1956 federal corporation income tax return, deducted depreciation on the assets for the time of their use in 1956. The Internal Revenue Bureau declared the deduction invalid because the assets were sold for an amount greater than the undepreciated basis as of the end of the 1955 business year. (In effect, the Internal Revenue Service

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1 Massey Motors Inc. v. United States, 364 U.S. 92, 80 Sup. Ct. 1411; 4 L.Ed. 2d 1592 (1960).

2 Rev. Rul. 62-92, 1962-1 Cum. Bull. 29: The depreciation deduction for the taxable year of disposition of an asset used in trade or business. . .is limited to the amount, if any, by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized from sale or exchange.

3 S & A Company v. United States, 218 F. Supp. 677 (D. Minn. 1963). Motorlease Corporation v. United States, 215 F. Supp. 356 (D. Conn. 1963). Kimball Gas Products v. United States——, F. Supp.,——, CCH 63-2 USTC 19507 (Texas 1963).

4 218 F. Supp. 677 (D. Minn. 1963).

used Revenue Ruling 62-92,[5] although they did not plead it as such.) The taxpayer claimed that if the depreciation deduction was not allowed, then the government would be equating the selling price of the assets, when greater than the undepreciated basis, to the salvage value of the assets. Does the selling price of business assets equal the salvage value of the assets?

The Internal Revenue's main point is that when a taxpayer purchases an asset for business production, he should not realize a profit upon disposal of the asset. Its desire to prevent profit upon the disposal of business assets motivates the above decision. Theorectically, the only reason for purchasing a business asset is either to maintain or increase production. Since no business asset lasts forever, its cost minus salvage value must be written off during its useful life. The Commissioner contends that a profit is realized upon the sale of a business asset only when the taxpayer's rate of depreciation is too high or the estimated salvage value is too low; therefore, if the taxpayer reports this profit as a capital gain, he will deprive the government of revenue which it should have received in previous years if the depreciation had been taken at a lower rate.

The government fails to realize that the assets could have been depreciated during a period of inflation. Assume that an asset with a twenty year life is purchased in 1945 and is disposed of in 1955. Under conservative orthodox accounting principles the taxpayer in 1945 would determine the salvage value of the asset in '1945 purchasing dollars'. He would then pick a method of depreciation recognized by the Internal Revenue Service, and apply it to the remainder of the asset's purchase price in terms of '1945 dollars'. He would be allowed no deduction for inflation under the tax laws, nor under any principles of accounting. Since no adjustment is allowed for inflation, in 1955 the asset is carried on the books in '1945 dollars', but is sold for '1955 purchasing dollars'. The taxpayer receives more dollars numerically than he is carrying the asset for, but they are '1955

[5] *Supra.*, note 2.

purchasing dollars' purchasing an asset appraised in '1945 purchasing dollars'. He probably has no more purchasing power and perhaps even less than if he had the adjusted dollars and was back in 1945. Since no accurate way of measuring inflation exists, it would seem more just in a situation where an asset's depreciation rate is reasonable and the salvage value adequate at the time of purchase to consider any gain realized upon disposal as appreciation and tax it at a lower rate.

The favorable decisions in *S & A* v. *United States*,[6] and other recent cases hinge on the interpretation of Treasury Regulation § 1.-167 (a)-1(b),[7] Treasury Regulation § 1.-167 (a)-1(c),[8] and Revenue Ruling 62-92.[9]

The government contends that the useful life of an asset is the useful life to the taxpayer in his business. Treas. Reg. § 1.-167 (a)-1(b) could very easily be interpreted in this way. The government goes further; however, and

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6 *Supra.*, note 4.

7 Treas. Reg. § 1.-167 (a)-1(b): *Useful Life.* For the purpose of section 167 the estimated 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 or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. . .The estimated remaining life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in useful life is significant and there is a clear and convincing basis for redetermination.

8 Treas. Reg. § 1.-167 (a)-1(c): *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realized upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or is to be retired from service by the taxpayer. Salvage value 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 under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. . .If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. . .but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. . . .

9 *Supra.*, note 2.

cites *Massey Motors Inc.* v. *United States*,[10] in which the taxpayer intended to use the assets for only part of their life. In the present case *S & A* intended to use the assets for their full life. The court, in *S & A*, holds that useful life does not necessarily mean useful life to the taxpayer, but useful life within the industry. This does not run contrary to *Massey Motors Inc.* because the assets were automobiles in a rental agency. Although the autos had a useful life physically, they were not useful as far as the industry i.e. auto rental, was concerned. In *S & A*, McCulloch continued to use the assets within the industry for which they were purchased.

Linked with useful life and depreciation is the salvage value of an asset. The Internal Revenue Service claims that one may redetermine salvage value in view of *Cohn* v. *United States*,[11] but the assets in *Cohn* differ from the assets in S & A. In *Cohn* the assets were at the end, or near the end, of their useful lives and the issue was whether the salvage value could be readjusted in view of the useful life nearing an end. In point with the present case is the power of altering the salvage value expressed in Treas. Reg. § 1-167 (a)-1(c). It states that the salvage value is determined upon acquisition in view of the asset's useful life to the purchaser when purchased. Price levels should not influence changing the salvage value. Only if the useful life is changed can the salvage value be changed. In *S & A* the useful life was not changed, nor were the assets at the end of their useful lives and so the salvage value could not be changed.

Wier Long Leaf Co. v. *C.I.R.*,[12] discusses both sides of the argument presented in *S & A*. In *Wier Long Leaf* there are two types of assets: (1) those near the end of their useful life, and (2) those still having a useful life. The court permitted readjustment of the salvage value of the first group, but denied readjustment as to the second group of

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[10] *Supra.*, note 1.
[11] 259 F.2d 371 (6th Cir., 1958).
[12] 9 T.C. 990 (1957).

assets which were sold for more than their undepreciated value. The court held that the profit realized was appreciation.

The court in *S & A* commented on the applicability of Revenue Ruling 62-92, to the present case, although the Commissioner did not plead it. It held that the Ruling interpreted the *Cohn*[13] case, but as written covered a broader area than the case. The court therefore held it either invalid as law or limited to facts similar to those in *Cohn*.

Considering the arm's length transaction between S & A and McCulloch, along with recent inflation, the *S & A* decision seems valid. It draws valid distinctions between the sale of a going concern and a salvage sale; and between appreciation and salvage value. Two other Federal District Courts have independently interpreted Treasury Regulations § 1.-167 (a)-1(b) and § 1.-167 (a)-1(c) in a similar manner.[14]

Motorlease v. *United States*,[15] cited in *S & A*, went further than *S & A*: It held that Congress in passing 26 U.S.C. § 1245,[16] impliedly admitted that companies could realize a capital gains on assets sold for more than undepreciated value before 1962.

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[13] *Supra.*, note 11.

[14] *Supra.*, note 3.

[15] 215 F. Supp. 356 (D. Conn. 1963).

[16] 26 USC § 1245 *Gain from Disposition of Certain Depreciable Property.*

a *General Rule*—

(1) Ordinary Income—Except as otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1961 the amount by which the lower of

(a) the recomputed basis of the property, or

(b) (i) in the case of a sale, exchange or involuntary conversion, the amount realized or

(ii) in the case of any other disposition, the fair market value of such property,

exceeds the adjusted basis of such property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

In view of 26 U.S.C. § 1245, profits realized upon the sale of assets, with certain qualifications, after December 31, 1961, will now be taxed as ordinary income. The act however, is not retroactive, and therefore, one tax service has advised in view of the decision in *S & A*, to file a claim where profits from the sale of assets before December 31, 1961, were taxed as regular income by the Commissioner.[17] This assumes the statute of limitations is not a bar.

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[17] Alexander Hamilton Institute, *Taxes Interpreted*, Vol. 2. No. 4.