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Taxation - Depreciation Allowance in Year of Disposition on Asset Sold at Gain, *Fribourg Navigation Co. v. Commissioner of Internal Revenue*, 86 S.Ct. 862 (1966)

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result of the decision, however, attention is again focused on the arguments in favor of the holding.

As contended by the petitioners in *Dalehite*, narrow interpretation of the words "negligent or wrongful act" in the FTCA¹⁵ so as to exclude injuries for which local law imposes liability contravenes the intent of the Supreme Court that the Act be construed liberally,¹⁶ and negates the logical meaning of Section 1346, which states that the United States will be liable to the same extent as a private person.¹⁷ It was urged that it was a safe inference of legislative intent to read the words "negligent" and "wrongful," stated in the disjunctive, as not synonymous, the second word encompassing the concept of wrongfulness by dint of statute. Other *Dalehite* critics¹⁸ believe that had exclusion of strict liability been the design, it could easily have been included in the FTCA's numerous express exemptions.¹⁹

The present case may be a preview if not a precedent. Should the Fourth Circuit, in which lies Virginia, again become a testing ground for this line of reasoning, a holding in accord therewith is not improbable.²⁰

Richard A. Repp

Taxation—DEPRECIATION ALLOWANCE IN YEAR OF DISPOSITION ON ASSET SOLD AT A GAIN.

In *Fribourg Navigation Co. v. Commissioner of Internal Revenue*,¹ the taxpayer had purchased a used Liberty ship on December 21, 1955, for \$469,000, and thereafter computed its depreciation thereon over a useful life of three years using the straight line method with an estimated salvage value of \$54,000. The Internal Revenue Service had advised the taxpayer in a letter ruling prior to the acquisition that it would accept a three year life, subject to change if warranted by subsequent experience,

15. *Supra* note 4.

16. *U.S. v. Yellow Cab*, 340 U.S. 543 (1951); *U.S. v. Aetna Casualty*, 338 U.S. 366 (1949).

17. *Supra* note 4.

18. See Jacoby, *Absolute Liability Under the Federal Tort Claims Act*, 24 Fed. Bar J. 139 (1964).

19. 28 U.S.C.A. § 2680 (1964).

20. Note: Two of the three strict liability decisions between *Dalehite* and *Long* were in the Fourth Circuit. *United States v. Praylou*, *supra* note 9; *Pendergast v. U.S.*, *supra* note 14. Cf. *Medlin v. U.S.*, 244 F.Supp. 403, 406 (D. S.C. 1965).

1. 86 S.Ct. 862 (1966).

and the estimated salvage value. Because of the Suez Canal seizure in July 1956, the sales prices of such ships rose sharply. The taxpayer sold the ship for \$695,500 on December 23, 1957, and on its 1957 tax return reported a capital gain for the amount received in excess of adjusted basis (cost less depreciation claimed which included \$135,367.24 for the year 1957). The Commissioner of Internal Revenue took the position that depreciation in the year of sale was limited to the amount by which adjusted basis exceeded the amount realized on the sale.² The Commissioner's position was sustained by a single judge in the Tax Court and by the Court of Appeals for the Second Circuit.³ The Supreme Court reversed and found for the taxpayer in allowing a depreciation deduction in the year of sale.

The Supreme Court recognized that depreciation claimed by a taxpayer might be redetermined if there was a miscalculation of the original estimate of useful life⁴ or salvage value⁵ and when the reasonableness is challenged.⁶ However, the Court found that the Commissioner had erroneously combined two distinct tax accounting concepts in considering the concept of depreciation with the concept of non-recognition of mere fluctuations in value because of changes in price levels or market values.⁷ Depreciation is defined as an amount representing the reduction in value of a capital asset through wear and tear.⁸ The amount deductible from gross income for a particular year is the sum which should be set aside so that at the end of the useful life of a capital asset an aggregate of the sums so set aside plus the salvage value would equal original cost.⁹ Furthermore, fluctuations in value caused by market

2. This position was first promulgated in Revenue Ruling 62-92, 1962-1 Cum. Bull. 29.

3. 335 F.2d 15 (1964).

4. See Revenue Procedure 62-21 for depreciation guidelines.

5. *Supra* note 1, at 865:

It is, of course, undisputed that the Commissioner may require redetermination of useful life or salvage value when it becomes apparent that either of these factors has been miscalculated. (Emphasis added.)

Regulations section 1.167(a)-1(c):

. . . (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. (Emphasis added.)

6. *Supra* note 1, at 866; Section 167(a), Internal Revenue Code of 1954, *infra* note 8.

7. *Supra* note 1, at 865.

8. *Ibid.*; *United States v. Ludey*, 274 U.S. 295, 300-301 (1959); Section 167(a), Internal Revenue Code of 1954:

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.

9. Regulations section 1.167(a)-1(a).

appreciation is ignored in computing depreciation for tax purposes.¹⁰ The case of *Cohn v. United States*,¹¹ upon which Revenue Ruling 62-92 was based, was distinguished from the present case in as much as in that case no salvage value had been estimated and the amount realized could properly be used in finding what salvage value should have been estimated in arriving at depreciable basis.

The significance of the decision is quite immaterial when depreciable personal property is involved because of the enactment in 1962 of § 1245 of the Internal Revenue Code.¹² Gain on a sale of such depreciable personal property is taxable as ordinary income rather than a capital gain to the extent of depreciation claimed; therefore, there is no tax savings to be derived from charging depreciation against income taxable at high ordinary rates and thereby increasing capital gains taxed at a lower rate. It is in regard to gains on the sale of depreciable real property where a depreciation deduction in the year of sale has current relevance, except to the extent that depreciation claimed on an accelerated method in excess of straight line may be recaptured as ordinary income by virtue of § 1250.¹³

However, the estimated useful life and salvage value may be challenged on the grounds of unreasonableness. If the taxpayer fails to sustain the burden of proof that the estimates were reasonable, and that the gain was attributable to an increase in market value, depreciation in the year of sale still might be adjusted regardless of the holding in this case.¹⁴

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10. *Supra* note 1, at 865; *Macabe Co.*, 42 T.C. 1105, 1109 (1964); *Weir Long Leaf Lumber Co.*, 9 T.C. 990, 999, reversed on other grounds, 173 F.2d 549; Regulations section 1.167(a)-1(a):

The allowance shall not reflect amounts representing a mere reduction in market value.

11. 259 F. 2d 371 (1958).

12. Section 1245, Internal Revenue Code of 1954.

13. Section 1250, Internal Revenue Code of 1954.

14. *Supra* note 1, at 865; *Bell Lines Inc.*, 43 T.C. 358 (1964); *Nichols*, 43 T.C. 135 (1964); *Specialty Paper and Board Co., Inc.*, T.C.M. 1965-208.