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Depreciation, Salvage Value and 1231 Capital Gains

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Ingenious taxpayers have for generations seized every opportunity imaginable in their efforts to avoid taxes. And the taxing bodies have just as persistently sought to prevent the imaginative taxpayer from capitalizing on statutory loopholes. One such battleground has been the taxpayer's practice of depreciating property under section 167[1] of the Internal Revenue Code, and subsequently reselling such property above the adjusted basis thereby realizing a 1231[2] capital gain. The Internal Revenue Service has always taken a dim view of the double benefit taxpayer's realize from deducting depreciation from gross income for a period of time, and then enjoying the limited taxation on the profits resulting from the sale of that same asset. But until recently the Internal Revenue Service has been thwarted in its attempt to eliminate this windfall for the taxpayer by adverse decisions of the courts and inaction on the part of Congress.

The Internal Revenue Service won its first victories in this area from the courts in obtaining decisions limiting the amount of depreciation allowable to taxpayers. The court held in *Cohn v. United States,*[3] decided by the United States Court of Appeals, Sixth Circuit, that where the actual salvage value of an asset is ascertained either by resale or other means, such as a charitable contribution, during a taxable year, depreciation for that year will be allowable in an amount not greater than the excess of the book value at the beginning of the year over the actual ascertained salvage value.[4] The United States Supreme Court placed further limitations on the amount of depreciation allowable when it decided *Massey Motor, Inc. v. United States.*[5] The taxpayer in that case was in the car rental business. The cars which he used in his business were sold after an average of twelve to fifteen months, but the cars were depreciated on a four year basis with no estimated salvage value. The taxpayer realized substantial capital gains upon the sale of the cars due to the disproportionate relationship between the book value of the cars and their actual resale value at the time of the sale. The Internal Revenue Service challenged the taxpayer's method of computing depreciation. The Supreme Court held that, "the taxpayer should under the allowance for depreciation, recover only the cost of the asset less the estimated salvage, resale or secondhand value." "This requires," the Supreme Court stated, "that the useful life of the asset be related to the period for which it may reasonably be expected to be related to the taxpayer's business." Therefore, "salvage value must include estimated resale or secondhand value."[6] The Federal Income Tax Regulations codify the Supreme Court's holding. They provide that, "Salvage value is the amount (determined at the time of

1. I.R.C. § 167. This section provides for the depreciation of business assets.
2. I.R.C. § 1231. Section 1231 long term capital gains are subjected to limtied taxation.
3. 259 F.2d 371.
4. Id. at 376, 377.
5. 364 U.S. 92.
6. Id. at 107.

acquisition) which it is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. . . ."[7]

The second blow to the taxpayer's double benefit was delivered by Congress in the Revenue Act of 1962 which added section 1245[8] to the Internal Revenue Code. Section 1245 provides that profits received from the sale of section 1245 property shall be treated as ordinary income to the extent that the recomputed basis[9] of the property or, in the case of a sale, exchange, or involuntary conversion, the amount realized or, in the case of any other disposition, the fair market value of such property, which ever of the three is lower, exceeds the adjusted basis of such property.[10] Simply stated the law now provides that income over the adjusted basis will be treated as ordinary income to the extent the 1245 asset has been depreciated after 1962. Section 1245 property is property (other than livestock) which is or has been property of a character subject to section 167 depreciation and is either personal property or other property (not including a building or its structural components) subject to certain limitations.[11]

Congress apparently felt some duty to the taxpayer's who had come to rely on the benefits resulting from the sale of a depreciated 1231 asset because it has directed the Internal Revenue Service to adopt regulations which will allow the taxpayer to reduce his salvage value by an amount which does not exceed ten percent of the acquisition basis of such personal property.[12] Personal property, as used in this context is defined as depreciable personal property (other than livestock) which has a useful life of three years or more and which has been acquired after the date of the enactment of the Revenue Act of 1962.[13] Such deductions from salvage value will have the effect of increasing the amount of depreciation which the taxpayer will be allowed to deduct from his gross income over the useful life of the asset. Such deductions, however, will not benefit the taxpayer in the long run after he has sold the asset.

It is interesting, at this point, to examine the effect of section 179[14] of the Internal Revenue Code in this area. Under section 179 a taxpayer (other than a trust) [15] may deduct, as depreciation, during the first taxable

7. Treas. Reg. § 1.167(a) (1) (c).
8. I.R.C. § 1245 added by 76 Stat. 960, § 13.
9. The term "recomputed basis" means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961, reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168.
10. I.R.C. § 1245(a) (1).
11. I.R.C. § 1245(a) (3).
12. I.R.C. § 1245(f) (1).
13. I.R.C. § 1245(f) (2).
14. I.R.C. § 179.
15. Treas. Reg. § 1.179-1(a).

year, twenty percent of the acquisition value of a section 179 asset[16] up to $10,000.00 if the taxpayer is single, or $20,000.00 if the taxpayer is married and files a joint return,[17] without taking into consideration the estimated salvage value.[18] The deduction is allowable even though the asset was acquired by the taxpayer on the last day of the taxable year.[19] A section 179 asset is any personal property subject to section 167 depreciation which is acquired after December 31, 1956, for use in the taxpayer's trade or business and which has an estimated useful life of six years or more.[20] The useful life of the section 179 asset is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business, in the production of his income.[21] Under section 179 a taxpayer may buy an asset subject to section 179, depreciate it to the full twenty percent, and resell it the following year realizing ordinary income, or in the case of livestock, capital gains, to the extent the resale value exceeds the new basis. This will afford the taxpayer an opportunity to shift his income from the year of acquisition to another in which he might be in a more favorable tax position. However, in the case of livestock, the taxpayer will be afforded the opportunity to trade a deduction from ordinary income for capital gains. The taxpayer should realize the concept of "useful life" in determining if he can qualify for the section 179 depreciation.

Congress has, through the enactment of section 1245, eliminated the double benefit which taxpayer's previously realized from trading ordinary income by depreciation for capital gains, with the exception of buildings and livestock. And the courts have joined with the Internal Revenue Service in curtailing excess depreciation by establishing a new definition of salvage value which has the effect of limiting the amount of income which can be transferred to another year or in the case of buildings and livestock, the amount of capital gains which can be realized. An analysis of the trend would lead one to speculate that the present tax advantages flowing from buildings and livestock might soon be the subject of further legislation.

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16. I.R.C. § 179(a).
17. I.R.C. § 179(b).
18. Treas. Reg. § 1.179-1(d).
19. Treas. Reg. § 1.179-1(e).
20. I.R.C. § 179(d)(1).
21. Treas. Reg. § 1.179-3(a).