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Taxation - Depreciation in Year of Sale - Revenue Ruling 62-92

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Several means may be employed by those who desire to avoid the tax consequences imposed upon Frazell. The parties immediately may elect to be excluded from the partnership rules through the statutory procedure.⁴⁵ The party contributing services may be granted a non-operating interest since such an interest does not fit the general partnership definition under section 761,⁴⁶ or other language might be employed to indicate that the agreement is to be strictly construed as a sharing agreement. Finally, the draftsman may construct the agreement so as to contemplate two distinct transactions: (1) the contribution of developmental services for an oil interest, and (2) the assignment by the service contributor of that interest for a period of time to the grantor.⁴⁷

Frazell suggests one important drafting principle: contract provisions pertaining to wages must be kept distinct from provisions outlining contemplated sharing arrangements. If this separation is not maintained, the latter will take on the character of compensation, with the resulting unfavorable tax consequences.

John B. Esch

Taxation — Depreciation In Year Of Sale — Revenue Ruling 62-92

I. BACKGROUND

Depreciation deductions in the year of sale have recently been the center of some controversy. *Cohn v. United States*¹ was the first case to disallow depreciation deductions on moveable assets in the year of sale when the sales price exceeded the first-of-the-year adjusted basis (*i.e.*, depreciated cost) of the assets. The taxpayer in *Cohn* operated three civilian pilot training schools during World War II. Because of the foreseeable termination of the government's need for civilian trained pilots, the taxpayer determined that for depreciation purposes the useful life of his equipment should terminate at the end of 1944. However, the taxpayer failed to set any salvage value on his equipment. In August and November of 1944, the assets were auctioned off at a price in excess of their adjusted basis at the begin-

⁴⁵ See the election provisions under the 1954 Int. Rev. Code, § 761(a).

⁴⁶ Int. Rev. Code of 1954, § 761(a).

⁴⁷ The drafting problem presented by *Frazell* is thoroughly analyzed in Galvin, *Another Look at Sharing Arrangements—Some Drafting Suggestions*, Southwestern Legal Foundation, *Sixteenth Annual Inst. on Oil and Gas Law and Taxation* 453 (1965).

¹ 259 F.2d 371 (6th Cir. 1958).

ning of 1944. The Commissioner disallowed a depreciation deduction computed without consideration of the asset's salvage value when the amount of the salvage value (the sales price) was known. The district court held that the depreciation deduction should have been based on a salvage value of ten per cent of the cost² for the first two years of useful life, but held that actual sales price should have been used for the salvage value in determining the depreciation deduction for the third and final year of useful life. This resulted in no depreciation deduction for the final year since the actual sales price exceeded the adjusted basis at the first of the year. Only the issue of salvage value in the final year was appealed to the Sixth Circuit which upheld the district court. The court reasoned that if an erroneous estimate of useful life may be redetermined,³ an adjustment of salvage value should be allowed "at or near the end of useful life of the asset when it is shown by an actual sale of the asset that there is a substantial difference between what was estimated and what it [the salvage value] actually is."⁴

II. REVENUE RULING 62-92

In response to a request on the applicability of *Cohn* to the 1954 Code, the Commissioner promulgated Revenue Ruling 62-92:

The depreciation deduction for the taxable year of disposition of an asset used in the trade or business or in the production of income, otherwise properly allowable under the taxpayer's method of accounting for depreciation, 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.⁵

Revenue Ruling 62-92 is a liberal interpretation of the *Cohn* holding; several instances may be noted where Revenue Ruling 62-92 oversteps the bounds of *Cohn*. First, the *Cohn* case authorizes a redetermination of salvage value only if there is a *substantial* difference in the estimated salvage value and the selling price of the asset, whereas Revenue Ruling 62-92 authorizes a redetermination when there is *any* difference. Second, *Cohn* allows such redetermination *at or near the end of estimated useful life*; Revenue Ruling 62-92 applies *whenever the asset is sold*. Third, the *Cohn* case did not authorize a redetermination of salvage value to reflect changes in

² *Id.* at 375. Ten per cent was the normal salvage allowed for similar flying schools.

³ *Id.* at 378. *Commissioner v. Mutual Fertilizer Co.*, 159 F.2d 470 (6th Cir. 1947), held that a redetermination of useful life might be made in the light of conditions known to exist at the end of the period.

⁴ *Id.* at 378.

⁵ 1962-1 Cum. Bull. 29.

market value, but Revenue Ruling 62-92 requires the disallowance of depreciation in the year of sale even if the sales price exceeds the first-of-year adjusted basis solely because of market appreciation.⁶

Revenue Ruling 62-92 has not enjoyed uniform acceptance in the courts. After initially accepting it in *Randolph D. Rouse*,⁷ the tax court withdrew its support in *Macabe Co.*⁸ The Eighth Circuit also rejected Revenue Ruling 62-92 in *United States v. S & A Co.*⁹ On the other hand, the Second Circuit endorsed the Commissioner's position in *Motorlease Corp. v. United States*¹⁰ and *Fribourg Navigation Company v. Commissioner*.¹¹

III. FRIBOURG NAVIGATION CO. V. COMMISSIONER¹²

In *Fribourg Navigation Co. v. Commissioner* the taxpayer, Fribourg, bought a Liberty-type ship, the *Feuer*, on December 21, 1955, to transport bulk commodities such as grain. Its cost was \$469,000. The taxpayer assigned the ship a salvage value of \$54,000 and a useful life of three years, both of which estimates were qualifiedly approved by the Internal Revenue Service.¹³ The Suez crisis of 1956 abnormally inflated the price of ships, and the taxpayer was approached by a competitor with an offer to buy the *Feuer*. The offer was accepted and the *Feuer* was sold on December 23, 1957, for \$695,000.

The taxpayer had depreciated the ship on the straight-line method which resulted in depreciation of about \$378.65 per day. At this rate, the adjusted basis of the ship on January 1, 1957 (the first day of the year of sale) was \$326,627.73. In its income tax return for fiscal (and calendar) year 1957, the taxpayer claimed a depreciation deduction of \$135,367.24 for the time it owned the ship in 1957.¹⁴

⁶ For a more detailed treatment of the taxpayer's contentions in this area, see Walther, *Depreciation in the Year of Sale: Recent Developments*, 51 A.B.A.J. 281 (1965).

⁷ 39 T.C. 70 (1962).

⁸ 42 T.C. 1105 (1965), presently on appeal to the Ninth Circuit.

⁹ 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed*, 33 U.S.L. Week 3267 (U.S. Jan. 27, 1965) (No. 862) (the sale of a going concern).

¹⁰ 334 F.2d 617 (2d Cir. 1964), *petition for cert. filed*, 33 U.S.L. Week 3192 (U.S. Nov. 13, 1964) (No. 685).

¹¹ 335 F.2d 15 (2d Cir. 1964), *cert. granted*, 379 U.S. 998 (1965).

¹² *Ibid.*

¹³ The taxpayer applied for a ruling from the Engineering and Valuation Branch of the IRS with respect to depreciation of the ship. The IRS ruled in a letter dated December 18, 1955, that it would accept a three year useful life and a \$54,000 salvage value. The letter also stated that estimated useful life was subject to change as experience might warrant and that the ruling was not to be construed as binding as to useful life.

¹⁴

Calendar Year	Period of Ownership (Days)	Depreciation Claimed
1955	10	3,786.50
1956	366	138,585.77
1957	357½	135,367.24

This deduction was entirely disallowed by the Commissioner, even though he had approved both the salvage value and the useful life estimated by the taxpayer at the time of acquisition.

A. *The Argument Supporting Allowance Of Depreciation In The Year Of Sale*

The taxpayer contends that the automatic disallowance of depreciation in the year of sale without regard to when the asset was sold, or to whether the depreciation schedule was reasonable, violates the judicial, legislative, and administrative authority which has developed around what is now section 167 of the Internal Revenue Code of 1954. The allowance of depreciation in the year of sale was so well established that it was seldom litigated prior to Revenue Ruling 62-92.¹⁵ In the most important case on the subject prior to *Cohn v. United States*, viz., *Wier Long Leaf Lumber Co.*,¹⁶ the Commissioner's attempt to deny depreciation solely because the sales price exceeded the adjusted basis was disapproved. In *Wier* the Commissioner equated the sales price to salvage value. The issue was whether the fact that the price received from the sale of depreciated automobiles was greater than their combined adjusted bases, should preclude a depreciation allowance. In answer to this question the court stated that "it must be taken as settled that mere appreciation in value due to extraneous causes has no influence on the depreciation one way or the other."¹⁷

The *Wier* case also involved the question of the propriety of depreciation of a mill when the taxpayer had failed to prove the reasonableness of its estimated salvage value. Here, the depreciation deduction was correctly disallowed. Hence, the *Wier* case stands for the proposition that the Commissioner may reject depreciation estimates if the estimates were unreasonable when made, but depreciation deductions should not be disallowed solely because the asset's market value falls below the adjusted basis. At this point it should be noted that the Commissioner in *Fribourg* is not questioning the reasonableness of the taxpayer's depreciation schedule, but is questioning an increase "normally associated with capital gain" due to a change in market conditions caused by the Suez Crisis of 1956-57.¹⁸ This attempted denial of depreciation in the *Fribourg* case is in direct conflict with the principle established in *Wier Long Leaf Lumber Co.*

¹⁵ For examples of early cases permitting a depreciation deduction in the year of sale, see *Ludey v. United States*, 274 U.S. 295 (1927); *Eldorado Coal & Mining Co. v. Mager*, 255 U.S. 522 (1921).

¹⁶ 9 T.C. 990 (1947).

¹⁷ *Id.* at 999.

¹⁸ 335 F.2d at 18.

In 1960, the Supreme Court, in *Massey Motors, Inc. v. United States*, held that the useful life of an asset should be determined by the length of time the taxpayer reasonably expects to use it in his business, and not by its physical life.¹⁹ But *Massey* does not support the Commissioner's action in equating the useful life of an asset to the taxpayer, with the length of time the asset actually is used.²⁰

Turning from the judicial viewpoint of depreciation to that of the legislative branch, one may note that Congress has allowed "a reasonable allowance for the exhaustion, wear and tear," since the Revenue Act of 1913. The tax concept of depreciation is to allow recovery of the cost of an asset through periodic deductions from ordinary income. Regardless of market appreciation, depreciation (exhaustion, wear, tear) occurs; it is this expense which Congress intended the taxpayer to recover. Congress was aware of the possibility of the use of depreciation deductions for tax avoidance.²¹ However, it was not until 1962 that Congress responded to the Commissioner's request to limit the tax reduction effect by enacting section 1245.²² That section provides for recapture, in the year of sale, of excessive depreciation.

Congress intended section 1245 to apply prospectively only.²³ The Commissioner, however, is attempting to apply the principle of section 1245 retroactively through Revenue Ruling 62-92. Moreover, it has been contended that the Commissioner might use Revenue Ruling 62-92 to disallow depreciation in areas exempted by Section 1245.²⁴ The Commissioner's attempted application of Revenue Ruling 62-92 clearly is out of line with congressional policy. In addition to violating the already established judicial and legislative precedent, Revenue Ruling 62-92 violates the government's own regulations. Those regulations provide, among other things, that an asset may not be depreciated below a reasonable salvage value, that salvage value shall be changed only if useful life is unreasonably estimated and not merely because of changes in price level, and that when an asset is sold at arms length, recognition of sections 1002 and 1231 should be given.²⁵ Treas. Reg. 1.167(b)(o) which allows the reasonableness of

¹⁹ 364 U.S. 92 (1960).

²⁰ "[I]t must be borne in mind that even the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held." 364 U.S. at 113 (Harlan, J., dissenting).

²¹ *S & A Co. v. United States*, 338 F.2d at 633.

²² See text accompanying notes 40, 41 *infra*.

²³ Section 1245 covers certain property disposed of after December 31, 1962.

²⁴ Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 Yale L.J. 1483, 1485 (1963).

²⁵ Treas. Regs. §§ 1.167(a)-1(a), 1.167(a)-1(c) (1964). See note 34 *infra* for text of

any claim of depreciation to be determined upon the basis of conditions known to exist at the end of the period, and upon which the Commissioner also relies, should be read only in light of the above provisions.

Not only is Revenue Ruling 62-92 contra to the regulations, but it also contradicts the Commissioner's position in *Whitaker v. Commissioner*.²⁶ In that case, the taxpayer argued that his salvage value should be reduced to allow additional depreciation because the sales price was substantially lower than the adjusted basis. This is of course the logical conclusion if one interprets Revenue Ruling 62-92 to the effect that actual sales price equals salvage value. But the Commissioner successfully argued that the reverse application of Revenue Ruling 62-92 should not be sanctioned. The Commissioner's position is that if the asset is sold above its adjusted basis, depreciation is disallowed so that salvage value equals sales price; but if the asset is sold at a loss, the taxpayer is not allowed to increase his depreciation so that salvage value equals sales price.

The Commissioner's reliance upon the *Cohn* case to expand his disallowance of depreciation when the sales price exceeds the beginning of the year adjusted basis results from a misinterpretation of that decision. The important facts in *Cohn* are: (1) the taxpayer failed to set a salvage value, and (2) only the reasonableness of the last year's salvage value was in question.²⁷ In giving its approval to the district court's determination of the salvage value in the year of sale, the Sixth Circuit was concerned with a question of fact (whether or not the salvage value set by the district court was clearly erroneous) and was not establishing a broad rule of law overturning existing judicial or legislative authority. Moreover, the fact that the Commissioner sought revision of salvage value for reasons other than market fluctuations shows that the policy the government is now following was not before the court in *Cohn*. Finally, it was not until four years after *Cohn* that the Commissioner challenged depreciation in the year of sale solely because an asset's sale price exceeded its first of year adjusted basis.²⁸

When properly limited to its factual holding, the *Cohn* case stands for the proposition that salvage value should be adjusted if the esti-

these regulations. Treas. Reg. § 1.167(a)-8(a)(1): "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 the law."

²⁶ 259 F.2d 379 (5th Cir. 1958).

²⁷ 259 F.2d 371, 374, 379.

²⁸ Merritt, *Government Briefs in Cohn Refute IRS Disallowance of Year-of-Sale Depreciation*, 20 J. Taxation 156 (1964).

mate was unreasonable when made. In other words, depreciation allowances should not be disturbed unless the taxpayer fails to set a salvage value, or employs one which is unreasonable when made. Thus, the resale value of an asset which has appreciated in value solely as a result of market conditions would not warrant readjustment of salvage value. Similarly, the sales price should never be determinative of salvage value unless the salvage value was unreasonable when estimated and unless the sale was made at or near the end of the useful life of the asset.²⁹ An anticipated sale before the end of useful life would have little, if any, relationship to salvage value.³⁰

Applying the above principles of depreciation to the factual situation in *Fribourg*, one sees that the sale of the asset involved does not call for a redetermination of salvage value. The depreciation estimates were reasonable when made. The estimated useful life of the ship sold was based upon the actual foreseeable use of the asset to the taxpayer. In addition, the reopening of the Suez Canal caused the market value of the Liberty-type ships to fall from the originally inflated price to the point that the salvage value of the *Feuer* as originally set was a reasonable estimate.³¹ Therefore, the capital gain received by the taxpayer was attributable solely to market factors and not to an unreasonable estimate of depreciation.

As previously stated, the sale of an asset in the middle of its useful life has little relevance in determining the reasonableness of the salvage value estimate. The taxpayer in *Fribourg* was approached by a buyer who was attempting to capitalize upon a development calling for an increase in use of the Liberty-type ship. The sale, therefore, was an unanticipated one with a substantial part of the ship's useful life remaining.

B. *Argument In Support Of The Commissioner's Position*

The Commissioner's basic position is simply that depreciation deductions should not be allowed in the year of sale when an asset is sold for more than its adjusted basis at the first of the year of sale. The reasoning behind this position is that to allow depreciation in the year of sale is, in effect, to allow the taxpayer to recover, tax-free, *more* than the cost of the asset to him. Otherwise stated, the taxpayer should not be allowed a depreciation deduction when he suffers

²⁹ The reason that a sale at or near the end of the useful life might be relevant in the determination of the reasonableness of salvage value is that salvage value is by its definition an estimation of value at the end of the useful life of the asset.

³⁰ *Macabe Co.*, 42 T.C. 1105, 1111 (1965).

³¹ Brief for Petitioner, pp. 4-5, *Fribourg Navigation Co. v. United States*, 335 F.2d 15 (2d Cir. 1964), *cert. granted*, 379 U.S. 998 (1965).

no loss on the asset.³² The Supreme Court has said that the purpose of Congress in establishing depreciation deductions was to allow the taxpayer to recover the cost of the asset (minus any salvage value); Congress' intent was *not* to provide the taxpayer with a means of tax avoidance.³³

The depreciation deduction is a deduction against ordinary income. If the estimated useful life is too short, if the estimated salvage value is too low, or if the method of depreciation allows too much depreciation in the early years, the adjusted basis may be less than the actual value. When this situation exists, sale of the asset results in a gain which would be taxed as capital gain, thus allowing what should be ordinary income to be converted into capital gain.³⁴

The government contends that the taxpayer should not be allowed to avoid taxes in this manner. The government further contends that it makes no difference whether the excess of sales price over first-of-year adjusted basis is due to incorrect estimates or to appreciation due to market fluctuations; the important thing is that the taxpayer not be allowed a depreciation deduction when the asset has not depreciated in value. The passage of section 1245 indicates that Congress is in agreement with the basic contentions of the government.

This basic position may be reconciled with the applicable Treasury regulations,³⁵ for even though salvage value must be estimated, its

³² For example, taxpayer, T, buys a truck for \$10,000 on January 1, 1965. He assigns it a salvage value of \$1,000 and a useful life of ten years; the depreciation deduction on a straight-line basis is \$900 a year. On July 1, 1966, he sells the truck for \$9,500. Should T be allowed the depreciation deduction of \$450 for the six months he owned the truck in 1966? The truck cost him nothing in the way of depreciation in 1966 because he sold it for more than its book value on January 1, 1966; to allow the taxpayer to take the depreciation deduction is to allow him to recover the \$450 at capital gains rates rather than ordinary income. Thus, the taxpayer could use depreciation deductions to avoid taxation.

³³ *Massey Motors v. United States*, 364 U.S. 92, 101, 107 (1960).

³⁴ U.S. Code Cong., 87th Cong., 2d Sess. 3398 (1962).

³⁵ Treas. Reg. § 1.167(a)-1(a) (1964) provides in part:

The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan . . . 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. . . . *An asset shall not be depreciated below a reasonable salvage value* under any method of computing depreciation. . . .

(Emphasis added.)

Treas. Reg. § 1.167(a)-1(b) (1964) provides in part:

[T]he 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. . . . *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 when necessary regardless of the method of computing depreciation.* However, estimated remaining useful life shall be redetermined only when the change

reasonableness may be redetermined on the basis of conditions known to exist at the end of the period for which the return is made.³⁶ In the *Fribourg* case, the *actual* salvage value (sales price) of the ship was known a week before the end of the accounting period.³⁷ It is unreasonable to continue to follow an estimate when it is known that the estimate is wrong.³⁸

Furthermore, the *Cohn* case authorizes a redetermination of salvage value at or near the end of useful life when there is a substantial difference in the salvage value estimated at the time of acquisition and the actual salvage value indicated by the sales price. Doubtless there is a substantial difference here in the selling price (\$699,500) and the estimated salvage value (\$54,000). According to the government's basic theory, as reflected by Revenue Ruling 62-92, it should make no difference whether the sale is at the end of useful life or in the middle.³⁹

As for the taxpayer's argument that Congress did not intend section 1245 and section 1250 to be retroactive and thereby does not approve of Revenue Ruling 62-92, it should be pointed out that those sections deal with a much broader problem than depreciation in the year of sale. They provide for the recapture of depreciation taken prior to the year of sale. For that reason it cannot be said that disallowance of depreciation in the year of sale is a retroactive applica-

in the useful life is significant and there is a clear and convincing basis for the redetermination. . . .

(Emphasis added.)

Treas. Reg. § 1.167(a)-1(c)(1) (1964) provides in part:

Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset. . . . 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 . . . salvage value may be redetermined upon facts known at the time of such redetermination of useful life . . . *in no event shall an asset . . . be depreciated below a reasonable salvage value.* . . .

(Emphasis added.)

³⁶ Treas. Reg. § 1.167(b)-0(a) (1956) provides in part:

[D]eductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. *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.*

(Emphasis added.)

³⁷ 335 F.2d at 16.

³⁸ The Tax Court has indicated that known conditions at the end of the year would be good cause to redetermine useful life. *Smith Leasing Co. v. Commissioner*, 43 T.C. 37, 47 (1964). It would seem that this same reasoning could be applied to salvage value.

³⁹ Useful life was held by the Supreme Court in *Massey Motors*, 364 U.S. 92, 97, 98, 99, 107 (1960), to be the time the asset is expected to be used by the taxpayer. The government would like to have the actual period the taxpayer holds the asset be considered its useful life.

tion of those sections. In addition, Congress seems to approve of the disallowance of depreciation in the year of sale. A committee report on section 1250 states:

[S]ince in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they actually reduce the adjusted basis of the property below the amount actually realized. This provision, in providing for ordinary income treatment for certain additional depreciation is not intended to affect this holding.⁴⁰

C. Sections 1245 And 1250

Much of the conflict presented by the adversary opinions above has been resolved by sections 1245 and 1250. Section 1245 was added to the Code by the Revenue Act of 1962 and provides for the "recapture" of all depreciation deductions on "section 1245 property"⁴¹ taken since December 31, 1961. The provision accomplishes this purpose by treating as ordinary income any gain on the sale of the asset to the amount of depreciation taken after 1961. Any amount realized on the sale *above* the amount of depreciation taken since 1961 is taxed at capital gains rates. The cut-off date of December 31, 1961, is one factor that makes *Fribourg* and its companion cases important. Many depreciable assets were sold before that date and much litigation concerning those sales is pending.

Section 1250 is more limited in scope than section 1245, but covers buildings and real property not subject to section 1245. This section provides for full recapture if the property is held for twelve months or less; thereafter, the section recaptures only that amount of depreciation which exceeds the straight line depreciation. If the property is held for more than twenty months, the excess depreciation is reduced by one percentage point for each month over twenty the property is held. Hence, if the property is held for ten years, there will be no recapture of depreciation.⁴²

IV. CONCLUSION

The taxpayer contends that since the asset sold bore a salvage value reasonable when made and since the gain from the sale resulted solely from market conditions, Revenue Ruling 62-92 should not deprive

⁴⁰ S. Rep. No. 830, 88th Cong., 2d Sess. 133 (1964).

⁴¹ "Section 1245 property" is (a) personal property, (b) other tangible property (not including a building or its structural components) which is an integral part of certain businesses, or (c) an elevator or escalator. Int. Rev. Code of 1954, § 1245(a)(3).

⁴² For a more detailed explanation see, Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 Yale L.J. 1483 (1963).