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Taxation -- Depreciation -- Useful Life, Salvage Value and Capital Gains Under the Declining Amount Depreciation Methods of the 1954 Code

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The warranty of quiet possession is abolished. Disturbance of quiet possession, although not mentioned specifically, is one way, among many, in which the breach of the warranty of title may be established.

The view advocated in this note, that the warranty of title is violated when the title conveyed is unsound although the buyer is not yet disturbed by adverse claimants, is adopted in the Code in connection with a particular situation. The Code specifies that "a seller who is a merchant regularly dealing in goods of the kind warrants that the goods shall be delivered free of the rightful claim of any third person by way of infringement or the like. . . ." ²¹ A comment states that "this section rejects the cases which recognize the principle that infringements violate the warranty of title, but deny the buyer a remedy unless he has been expressly prevented from using the goods. Under this Article 'eviction' is not a necessary condition to the buyer's remedy since the buyer's remedy arises immediately upon receipt of notice of infringement; it is merely one way of establishing the fact of breach." If this be sound law as to merchants when a title is invalid by reason of infringements, it would appear to be sound law generally where the title is invalid by reason of other infirmities.

BAILEY PATRICK, JR.

Taxation—Depreciation—Useful Life, Salvage Value and Capital Gains Under the Declining Amount Depreciation Methods of the 1954 Code

The Internal Revenue Code of 1954 authorizes taxpayers in business to compute a reasonable allowance for depreciation by means of liberalized, declining amount methods in addition to the ordinary straight line method.¹ However, section 167(c) expressly provides that these liberalized methods "shall apply only in the case of property (other than intangible property) . . . with a *useful life* of 3 years or more" (Emphasis added.)²

²¹ UNIFORM COMMERCIAL CODE § 2-312 (3).

¹ INT. REV. CODE OF 1954, § 167. Section 167(b) provides:

For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

- (1) the straight line method,
- (2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),
- (3) the sum of the years-digits method, and
- (4) any other consistent method productive of an annual allowance. . . .

² Section 167(c) has other limitations on the use of the liberalized methods of depreciation, not pertinent to this Note, which in effect require that such

In *Hertz Corp. v. United States*,³ a recent district court decision, a thorough analysis was made of some of the most common issues of depreciation—useful life and salvage value. In 1954, 1955, and 1956, the taxpayer, an automobile rental agency, had held and used some of its automobiles an average period of 26 months. The average economic life of these vehicles for business purposes was four years. On the basis of this latter period, taxpayer sought to depreciate the vehicles under the declining balance method. The Commissioner disallowed the use of this method because the taxpayer had held the vehicles for only 26 months—a period less than the three-year period prescribed by section 167(c). Furthermore, the Commissioner disallowed declining balance depreciation deductions on trucks, even though the taxpayer had held the trucks more than three years, contending that taxpayer had taken depreciation beyond a reasonable salvage value.⁴

Taxpayer contended that it was entitled to use the method, urging that the useful life of the vehicles extended over the entire business life of four years, regardless of the holding period.⁵ Further, taxpayer contended that no salvage value need be estimated and accounted for under the declining balance method, other than the residual sum inherent therein.

The specific issues before the court were: (1) whether it was the intent of Congress to change the meaning of "useful life" when enacting the 1954 Code; (2) if so, whether such new definition may be retroactively applied from the time of its appearance in the 1956 regulations; and (3) whether salvage value is inherent in the declining balance method or must be accounted for as required under the 1956 regulations.⁶

The court, after a review of legislative history and pertinent case law, concluded that taxpayer could not use the declining balance method for those vehicles held by it for less than three years, because Congress intended "useful life" to mean the life of the asset in the hands of taxpayer. However, it was held that the deficiency assessments of the Commissioner could not be applied retroactively to years before the promulgation of the asserted regulations of 1956, due to the fact that the taxpayer was justified in relying upon the Commissioner's acquiescence in the meanings of "useful life" and "salvage value" as those asserted by the taxpayer. Also, the court allowed the taxpayer to

tangible property shall have been completed or originally acquired after December 31, 1953.

³ 165 F. Supp. 261 (D. Del. 1958).

⁴ See generally Treas. Reg. §§ 1.167(a)-1(a), (c) (1956).

⁵ Certified public accountants testified on behalf of the taxpayer that "useful life" has consistently meant, and still means, the economic life of the asset in whatever hands; and that the useful life of automobiles used for business purposes is four years. 165 F. Supp. at 265.

⁶ 165 F. Supp. at 266.

depreciate the qualifying trucks down to the inherent residuum without accounting for salvage value as defined under the new regulations.⁷

As the court admitted, the problems raised are not only "interesting and novel, but also difficult of approach."⁸ Perhaps an acceptable approach would be to show why depreciation assumes greater importance today than mere accounting procedure, how this importance led to the problems raised in the principal case, and how the court there deviated from the purpose of the 1956 regulations in holding salvage value to be inherent in the declining balance method.

Taken literally, "depreciation" is the converse of "appreciation," and means a decrease in value not necessarily due either to use or lapse of time. Here, the word is used to reflect, not the literal meaning, but the statutory language, *i.e.*, the amortization of long-term costs by periodic deductions of a "reasonable allowance for . . . exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . ."⁹

One authority concludes from an examination of early accounting literature in England that the idea of depreciation was recognized at the time of the American Revolution and related to the assignment of long-term plant costs to the various accounting periods.¹⁰ Today, however, the concept of "depreciation" has come to mean more than mere accounting procedure. This is true because of the occurrence of two events: (1) the steady decline of the dollar's purchasing power, and (2) the enactment of the Internal Revenue Code of 1954. The former has induced business to seek a process whereby higher replacement costs can be anticipated in part from revenues to supplement the inadequate allowances of amortization—more specifically, depreciation. The 1954 Code appeared to give business such a process by way of the liberalized, declining-amount depreciation methods found under section 167, and the

⁷ "On this latter point, both the Commissioner in the past and Congress presently are in complete agreement, and the intent of Congress being clear, I conclude that salvage value other than that which is inherent in the method is not a factor in determining depreciation under the declining balance theory of depreciation." 165 F. Supp. at 275.

⁸ 165 F. Supp. at 266.

⁹ INT. REV. CODE OF 1954, § 167(a). In *United States v. Ludley*, 274 U.S. 295 (1927), Mr. Justice Brandeis set out the general formula as follows:

"The amount of the allowance for depreciation is that sum which should be set aside for the taxable year, in order that, at the end of the *useful life* of the plant in the business, the aggregate of the sums set aside will (with *salvage value*) suffice to provide an amount equal to the original cost." (Emphasis added.) *Id.* at 300.

See also *Even Realty Co.*, 1 B.T.A. 355 (1925); 4 MERTENS FEDERAL INCOME TAX § 23.33 (1954).

¹⁰ In 1764, the following entry was made in an expense report for maintaining and preserving the canal from Forth to Carron Water: "I suppose in 20 years time many of the locks will want new gates, all of which will gradually fail in a few years after. I, therefore, suppose them all made at the end of 20 years and, therefore, 72 locks at 60 pounds per lock . . . 4,320 pounds." Perry Mason, *Illustrations of the Early Treatment of Depreciation*, 8 ACCOUNTING REV. 209, 210 (1933).

preferential capital gains treatment afforded certain business assets under section 1231.¹¹ These declining-amount methods allow the taxpayer to depreciate high initial costs against present sales so as to reduce taxable income and thereby gain a temporary advantage.¹² Probably the primary purpose of the declining-amount methods is to keep American industry modern by encouraging firms to retire plant assets before such assets became absolutely obsolete.¹³ The declining balance method used by the taxpayer in the principal case was one of these methods.¹⁴

To the tax-conscious taxpayer who could take advantage of the declining-amount methods and the capital gain benefits of section 1231, an obvious opportunity to avoid taxes by converting ordinary income into capital gains presented itself. Even with the requirement of a three-year useful life as a condition precedent to the use of the declining-amount methods, the taxpayer, assuming that "useful life" was the period of economic usefulness of the asset, proposed to take the largest depreciation deductions allowable and then sell the assets after a one or two year holding period—a period during which the asset would be useful to him, but less than the economic life of the asset.¹⁵ Obviously, since

¹¹ INT. REV. CODE OF 1954, § 1231. Section 1231(a) allows capital gain treatment, under specific circumstances, of "recognized gains on sales or exchanges of property used in trade or business." Section 1231(b) defines the term "property used in the trade or business." It includes, *inter alia*, non-inventoriable property which is held for more than six months and is depreciable under § 167.

¹² Most businessmen and accountants agree that the two basic objectives of a sound depreciation policy are: (1) to incur the lowest possible long-term tax costs, and (2) to achieve the maximum conservation of working capital. Inasmuch as depreciation generally does not affect the volume of sales, it is obvious that any change in working capital must come from the postponement of tax payments. This is the function of those liberalized methods of depreciation found under § 167(b) of the 1954 Code. Though the tax is merely deferred, a permanent advantage is derived from the *use* of the increased working capital. See generally Reynolds, *The Impact of the Choice of Base and Method of Amortization*, May 1957 (unpublished thesis in University of North Carolina Main Library).

¹³ 165 F. Supp. at 272. H. R. REP. No. 1337, 83rd Cong., 2d Sess. 24 (1954), contains the following:

More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well-timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risks. The faster write-off would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living. *Ibid.*

¹⁴ See note 1 *supra*.

¹⁵ The use of the 200 percent declining balance rate in case of short-lived properties would result in extremely fast write-offs. For example, in the case of an asset with a 2 year service life, the doubling of the 50 percent straight line rate would be equivalent to *expensing* the cost in the year of acquisition. These properties would retain substantial value and could be resold subject to capital gains rates.

To prevent unrealistic deductions and resulting tax avoidances, your committee has provided that the liberalized methods be made available only with

"useful life" was assumed to be the entire business life of the asset, "salvage value" was understood to be that residual or scrap value remaining after the business life was exhausted; and the taxpayer only accounted for salvage value in this manner, if at all.¹⁶ Thus, in view of the relatively high market demand for used assets and the rapid depreciation of initial cost, it can be seen that these assets brought a price substantially higher than scrap value. The taxpayer obtained 1231 treatment on the gains realized,¹⁷ causing revenue losses which the Treasury sought to combat by various methods.

These methods of attack by the Treasury were basically as follows:

(1) asserting that the assets sold by taxpayer were items of inventory, and therefore not qualified for capital gain treatment under section 1231; (2) seeking to readjust useful life and salvage value, either by lengthening useful life so as to reduce the depreciation rate per annum or by increasing salvage value so as to reduce the amount of depreciation allowable; or (3) asserting that "useful life" was meant to be that period during which the asset was in the hands of the individual taxpayer, and "salvage value" to be the estimated value of the asset at time of disposition. It was on the basis of this third method that the 1956 regulations sought to prevent the tax avoidances and resulting revenue losses mentioned.

respect to assets with *useful lives of 3 or more years*. (Emphasis added.) S. REP. No. 1622, 83rd Cong., 2d Sess. 29 (1954).

¹⁶ Koelling v. United States, 57-1 U.S. Tax Cas. ¶ 9453 (E.D. Neb. 1957); 4 MERTENS FEDERAL INCOME TAX § 23.28 (1954) ("as a matter of practice salvage value is sometimes ignored").

¹⁷ INT. REV. CODE OF 1954, §§ 1221, 1231.

To illustrate this idea assume that an automobile agency starts business in 1954 with 200 cars costing \$300,000. If it depreciates these cars on a three-year basis and takes 66⅔% depreciation in the first year (twice the straight line rate) as allowed under the Code, its depreciation expense in 1954 would be \$200,000. Assuming revenue of \$500,000 and expenses other than depreciation of \$300,000, net taxable income would be zero. Then suppose that the cars are sold at the end of the first year for \$200,000; there would be a capital gain of \$100,000. The total tax would be only \$25,000. Comparatively, if the straight line method were followed, there would be, under the same facts, \$125,000 ordinary income. The tax bill on this income at the corporate tax rate would be \$59,500. The following schedule illustrates the difference:

CORPORATE PROFIT AND LOSS	DECLINING BALANCE	STRAIGHT LINE
Ordinary Income	<u>\$500,000</u>	<u>\$500,000</u>
Expenses:		
Depreciation (*adjusted for salvage value)	200,000	\$ 75,000*
Other	300,000	300,000
Total	<u>\$500,000</u>	<u>\$375,000</u>
Taxable Ordinary Income	<u>-0-</u>	<u>\$125,000</u>
Tax on Ordinary Income (corporate rates)	<u>-0-</u>	<u>\$ 59,500</u>
Capital Gains	<u>\$100,000</u>	<u>-0-</u>
Tax on Capital Gains (25%)	<u>\$ 25,000</u>	<u>-0-</u>
Total Tax	<u>\$25,000</u>	<u>\$ 59,500</u>

In *Philber Equipment Co. v. Commissioner*,¹⁸ new automobiles were leased for one or two years to taxpayer's customers and then sold upon termination of the leases. The Commissioner contended that the automobiles were inventoriable goods held principally for sale to the customers in the ordinary course of business and, therefore, that the gains received from the sales could not qualify for capital gain treatment under section 1231. The court of appeals reversed the judgment of the lower court in favor of the Commissioner upon the theory that the acquisition, use, and disposition of the vehicles were consistent with the *business purpose* of vehicle rentals. It was held that the gains from the sale of such assets qualified for 1231 treatment.¹⁹

In *Pilot Freight Carriers, Inc.*,²⁰ the taxpayer was depreciating its tractors over a period of four years, and its trailers over a period of five years. These vehicles were disposed of after average holding periods of 33 and 38 months, respectively. The Commissioner contended that the useful lives of the assets were being *understated* by the taxpayer because it (taxpayer) was receiving amounts upon disposition of the assets greatly in excess of their adjusted bases at time of sale. The Commissioner determined tax deficiencies computed on the basis of a useful life of *five* years for the tractors and *six* years for the trailers. The court held that the useful lives were correctly stated by the taxpayer. The Commissioner was not allowed to assert an understatement of salvage value because the issue had not been framed in his pleadings; but since salvage value cannot be redetermined unless useful life is also redetermined,²¹ the omission probably did not weaken the Commissioner's case.

It can be seen that in seeking to prevent the taxpayer from realizing a substantial capital gain in the *Pilot* case and in seeking to prevent taxpayer from obtaining capital gain treatment altogether under section 1231 in the *Philber* case, the Commissioner was taking inconsistent positions. In the *Pilot* case, the Commissioner was seeking to prevent a capital gain by extending the useful lives of the assets beyond those periods estimated by the taxpayer. In the *Philber* case, the Commis-

¹⁸ 237 F.2d 129 (3d Cir. 1956).

¹⁹ *Accord*, Davidson v. Tomlinson, 165 F. Supp. 455 (S.D. Fla. 1958); Lynch-Davidson Motors, Inc. v. Tomlinson, CCH 1958 STAND FED. TAX REP. ¶ 9738. Taxpayer, an auto dealer, was held entitled to depreciation and capital gains treatment on various cars and trucks that were set aside from its used car business and used for company purposes. They were not properly includible in inventory since they were not held primarily for sale in the ordinary course of business.

²⁰ 25 P-H Tax Ct. Mem. 195 (1956).

²¹ Treas. Reg. § 1.167(a)-1(c) provides in part:

[S]alvage 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), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life.

sioner was apparently acquiescing in the useful lives of the assets, and allowing the gains realized, but asserting that such gains could not qualify for capital gain treatment.²² These positions of the Commissioner were also inconsistent with his later position based on the 1956 Regulations where he sought to prevent the realization of a 1231 gain on the sale of such assets by defining "useful life" as *that period during which the asset was used by the individual taxpayer* and not as the business life of the asset.

Before the appearance of the 1956 Regulations, the taxpayer relied on the business community's definitions of the concepts of "useful life" and "salvage value."²³ Such reliance appeared justified since Congress, while recognizing the need for such concepts, has never announced an official explanation of either term.²⁴ The courts apparently construed the terms in the same manner as did the taxpayer; and the Commissioner, as illustrated by such cases as *Pilot*,²⁵ acquiesced in the community-developed meanings, *viz.*, just as "useful life" was considered that period for which the asset was functionally usable, "salvage value" was understood to mean that residual or scrap value which naturally remained after the asset was physically exhausted. Probably the most affirmative position towards definition taken by the Treasury, before the 1956 regulations, appeared in Bulletin "F." There the government listed such factors as wear and tear, decay or decline from natural causes, and "various forms of obsolescence attributable to the art, economic changes, inventions, and inadequacy to the growing needs of the trade or business" as important in the determination of the useful life of

²² This contention of the Commissioner is clearly inconsistent with congressional intent as manifested by § 1231(b), expressly providing for capital gain treatment of certain depreciable assets. See note 11 *supra*. Cf. INT. REV. CODE OF 1954, § 179 (added by Technical Amendments Act of 1958, § 204), where businesses (not including trusts) may elect to write off 20% of the cost of tangible personal property in the year of acquisition, *in addition to* the regular depreciation on the balance. However, this additional 20% allowance is limited to tangible assets with a remaining useful life of at least 6 years.

²³ See note 16 *supra* and accompanying text.

²⁴ Although the terms were not given definition, the Treasury has utilized them from an early date. Treas. Reg. 45, art. 161 (1919) provided: "A reasonable allowance for depreciation is that amount which should be set aside for the taxable year [so that] . . . the aggregate of such amounts for the *useful life* of the property in the business will suffice, with the *salvage value*, at the end of such useful life to provide in place of the property its cost. . . ." (Emphasis added.) Article 165 of the same regulation provided that the "capital sum to be replaced should be charged off over the useful life of the property." See also Treas. Reg. 118, § 39.23(l)-1 (1953); Treas. Reg. 111, § 29.23(l)-1 (1942).

²⁵ See also Dorothy Caruso, 23 T.C. 836 (1955); Wier Long Leaf Lumber Co., 9 T.C. 990 (1947), *rev'd on other grounds*, 173 F.2d 549 (5th Cir. 1949); Norris Lumber Co., 7 CCH Tax Ct. Mem. 728 (1948); General Sec., Inc., 11 P-H B.T.A. Mem. 219 (1942), *aff'd per curiam*, 137 F.2d 201 (6th Cir. 1943) (taxpayer used cars for one or two years—depreciation allowed on basis of three-year useful life); Terminal Realty Corp., 32 B.T.A. 623 (1935); American Refrigerator Transit Co., 31 B.T.A. 465 (1934); Merkle Broom Co., 3 B.T.A. 1084 (1926) (automobiles exchanged within two years of purchase; court held that the proper rate of depreciation was 25%, over a *four year period*).

property in the trade or business. But nowhere in the Bulletin appear definitions of "useful life" and "salvage value."²⁶ The taxpayer, therefore, established depreciation policies based upon the accelerated methods of depreciation when they first became available under Section 167(b) of the 1954 Code, and in some instances, since it was understood that "useful life" meant the economic life of the assets, these methods were also applied to assets that were *held* for less than three years by the taxpayer.

Probably the first public notice of the coming change in the definitions of "useful life" and "salvage value" appeared when the Assistant to the Secretary of the Treasury, Laurens Williams, submitted a letter to Representative Thomas B. Curtis of Missouri. This letter appeared in the *Congressional Record* on June 16, 1955, and stressed the definitions of "useful life" and "salvage value" as they were to later appear in the new Regulations. The following is an excerpt from that letter:

[U]seful life . . . is not the full, normally inherent useful life of the property. It is rather, the useful life of the property determined in accordance with the practice of the particular *taxpayer in his trade or business* or in the production of income. If a taxpayer has no consistent practice regarding the disposition of depreciable property, the estimated useful life of his depreciable assets should be determined in the light of experience in the taxpayer's business or industry. (Emphasis added.)²⁷

Then, in 1956, the Treasury Regulations were issued defining "useful life" and "salvage value." The relevant depreciation provisions, set forth in section 1.167(a)-1, state that a reasonable allowance (for depreciation) 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 The allowance shall not reflect amounts representing a mere reduction in market value." (Emphasis added.)

Section 1.167(a)-1(b) provides that the useful life "is the period over which the asset may reasonably be expected to be *useful to the taxpayer* in his trade or business" And, finally, section 1.167(a)-

²⁶ INT. REV. BULL. "F" (1920, rev. 1942), contained such information and statistical data as then constituted the best available indication of Internal Revenue practice and the trend of official opinion in the administration of the pertinent provision relating to determination of deductions for depreciation and obsolescence. The text was revoked in part by Rev. Rul. 90, 91, 1953-1 CUM. BULL. 43, 44, in which the IRS announced its general policy, *still in effect*, not to disturb depreciation deductions, and to propose adjustments only where there was a clear and convincing basis for a change. In 1955, the IRS announced that the remainder of the text was revoked. 1955-8 CUM. BULL. 53.

²⁷ 101 CONG. REC. 8570 (1955).

1(c) provides that "salvage value is the amount (determined at time of acquisition) which 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 . . ." (Emphasis added.)

Obviously this change in policy was not well received by such taxpayers as the plaintiff in the *Hertz* case. They argued that the 1956 Regulations were not in accord with the intent of Congress,²⁸ that Congress understood the former definitions to be correct and contemplated the continued use of such former meanings, and that any change in these meanings would be a change in policy, requiring Congressional action.²⁹ On the other hand, the government argued that Congress left such definitive action to the Treasury under its interpretative powers, that the new regulations merely defined "useful life" and "salvage value" in more detail, and that there was actually no change in their definitions.³⁰

The courts in the few cases decided under the 1956 Regulations seemed to uphold the authority of the Treasury to make such definitions, but took a modified position as to when the definitions were to become effective. This was because the statute of limitations had not run on the taxable years for which the Commissioner was seeking to assess deficiencies, and because the Commissioner had taken inconsistent positions before the 1956 Regulations and had long acquiesced in the practice followed by the taxpayer.³¹ Courts generally do not favor retroactive laws,³² nor the retroactive application of administrative regulations in-

²⁸ In *Hertz*, the court referred to extensive revenue hearings held by Congress during which the Treasury submitted reports to the Ways and Means Committee and the Senate Finance Committee warning against revenue losses through the benefits of capital gains treatment of profits from the sale of assets subject to accelerated depreciation. Also, when Congress limited the taking of capital gains in connection with the rapid amortization of emergency facilities, it did not see fit to limit capital gains upon the sale of assets used in the trade or business. 165 F. Supp. at 273. See H. R. REP. No. 1337, 83rd Cong., 2d Sess. 25 (1954); S. REP. No. 1622, 83rd Cong., 2d Sess. 29 (1954); cf., INT. REV. CODE OF 1954, §§ 168, 1238.

²⁹ "While it is true that a regulation by a department of Government addressed to and reasonably adapted to the enforcement of an Act of Congress, the administration of which is confided to such department, has the force and effect of law if it be not in conflict with express statutory provision, yet the power to enact regulations is not power to alter the law and the regulations have no power to amend or change existing statutory provisions." *St. Louis Co. v. United States*, 134 F. Supp. 411, 414 (D. Del. 1955).

³⁰ The Commissioner's argument could be supported by the fact that Congress set up a standard of "reasonable allowance for depreciation." Thus, it would not be a delegation of legislative power to permit the Treasury, a legislative agency, to make rules that best *define* what is reasonable. *Maryland Cas. Co. v. United States*, 251 U.S. 342 (1920).

³¹ *Evans v. Commissioner*, CCH 1959 STAND. FED. TAX REP. (59-1 U.S. Tax Cas.) ¶ 9208 (9th Cir. Jan. 26, 1959), *reversing and remanding* 26 P-H Tax Ct. Mem. 156 (1957); *Hertz v. Commissioner*, 165 F. Supp. 261 (D. Del. 1958); *Koelling v. United States*, 57-1 U.S. Tax Cas. ¶ 9453 (E.D. Neb. 1957).

³² *Nichols v. Collidge*, 274 U.S. 531 (1927); *Schwab v. Doyle*, 258 U.S. 529 (1922).

interpreting laws in such a manner as to be inconsistent with prior practice.³³

In the recent case of *Evans v. Commissioner*,³⁴ the Commissioner asserted the new Regulations as he did in the principal case. The taxpayer was in the auto-leasing business. During the taxable years of 1951 and 1952, taxpayer leased all of his automobiles through a corporation owned by his son. The leased vehicles were returned to taxpayer at the termination of the leases, usually within 15 months of their original purchase, and then were immediately sold. The vehicles were to be depreciated on the basis of a four-year useful life period and taxpayer made no provision for salvage value. The Commissioner redetermined the depreciation on the basis of a useful life of 17 months and a salvage value of \$1,325 for each vehicle, using as authority subsections 1.167(a)-1(b) and 1.167(a)-1(c) of the new regulations.³⁵

The Tax Court held that "the automobiles which it (taxpayer) leased to U-Drive, Inc. for short-term, had a useful life of 15 months and a salvage value of \$1,375."³⁶ Upon appeal by the taxpayer, the court of appeals reversed because the regulations asserted by the Commissioner and upheld by the Tax Court had been retroactively applied. The court relied on the *Hertz* case where it was stated:

[T]axpayers had a right to file their returns in reliance upon the Commissioner's long-continued interpretation of his own regulations. Here a new regulation has been promulgated defining the term 'useful life' pursuant to a statute which for the first time has employed the term and where the intention of Congress is clearly contrary to the interpretation, as evidenced by conduct and frequent pronouncements, which the Commissioner has given it in the past. Common justice requires it be given a prospective construction only. (Emphasis added.)³⁷

The court implied that the new regulations would be given effect prospectively.³⁸

³³ *Woodworth v. Kales*, 26 F.2d 178 (1928); *cf.* *Gasper v. Commissioner*, 225 F.2d 284 (1955).

³⁴ *Evans v. Commissioner*, *supra* note 31.

³⁵ In the notice of deficiency directed to the petitioner, the Commissioner stated: "It has been determined that the average useful life of the automobiles used in your business based on your actual experience was not in excess of seventeen months and the average salvage value of said automobiles at the end of their useful life in your business was not less than \$1,325. . . ." (Emphasis added.) *Id.* at 71, 399.

It is interesting to note that the Commissioner abandoned his contention that the taxpayer should not be allowed to treat the income from the sales as capital gain. As to this, the court remarked: "The Commissioner's abandonment of this approach was probably influenced by the decision of *Philber Equipment Corp. v. Commissioner*." *Ibid.*

³⁶ CCH 1959 STAND. FED. TAX REP. ¶ 9208 at 71, 392.

³⁷ 165 F. Supp. at 275.

³⁸ The court also allowed capital gain treatment to the taxpayer on the basis of *Philber*.

CONCLUSION

It appears reasonable to predict from *Philber*, and other more recent cases dealing with similar facts,³⁹ that any substantial gains realized by way of extraordinary circumstances from the sale of depreciable assets will be afforded capital gain treatment under section 1231, but that such gains will no longer be obtainable through a depreciation policy based upon the *economic* life of the asset because of the new definitions found under the 1956 Regulations. However, it seems clear from the principal case and the *Evans* case that the new regulations shall not be applied retroactively to years before their promulgation. The taxpayer, relying on the long-continued practice and position of the Commissioner in measuring useful life by the physical or economic life of the depreciable asset, cannot be retroactively assessed for an overstatement of depreciation based on the functional life of the asset.

In all probability, the taxpayer must look for a prospective application of "useful life" to mean the life of the asset in the taxpayer's individual trade or business. "Salvage value" will mean the estimated value of the asset to be realized at the time of its disposition.

However, it should be noted that, under the holding of the principal case, the taxpayer using the declining balance method need not account for salvage value as the estimated realizable value of the asset at time of disposition. The effect of such a holding, upon close analysis, is that a capital gain concession results in favor of the taxpayer using the declining balance method which is not available to taxpayers using any of the other methods of depreciation allowed by the Code.⁴⁰ This is because, under all other methods, salvage value must be deducted before arriving at depreciable basis.⁴¹ Thus, under the other methods, the only capital gain possible is the difference between the estimated value and the price actually realized.

For illustrative purposes, assume that two taxpayers each acquire an asset at the cost of \$3,000, intending to use it in the business for a period of four years. Taxpayer *A* uses the declining balance method. Taxpayer *B* uses the straight line method (any other method could also

³⁹ See note 19 *supra*.

⁴⁰ See note 1 *supra*. Such concession is based on the assumption that taxpayer holds the asset for more than the three years required by section 167(c), but less than the full business life, so that a substantial disparity will result between the price at time of disposition (salvage value, under the new regulations) and the inherent residual balance, the former exceeding the latter.

⁴¹ Treas. Reg. § 1.167(a)-1(c) (1956) provides that "salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation, or by a reduction in the rate of depreciation. . . . See, however, section 1.167(b)-2(a) for the treatment of salvage under the declining balance method."

Treas. Reg. 1.167(b)-2(a) provides that "while salvage value is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value."

apply here). Both expect to sell the asset at the end of the four-year period for an estimated price of \$1,000. Assume, further, that the new concepts of "useful life" and "salvage value" under the 1956 Regulations are in effect, and that the principal case is available for precedent. Taxpayer *A*, by using the declining balance method, need not account for salvage value in arriving at his depreciable basis; taxpayer *B* must subtract his salvage value (\$1,000) in arriving at the depreciable basis of his asset.

The comparative schedule is as follows:

	TAXPAYER <i>A</i>	TAXPAYER <i>B</i>
	DECLINING BALANCE	STRAIGHT- LINE
ACCOUNTING		
Cost of Asset	\$3,000	\$3,000
Less Estimated Salvage Value	-0-	1,000
Depreciable Basis	<u>\$3,000</u>	<u>\$2,000</u>
Depreciation:		
1st year	\$1,500	\$ 500
2nd year	750	500
3rd year	375	500
4th year	187.50	500
Total Depreciation	<u>\$2,812.50</u>	<u>\$2,000</u>
Basis at Time of Sale (cost less deprn.)	\$ 187.50	\$1,000
Selling Price (after 4 yr period)	1,000.00	1,000
Long Term Capital Gain	<u>\$ 812.50</u>	<u>\$ -0-</u>
Tax at 25% (maximum)	203.13	-0-
Net Gain After Taxes	<u>\$ 609.37</u>	<u>\$ -0-</u>
add Recovery on Remaining Basis	187.50	1,000
add Recovery via Depreciation Deductions	2,812.50	2,000
Total Recovery on Investment	<u>\$3,609.37</u>	<u>\$3,000</u>
deduct Original Investment	<u>3,000.00</u>	<u>3,000</u>
Recovery Beyond Original Cost (available for replacement)	<u>\$ 609.37</u>	<u>\$ -0-</u>

Thus, taxpayer *A*, entitled to use the declining balance method because the useful life of the asset in his hands met the three-year condition imposed by section 167(c), was able to compensate for the declining purchasing power of the dollar by recoupment of more than the original cost of the asset and provide funds to meet the expected higher replacement cost of another asset.⁴² Under the holding of the principal case, taxpayer *A* is allowed to depreciate beyond the estimated value at time of disposition (salvage value, under the new regulations) down to the

⁴² See note 11 *supra*.

inherent residual value at the end of the useful life.⁴³ In all probability, this residual value will be a great deal smaller than the estimated value at the time of disposition; especially where the useful life is relatively short so that general obsolescence does not come into play to any appreciable degree.

Taxpayer *B*, having to estimate a reasonable salvage value as the expected price for the asset upon disposition, was confined to realize only the return of his original investment; and the increased cost of his replacement must be obtained from retained earnings or future income, after taxes at the ordinary rate. He gets no concession from the use of section 1231 other than those incidental capital gains which might result from the difference between estimated and actual salvage value.

Assuming that the inherent salvage value in the declining balance method is a "reasonable salvage value," it is obvious from the illustration, *supra*, that business will find it more lucrative to maintain a depreciation policy based on this method. The probable consequence is a mass exodus by industry from the other depreciation methods and a shift to the declining balance method.

That this is obviously not what Congress intended is evidenced by the fact that other methods were enacted without any indication of discrimination in favor of the declining balance method.⁴⁴ It may well be that Congress intended to grant taxpayers in industry extra benefits through the use of the accelerated depreciation methods; but to grant the concession allowed by the court in the principal case only to the declining balance method would result in the relative obsolescence of the other methods allowed under section 167(b) of the 1954 Code.

It is submitted that the *Hertz* case will not be followed on its specific holding that salvage value is inherent in the declining balance method and that the taxpayer need not cease depreciation at the point where the depreciated basis reaches the estimated value of the asset at the time of disposition.⁴⁵ It seems likely that the provisions of the new regulations relating to the definitions of "useful life" and "salvage value" will be upheld in toto, limited only by the requirement that they be given prospective effect.

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⁴³ That the court found such residual sum to be a "reasonable salvage value," although not clearly so stated, may be inferred from two facts. First, the issue of "reasonable salvage value" was asserted by the Commissioner; and, second, the court nevertheless decided in favor of the taxpayer. 165 F. Supp. at 274.

⁴⁴ See note 2 *supra*.

⁴⁵ It is possible that other courts, by a "stretch of the legal imagination," could construe this latter holding to mean that although the taxpayer does not have to account for salvage value other than that inherent in the method, he will have to stop the depreciation process upon reaching an adjusted basis equal to the estimated value of the asset at time of disposition. This is what section 1.167(b)-2(a) of the 1956 Regulations requires. Since the Commissioner was asserting this very section, it would appear difficult for the courts to give such construction to the holding.