RECAPTURE OF DEPRECIATION AND SECTION 1245 OF THE
INTERNAL REVENUE CODE

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THE Revenue Act of 1962,¹ among its other features, brought into the tax base a great many items which, under prior law, had been considered unrealized income and therefore not yet subject to tax. The 1962 Act also broadened the scope of the ordinary income tax at the expense of the capital gains tax. New provisions dealing with controlled foreign corporations² and recapture of depreciation³ are significant in both respects. This article deals with recapture of depreciation under the newly enacted Code section 1245.

I. RECAPTURE OF DEPRECIATION IN GENERAL AND SUMMARY OF
SECTION 1245

Even though depreciation deductions are offset against ordinary income, under previous legislation gains on the sale of depreciable property have been taxed generally as capital gains.⁴ The Treasury Department has been concerned by the revenue loss which results from depreciation deductions which reduce the tax cost basis of depreciable property below its selling price on

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1. Pub. L. No. 87, 87th Cong., 2d Sess. (October, 1962) [hereinafter cited as 1962 Act]; see H. R. REP. No. 1447, 87th Cong., 2d Sess. (1962) [hereinafter cited as H. R. REP. No. 1447] and S. REP. No. 1881, 87th Cong., 2d Sess. (1962) [hereinafter cited as S. REP. No. 1881].

2. Sections 12 and 15 of the 1962 Act.

3. Section 13 of the 1962 Act. This amended the 1954 Code by (1) adding section 1245; (2) amending section 167(e) (permitting more flexibility in changes in methods of depreciation); (3) adding section 167(f) (permitting salvage value of personal property to be disregarded in certain instances); (4) adding section 170(e) (providing for a reduction of the amount allowable as a charitable contribution in certain instances); (5) amending section 613(a) (dealing with percentage depletion); (6) amending section 751(c) (expanding the scope of unrealized receivables under the partnership provisions); (7) making conforming changes to sections 301 and 311 (dealing with measurement of the amount of certain corporate distributions and computation of earnings and profits); (8) amending section 341(e) (dealing with collapsible corporations); and (9) amending section 453(d) (dealing with gain to a corporation distributing installment obligations).

4. Depreciable property is usually an asset described in INT. REV. CODE OF 1954 § 1231. This section provides, in general, that net gains in any taxable year on sales of § 1231 property are treated as capital gains while net losses in any taxable year are deductible as ordinary losses. Illustrations in this paragraph of text assume no other transactions in § 1231 property during the taxable year.

disposition. These depreciation deductions reduce tax at ordinary income rates while the gain on sale resulting from the difference between depreciated value and sale price is taxed at lower capital gains rates. Assume, for example, that a corporate taxpayer paying ordinary income taxes at a fifty-two per cent rate purchases property subject to depreciation at a cost of \$1,000, utilizes it in its business, and subsequently sells it for \$700. If the depreciation claimed were \$300 or less, there would be no gain on sale. (Any loss would generally be deductible from ordinary income.) If, however, the depreciation deduction claimed were \$400, there would be a \$100 gain on sale. The additional \$100 of depreciation deductions would reduce tax by \$52 while the additional gain on sale would generally increase tax by only \$25, creating a tax benefit of \$27. The 1954 revenue legislation, which permitted deductions under the so-called accelerated methods of depreciation,⁵ accentuated the revenue loss, or, as it is sometimes stated, increased the extent to which ordinary deductions were transmuted into capital gain.

Prior to the 1962 Revenue Act, the Commissioner had some success in limiting depreciation deductions which reduced the tax cost basis of property below selling price. Thus, in *Cohn v. United States*,⁶ which may be viewed as the precursor of section 1245's recapture of depreciation provision, the court held that a taxpayer could claim no deduction for depreciation in the taxable year in which the property was sold where the selling price was greater than the depreciated base at the start of the year.⁷ The *Cohn* principle acquired added stature as a result of the Supreme Court decisions in the *Massey Motors*, *Evans* and *Hertz* cases,⁸ which held that the salvage value to which property could be depreciated was to be determined by reference to the useful life of the property in the business of the taxpayer and not by its abstract useful or physical life. This principle was applied to prevent taxpayers in the business of leasing new cars from calculating depreciation on the cars with a view to their salvage value as "junk"; the cars were customarily sold as second-hand vehicles prior to the end of two years, although they had a useful physical life of four or five years. The taxpayers' calculations had resulted in claimed depreciation deductions over the initial two-year period which reduced the basis of the automobiles to an amount less than their resale price, thereby generating a claimed capital gain on the sale of the cars. The *Cohn*, *Massey Motors*, *Evans* and *Hertz* cases were relied upon by the Revenue Service in Rev. Rul. 62-92,⁹ which announced that the holding of the *Cohn* case would be followed by the Service under the 1939 and 1954 Codes. In some but not all of the cases, the Commissioner has been successful in denying depreciation

5. INT. REV. CODE OF 1954 §§ 167(b) (2) and (3). All references in this paper are to sections of the 1954 Code as amended, unless otherwise specified.

6. 259 F.2d 371 (6th Cir. 1958).

7. The technical issue was the correctness of the Commission's upward adjustment of salvage value to an amount equal to the selling price of the asset.

8. *Massey Motors, Inc. v. United States* and *Commissioner v. Evans*, 364 U.S. 92 (1960); *Hertz Corp. v. United States*, 364 U.S. 122 (1960).

9. 1962-1 CUM. BULL. 29.

deductions claimed on property in the year of its sale when the adjusted basis of the property at the start of the taxable year was less than the sale price.¹⁰

It has been reported that the Revenue Service may attempt to extend the principle of *Cohn* and Rev. Rul. 62-92 to transactions not involving taxable sales.¹¹ Apparently, Revenue Service personnel are considering the application of the rule to depreciation claimed in the final return of a deceased taxpayer and the return of a donor of depreciable property for the year of the gift, even if the donee is a charitable organization. The Service is also considering whether the principle should be applied to corporate liquidations under sections 331, 334(b)(2), 337 and 333,¹² and to involuntary conversions. The Service has apparently indicated informally that the rule probably would not be applied to tax-free corporations under section 351, or to tax-free exchanges of property of like kind under section 1031. Also, the Service may attempt to push back disallowance to a year prior to sale, particularly where a closing is deliberately put over into the following year.

If it is deemed desirable to recoup the revenue lost whenever the proceeds of a sale in excess of the asset's basis as adjusted for depreciation are taxed at capital gain rates, then the rule of the *Cohn* case is obviously inadequate, because its applicability is limited as to the amount of depreciation disallowed and the occasions for disallowance. President Kennedy proposed the enactment of a rule which, broadly speaking, would have provided prospectively for the recapture on all types of property of the total revenue lost by reason of depreciation deductions which reduced the basis of property to less than fair market value at the time of disposition.¹³ The recapture provision as enacted was more limited;¹⁴ it applies only to personal property (whether

10. Randolph D. Rouse, 39 T. C. 70 (1962) (Comm'r prevailed in a contention that no depreciation was allowable on houses in year of sale; depreciation was allowed on houses not sold during taxable year); *Fribourg Navigation Co.*, 31 P-H Tax Ct. Mem. 1698 (1962) (on taxpayer's appeal to the Second Circuit) (Comm'r prevailed in a contention that no depreciation was allowable in year of sale of a liberty ship). *Contra Costa Trucking Company*, 63 P-H Tax Ct. Mem. 204 (1963); *cf. Wasmer v. United States*, 10 Am. Fed. Tax R.2d 6162 (E.D. Wash. 1962) (held that portion of lump sum selling price properly allocable to depreciable assets was less than undepreciated cost so depreciation in year of sale allowable). *Contra, Motorlease Corp. v. United States*, 215 F. Supp. 356 (D. Conn. 1963) (on Commissioner's appeal to the Second Circuit) (*Cohn* case not followed and depreciation in year of sale allowed); *S & A Company v. United States*, 63-2 U.S.T.C. ¶ 9591 (D. Minn. July 3, 1963) (distinguishes *Cohn* case and refuses to follow Rev. Rul. 62-92).

11. J. Accountancy, May 1963, p. 75. See also *Kimball Gas Products Company*, 63-2 U.S.T.C. ¶ 9507 (D. Tex. Mar. 14, 1962 on Commissioner's appeal to Fifth Circuit), in which Commissioner unsuccessfully urged that depreciation deduction to corporation be disallowed in year of liquidation. In view of the effective date of § 1245 and its nonapplication to certain depreciable real estate, the principle of Rev. Rul. 62-92 has continued vitality.

12. See notes 18 and 21 *infra*. Section 337, where applicable, provides for no gain or loss to a corporation on sales made within one year of adoption of a plan of liquidation.

13. Statement of Secretary Dillon submitted to House Committee on Ways and Means, 87th Cong., 1st Sess., May 3, 1961 (CCH Print pp. 34-37); H.R. REP. No. 1447 at 67.

14. H.R. REP. No. 1447 at 67-8.

tangible or intangible¹⁵) and certain types of real estate, not including buildings and structural components.

This new recapture provision, Code section 1245,¹⁶ changes preëxisting law in two important respects. First, it treats gain on the transfer of specified property to the extent of depreciation taken subsequent to 1961 as ordinary income rather than capital gains.¹⁷ (The amount which may be subject to ordinary income tax is referred to in this article as the "section 1245 potential.") Second, section 1245 imposes a tax on certain dispositions of property (*e.g.*, transfers by a corporation in liquidation)¹⁸ which theretofore had not been considered taxable events.

Section 1245(a)(3) describes, in deceptively simple terms, the property to which the new provisions apply as including all personal property, tangible or intangible, which is or *has been* subject to depreciation allowance, and certain tangible real property (not including buildings or structural components) similarly subject to depreciation which also meets tests as to use parallel to those in the investment credit provision which also was enacted as part of the 1962 Act. Property once meeting these tests remains section 1245 property, even though it no longer qualifies for the depreciation allowance (*e.g.*, because it has been removed from a business use) or no longer meets the tests as to use. There are many occasions on which section 1245 potential becomes taxable income. The potential usually becomes taxable on dispositions in which the transferee of the property does not have a carryover basis, that is, where the transferee does not have a basis determined by reference to the basis of the property when it was in the hands of the transferor. When the basis is carried over, the taxable event is postponed, but the potential remains subject to tax when the transferee disposes of the asset. An intercorporate dividend in kind—or more properly an intercorporate distribution under section 301—is an event upon which section 1245 potential is taxed, although under prior law the transferor would have had a carryover basis.¹⁹ Undoubtedly the decision

15. H.R. REP. NO. 1447 at A109; S. REP. NO. 1881 at 282.

16. The complete text of § 1245 is reprinted in Appendix, at the end of this Article.

17. The new section applies to taxable years beginning after December 31, 1962, but brings into ordinary income depreciation deductions taken since December 31, 1961. For example, a taxpayer on a fiscal year ended June 30, would not be subject to the new statute in the case of dispositions of property prior to July 1, 1963, but would be subject to the new rule for dispositions made after June 30, 1963. In the case of dispositions during taxable years subject to the new rule, depreciation taken since December 31, 1961 is "recaptured."

18. The liquidation of a corporation presents two occasions for creating gross income or gain or loss. The first is taxation of shareholders. Section 1245 makes no direct changes in the rules provided by sections 331, 332 and 333 for the taxation of shareholders receiving liquidating distributions. The second occasion for tax consequences on a liquidation arises with respect to the liquidating corporation itself. Prior to enactment of section 1245, a liquidation did not give rise to income, gain or loss to the corporation, except where installment obligations were distributed as provided in sections 336 and 453(d). Section 1245 did make a far-reaching change in expanding the incidence of tax to the liquidating corporation itself.

19. Prior to the 1962 amendments, § 301(b)(1)(B) provided that on distributions from one corporation to another the recipient, generally speaking, took the property into account at its basis to the distributing corporation.

to tax their transfers was adopted to cover instances such as that of a distributing corporation which has both individual and corporate shareholders. Since the individual shareholders would obtain a new basis (equal to the fair market value of the distributed property) on any distribution under section 301 (whether a dividend or a return of capital),²⁰ the draftsmen of section 1245 probably decided that the distribution by the transferor corporation must occasion bringing the section 1245 potential into account.

There remain several instances in which the transferor can escape tax while the transferee acquires a basis in the section 1245 property determined without reference to the transferor's basis. There is no tax imposed on the transfer of section 1245 property on death, even though the transferee obtains a new basis. In the case of exchanges of property of like kind and involuntary conversions, the transferor of section 1245 property is not required to bring the section 1245 potential into account if and to the extent he recognizes no gain on the transfer under other provisions of the Code and acquires substituted section 1245 property in exchange. The substituted section 1245 property acquired by the transferor continues to contain the same section 1245 potential. There is also no tax under section 1245 on sales under sections 1071 or 1081 to effectuate policies of the Federal Communications Commission or the Securities and Exchange Commission.

Section 1245 potential is brought into ordinary income not only on the common sale or exchange of section 1245 property; sales or exchanges under section 337 and transfers incident to corporate liquidations under sections 331, 333 and 334(b) (2) are also included.²¹ However, transfers through gift, corporate reorganization, tax-free incorporation under section 351, contribution of property to a partnership, and distribution of property by a partnership to a partner do not bring the section 1245 potential into income. In these last instances, the transferee takes the property at its basis in the hands of the

20. INT. REV. CODE OF 1954 § 301(b) (1) (A).

21. Corporate liquidations can, broadly speaking, be sub-divided into four categories by reference to their effect on the distributee shareholders: (1) Under the general rule of § 331, the shareholders recognize gain or loss measured by the difference between the value of the property received and the tax cost basis of the stock surrendered. Section 334(a) provides that the tax cost basis in the hands of the shareholders of the property received is its fair market value. (2) Under § 332 a special rule involving nonrecognition of gain or loss is provided for the liquidation of subsidiary corporations in which the parent corporation has an 80% or more stock ownership. These intercorporate liquidations must in turn be sub-divided into (a) instances in which the parent corporation takes the distributed property at its cost basis to the subsidiary under § 334(b) (1), and (b) instances in which the parent corporation takes the distributed property at a basis determined by reference to the cost of the stock to the parent under § 334(b) (2). Section 334(b) (2) applies in general where the parent has recently purchased the stock from an outsider. (3) Finally, under the elective provisions of § 333, a corporate liquidation completed within a 30 day period brings into play somewhat complex rules which, most broadly described, provide for nonrecognition to the shareholders of unrealized appreciation in value of corporate property with the basis of the distributed property being determined under § 334(c) by reference to the tax cost basis of the shareholders' stock.

transferor but remains subject, upon sale of the property, to 1245 potential, which includes depreciation deductions taken by the transferor.

II. TRANSFERS ON WHICH SECTION 1245 POTENTIAL IS INCLUDED IN INCOME

Section 1245 provides not once, but twice,²² lest there be any doubt, that its rules are to govern "notwithstanding any other provision of this subtitle [covering all the income tax law]." The general rule that section 1245 potential is brought into income whenever property is "disposed of" is contained in section 1245(a)(1). Exceptions to the general rule are then enumerated in the first five subparagraphs of section 1245(b), which deal with (1) dispositions by gift, (2) transfers at death, (3) incorporations under section 351, reorganization exchanges, and transfers of property between a partnership and partner, involving contribution of property to the capital of a partnership or distributions by the partnership to the partner, (4) like kind exchanges and involuntary conversions, and (5) transactions effectuating the policies of the Federal Communications Commission or the Securities and Exchange Commission.²³

22. INT. REV. CODE OF 1954 §§ 1245(a)(1) (last sentence) and 1245(d); H.R. REP. NO. 1447 at A112; S. REP. NO. 1881 at 285.

23. The concept of bringing unrealized appreciation or deferred income into account on a transfer not involving a sale or exchange is not novel in the tax law. The chief statutory provisions existing prior to 1962 which embodied the same concept are § 691 dealing with income in respect of a decedent and § 453 dealing with installment obligations. Section 691(a)(2) provides that a right to receive income in respect of a decedent shall be taken into gross income upon any sale or exchange or upon any other "disposition" except for transmissions at death or to a legatee, etc. The amount taken into gross income is the consideration received or the fair market value of the right, whichever is greater. If the right is disposed of by gift, its fair market value must be taken into income. Treas. Reg. § 1.691(a)-4(a) (1957).

Section 453(d) provides that gain or loss results if an installment obligation is satisfied at other than face value or "distributed, transmitted, sold, or otherwise disposed of." Treas. Reg. § 1.453-9(b) provides that on disposition other than by sale or exchange the amount of gain or loss is determined by reference to the fair market value of the obligation. Broad exceptions to the rule requiring gain or loss be recognized are provided in general for transactions on which gain or loss is not to be recognized under other provisions of the Code. Treas. Reg. § 1.453-9(c). Gifts of installment obligations result in recognition of gain or loss.

In addition to the statutory provisions, there are, as well, general principles of tax law developed by the courts which tax income to a taxpayer who earned it, and § 482 which, for example, in conjunction with the accounting provisions, has enabled the Internal Revenue Service to tax a transferor corporation on its disposition of work in process reported on a completed contract basis. *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir. 1951); *cf. Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962).

Section 1245 potential is treated for the most part in the same manner as dealer installment obligations. The principal differences between dealer installment obligations and § 1245 potential are: (1) dealer installment obligations become taxable on gift, while § 1245 potential is not taxable to a donor on a gift (the donee taking a carryover basis); (2) dealer

The statute would have been easier to apply, however, if the draftsmen had chosen to adopt a general exemption from the recapture rules for all transfers on which the transferee has a carryover basis.²⁴ Appropriate exceptions could then have been made to the general exemption to require recapture, for example, on tax-free transactions involving boot²⁵ and for intercorporate distributions under section 301. The failure to adopt the technique of granting a general exemption for all transfers on which there is a carryover basis has raised questions concerning the application of section 1245(a)(1) to several types of common transactions. For example, is recapture intended to apply on shareholder contributions of section 1245 property to the capital of a corporation?²⁶ Or to distributions of section 1245 property from an estate or trust to beneficiaries?²⁷ Or to transfers of section 1245 property between members of an affiliated group of corporations filing a consolidated return?²⁸ As a matter of consistent policy, the section 1245 potential should not be brought into income in these cases not specifically covered by the statute so long as the transferee would have a carryover basis under rules in effect prior to section 1245. This is a result which can be achieved, if it is desired, by regulations under the statute as drafted.

Contributions by shareholders to corporate capital might be regarded as a gift within the meaning of section 1245(b)(1) on the ground that the contributor received no consideration in exchange for the contribution. The alternative, and probably more supportable, theory would be that stockholder contributions to capital are to be regarded as transfers in constructive exchange for stock. Thus it could be held that the transferee corporation acquired a

installment obligations do not acquire a step-up in basis in the hands of a decedent's estate, while § 1245 potential disappears (because the transferee acquires a new basis) on transfers by reason of death, (3) dealer installment obligations (except those arising on the sale of § 1245 property) are not taxable to a corporation distributing such obligations in a liquidation governed by § 334(b)(2), while the § 1245 potential is taxed to a corporation making a distribution under § 334(b)(2), and (4) charitable gifts of § 1245 property are reduced in value by the § 1245 potential but the § 1245 potential (unlike the dealer installment obligations) is not brought into income at the time of transfer. Gifts to charity of § 1245 assets thus receive less favorable treatment than gifts of items such as inventory assets or of § 306 stock, but more favorable treatment than that accorded to dealer installment obligations.

24. Report of Tax Section, New York State Bar Ass'n, *Hearings on H.R. 10650 Before the Senate Finance Committee*, 87th Cong., 2d Sess., pt. 8, at 3834 (1962) [hereinafter cited as Senate Hearings].

25. Code sections providing for nonrecognition of gain generally restrict the type of property which can be received tax free. Where, in addition to property permitted to be received tax free, the taxpayer acquires money or "other property" (i.e. something to boot) on exchange, the sections sometime provide for recognition of gain only to the extent of the money or "other property." The term "boot" is used to describe money or property which is not within the restricted type of property which can be received on an exchange without causing recognition of gain.

26. INT. REV. CODE OF 1954 § 362.

27. Treas. Reg. § 1.661(a)-2(f) (1963).

28. INT. REV. CODE OF 1954 §§ 1501, 1502 and Treas. Reg. § 1.1502-31(b)(1)(i) (1963).

carryover basis "by reason of the application of section . . . 351" within the meaning of section 1245(b)(3).

Transfers to beneficiaries from an estate or trust could properly be regarded as "transfers at death" within the meaning of section 1245(b)(2) or "disposition by gift" within the meaning of section 1245(b)(1) in those instances where the so-called "uniform basis" rules of Regulations sections 1.1014-4, 1.1015-1 and 1.1015-2 apply. For purposes of determining basis, these regulations, in substance, relate distributions from a trust or estate back to the transfer by the donor or the decedent to the trust or estate. If distributions can be related back for purposes of basis computation, they can also be related back for purposes of section 1245 so as to exempt the distributions from the application of section 1245. If property is donated or bequeathed by A to B, there is no tax imposed on A under section 1245 upon B's acquisition of the property. Similarly, a different rule is neither required by the words of the statute nor supported by its policy if a trust or estate is interposed before B receives the asset transferred by A.

Transfers between members of an affiliated group of corporations filing consolidated returns, which under the consolidated return regulation give rise to no taxable gain or loss or change in basis,²⁹ should not give rise to recapture. Section 1245 could be held not to override the consolidated return regulation on the ground that these regulations are not contained in "this subtitle" as the term is used in the provisions making the rules of section 1245 paramount to all other Code provisions. The consolidated return regulations are prescribed by the Treasury under a special delegation of authority to impose particular rules binding on both the Treasury and taxpayers electing to file consolidated returns. Since there is no danger of section 1245 potential evaporating by reason of transfers among corporations included in a consolidated return, it would be entirely reasonable in this special case to resolve in favor of the consolidated return regulations the apparent conflict with section 1245.

The Treasury ought not hesitate to draw regulations liberally defining the types of transactions exempt from recapture so long as the Government can be certain that the property will have a carryover basis in the hands of the transferee and that, as a consequence, the exemptions do not provide an opportunity for contravening the recapture of depreciation policy embodied in the statute. Section 1245(c) directs the Treasury to prescribe regulations that it "may deem necessary to provide for adjustments to the basis of property to reflect gain recognized" under section 1245(a). If regulations under section 1245(c) make it clear that no increase in basis by the transferee is permitted for transactions which are held to be free of recapture under section 1245(a) regulations, the courts would be unlikely subsequently to hold that the transferee nevertheless had an increased basis. Under other Code provisions, such as the corporate reorganization sections, the Treasury is properly concerned that a failure to impose a tax at the first opportunity may foreclose the col-

29. Treas. Reg. § 1.1502-1(d) (1963) ; INT. REV. CODE OF 1954 § 1503.

lection of revenue related to the foregone taxable event. If, with the intent of taxing the difference between a carryover basis and value on a subsequent taxable occasion, the Treasury does not impose a tax on a given transaction and regards the taxpayer as having no basis step-up, a court may uphold the later inconsistent contention that the earlier transaction was in fact taxable and the property acquired in that transaction has a stepped-up basis. The statute of limitations might then bar the Revenue Service from collecting a tax on the earlier transaction.³⁰ The chance of such a whipsaw effect occurring under section 1245, however, is remote, especially if the suggested regulation is promulgated under subsection (c).

III. MEASUREMENT OF AMOUNT SUBJECT TO RECAPTURE

Determining the amount to be taxed as ordinary income on a transfer of section 1245 property involves a computation of (a) the "amount realized" in the case of a sale or exchange, or the "fair market value" of property in the case of other dispositions, (b) the "adjusted basis" of property, and (c) the "recomputed basis" of property. The amount includible in ordinary income through the recapture provision is the difference between the adjusted basis of section 1245 property and the recomputed basis of such property, but not more than the difference between the amount realized on the sale of such property (or its fair market value on other dispositions) and its adjusted basis.

The terms "amount realized," "fair market value" and "adjusted basis" are familiar to the tax law and present no problem peculiar to the interpretation of section 1245. "Recomputed basis," however, is a new concept defined in section 1245(a)(2) as follows:

RECOMPUTED BASIS.—For purposes of this section, 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.

In other words, calculation of recomputed basis involves increasing the adjusted basis by an amount (hereinafter called the "section 1245 add-on") determined under section 1245(a)(2). The "section 1245 add-on" for property in the hands of a particular taxpayer takes into account not only the depreciation deductions claimed by that taxpayer with respect to that property, but also depreciation allowed to the same taxpayer in respect to other property and to other taxpayers in respect of the same or other property when such depreciation deductions are "reflected" in the adjusted basis of the particular property under consideration.

There is no conceptual difficulty in determining the section 1245 add-on attributable to depreciation deductions claimed by a taxpayer in respect to

30. The mitigation provisions of §§ 1311-14 might not be applicable.

particular property he owns. There are, however, difficulties in determining the section 1245 add-on attributable to depreciation deductions taken by a taxpayer with respect to other property, or by other persons with respect to the same or other property in cases where there have been tax-free exchanges involving boot or transactions classified as part gift, part sale transactions. The problems involved may be analyzed under two separate headings: (1) In what circumstances is depreciation claimed by other taxpayers to be taken into account in determining the section 1245 add-on? Or in other words, in what circumstances are deductions claimed by other persons "reflected" in the adjusted basis of the property held by the taxpayer? (2) How does a taxpayer compute the amount of the section 1245 add-on attributable to depreciation deductions he claimed in respect to other property or depreciation deductions claimed by other persons.

Superficially, it might appear that (1) a section 1245 add-on in respect to depreciation taken by another person is required only when the adjusted basis of the property in the hands of the taxpayer is determined by reference to its adjusted basis in the hands of another person, and (2) the amount of the section 1245 add-on attributable to depreciation taken by another person or attributable to depreciation taken by the same taxpayer in respect of other property is the full amount of the post-1961 depreciation taken. At any rate, some commentators have adopted this analysis.³¹ However, on closer examination of tax-free transactions involving boot and part sale, part gift transactions, it appears that this analysis does not accord with the policy of section 1245 and therefore requires modification.

The question arising on a part sale, part gift transaction can be best illustrated by an example. Assume that after 1961, individual T acquired a machine, which is section 1245 property, at an original cost of \$17,000 and claimed \$7,000 of depreciation. Accordingly the property in his hands has an adjusted basis of \$10,000 and a recomputed basis of \$17,000. T sells the machine to his son for \$11,000 at the time it has a value of \$18,000. T recognizes gain of \$1,000, all of which is taxable under section 1245(a)(1) and has made a gift of \$7,000. Apart from any increase in basis for gift tax paid, the son's adjusted basis for the machine is \$11,000.³² Before claiming any further depreciation the son sells the machine for \$18,000 producing a gain of \$7,000. How much of this gain should be taxed under section 1245(a)(1)?

The purpose in enacting section 1245 seems to be frustrated if the son is not

31. See, e.g., Chapman & Baity, *Section 1245: Its Scope and Unexpected Effects on Tax Planning*, 18 J. TAXATION 322 (1963) (appears to assume that § 1245(a) does not apply to a taxpayer whose basis is not determined with reference to basis in hands of prior holder); Supplemental Statement of Committee on Federal Taxation of the American Institute of Certified Public Accountants, Senate Hearings Pt. 2, at 570.

32. In simple gift transaction, the donee's basis for determining gain is the adjusted basis of the donated property in the hands of the donor. Section 1015. In the part sale, part gift transaction, the rules for recognizing gains to the donor and fixing basis to the donee applied in the text are set forth in Treas. Regs. §§ 1.1001-1(e) and 1.1015-4 (1957).

subject to ordinary income tax under section 1245(a) on \$6,000 of the gain since the father donor claimed \$7,000 of depreciation and returned only \$1,000 of income on the sale to the son. But this result cannot be reached if a section 1245 add-on is made to property acquired by a donee only when the adjusted basis of the acquired property in the hands of the donee is in fact determined by reference to the adjusted basis of the property in the hands of the donor. The proper result can be reached, however, if depreciation claimed since 1961 is considered to be "reflected" in a donee's basis within the meaning of section 1245(a)(2), whenever the adjusted basis of the property in the donee's hands would have been determined by reference to the basis in the hands of the donor if no depreciation at all had been claimed by the donor since December 31, 1961. If the father in the example had claimed no depreciation since December 31, 1961, his adjusted basis for the property would be \$17,000 and the basis to his donee son, who paid only \$11,000 for the property, would be \$17,000, determined by reference to his father's adjusted basis. It is reasonable that depreciation claimed since December 31, 1961 be deemed "reflected" in the adjusted basis of the depreciated property whenever the actual adjusted basis differs from the adjusted basis the property would have had if no depreciation had been claimed since that date.

The difficulties in determining the amount of depreciation "reflected" in property acquired in a tax free exchange involving boot can be illustrated by two examples which, like the preceding example, assume that after 1961, individual T acquires a machine, which is section 1245 property, at an original cost of \$17,000 and claims \$7,000 of depreciation. Accordingly the machine in his hands has an adjusted basis of \$10,000 and a recomputed basis of \$17,000. Assume further that the machine is then worth \$18,000.

Example (1). In a transaction qualifying under section 351, T transfers the machine to a corporation in exchange for stock valued at \$17,000 and \$1,000 cash. T realizes a gain of \$8,000, of which only \$1,000 (equal to the boot) is recognized and taxed under section 1245(a). The corporation's adjusted basis for the machine is \$11,000, the basis in the hands of T increased by the \$1,000 gain recognized to T. Then before claiming any further depreciation, the corporation sells the machine for \$18,000 producing gain of \$7,000.

Example (2). In a transaction qualifying under section 1031, T exchanges the machine for a new machine, valued at \$17,000, and \$1,000 cash. T realizes gain of \$8,000 of which only \$1,000 (equal to the boot) is recognized and taxed under section 1245(a). The new machine in the hands of T has an adjusted basis of \$10,000, the basis of the old machine plus gain recognized minus cash received. T subsequently sells the new machine for \$17,000 before claiming any further depreciation resulting in a gain of \$7,000.

The question in both examples is how much of the \$7,000 gain on final disposition is subject to tax under section 1245(a). If the section 1245 add-on for purposes of the final sale is \$7,000, equal to the full depreciation claimed, the total amount subject to section 1245(a) in each illustration has been \$8,000. There is no statutory policy of taxing \$8,000 at ordinary income rates

when only \$7,000 was claimed as depreciation. The proper result of restricting ordinary income tax to \$6,000 on the final sale can be achieved if depreciation "reflected" in property acquired by the taxpayer from another person or on an exchange for property of like kind is reduced (but not below zero) by any gain recognized in the transaction on which the taxpayer acquired the property. Such a construction of the statute is supported by an illustration in the Committee reports and accords with the sense of the provision.³³

IV. RECAPTURE OF AMORTIZATION IN LIEU OF DEPRECIATION

One of the principal questions arising under section 1245 is whether the recapture rule should apply to allowances for amortization "in lieu" of depreciation under Regulation sections 1.162-11 and 1.167(a)-(4).

A lessee can recover his capital investment in a leasehold improvement either through "depreciation" under section 167 or "amortization" under section 162. The regulations provide that where the useful life of a leasehold improvement is shorter than the term of the lease,³⁴ a deduction for depreciation is allowable.³⁵ If the useful life of the improvement is longer than the term of the lease, a deduction is provided for amortization "in lieu" of depreciation allowances.³⁶ The distinction between these two methods of cost recovery has heretofore been important primarily in determining whether a taxpayer could employ accelerated depreciation methods in order to recover greater portions of cost during the early years of the property's useful life or whether he was restricted to the equal annual deductions which amortization provides.

A similar distinction is made in regard to the recovery of a taxpayer's capital investment upon purchasing an existing leasehold with improved real estate. Assume, for example, that A is lessee of Blackacre, upon which stands a building. If the commuted value of the right to occupy the premises (or the right to collect rents from subtenants) is more valuable than the commuted rent payable to the fee owning lessor, A's leasehold estate will have an independent value. Upon purchasing A's interest, T becomes entitled to recover his capital investment. Under the principles set forth in Rev. Rul. 61-217,³⁷ the method and timing of T's deductions depend on whether A made a capital investment in the building, or whether A leased the property in its improved state from the fee owner. If A made a capital investment in the building and the length of the lease (according to the rules of section 178) is

33. H.R. REP. No. 1447 at A 110; S. REP. No. 1881 at 283. The Committee reports also state that the adjustments to basis contemplated by § 1245(c) were intended to prevent imposition of a double tax. H.R. REP. No. 1447 at A 112; S. REP. No. 1881 at 283. Presumably it was also intended to avoid double recapture of the same depreciation under § 1245(a)(1).

34. The rules for renewal periods set forth in § 178 should be taken into account.

35. Treas. Reg. § 1.167(a)-4.

36. Treas. Reg. § 1.162-11(b).

37. 1961-2 CUM. BULL. 49.

longer than the life of the building, T is entitled to depreciation deductions in respect to the portion of his cost allocable to the building. The balance of T's cost, or his entire cost if the life of the building is longer than the term of the lease, is recoverable under Regulations section 1.162-11 through amortization deductions in lieu of depreciation. If A leased the property in its improved state from the fee owner, T's entire cost must be recovered through amortization deductions even if the life of the building is shorter than the lease.

The question whether the recapture principle of section 1245 applies to property subject to allowances for amortization presents the issue whether, in calculating recomputed basis under section 1245(a)(2), the adjustments made on account of depreciation should include adjustments arising out of amortization in lieu of depreciation. The companion issue under section 1245(a)(3) is whether the term "property of a character subject to the allowance for depreciation provided in section 167" used in defining section 1245 property includes property subject to an allowance for amortization in lieu of depreciation. These parallel questions should be answered in a consistent manner.

The issue whether section 1245 was intended to recapture amortization in lieu of depreciation arises principally because the statutory language in section 48³⁸ relating to property qualifying for the investment credit does not parallel the language of section 1245. Since both sections were added by the Revenue Act of 1962, the differences in language could be significant. Section 48, which defines property eligible for the investment credit, refers to property "with respect to which depreciation (or amortization in lieu of depreciation) is allowable." On the other hand, section 1245(a)(2) requires adding back adjustments to basis "on account of" deductions for "depreciation, or for amortization [of emergency facilities] under section 168." Omission in section 1245(a)(2) of the words "amortization in lieu of depreciation" accompanied by a specific reference to emergency amortization could be construed to evidence a congressional intent that deductions for amortization in lieu of depreciation are not subject to recapture. Section 1245(a)(3) (defining section 1245

38. Section 48 was added by § 2 of the Revenue Act of 1962 which enacted the credit for certain types of investment in depreciable property. Property qualifying for the investment credit is defined as "§ 38 property." The definition of § 38 property, which is in some respects parallel to the definition of § 1245 property, is set forth in § 48(a)(1) as follows:

(1) *In General.* Except as provided in this subsection, the term "§ 38 property" means—

(A) tangible personal property, or
(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constitutes a research or storage facility used in connection with any of the activities referred to in clause (i).

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more.

property, refers to "property of a character subject to the allowance for depreciation provided in section 167." The lack of reference in section 1245(a)(3) to an allowance for amortization in lieu of depreciation could be viewed as cumulative support for the view that recapture of amortization in lieu of depreciation was not intended. On a policy basis, it could be contended that the evil of over-depreciation at which section 1245 is directed cannot arise when equal amortization deductions are claimed for property whose life is definite and limited.

The view that no recapture of amortization in lieu of depreciation was intended, however, will probably not prevail.³⁹ The Committee reports on the 1962 Act, while not dealing directly with recapture of amortization in lieu of depreciation, state specifically that the recapture provisions of section 1245 were intended to apply to all property qualified for the investment credit,⁴⁰ as well as to certain property not qualified for the investment credit.⁴¹ Since property subject to an allowance for amortization in lieu of depreciation can qualify for the investment credit,⁴² it would follow that such property is also subject to the recapture rules of section 1245.

The statutory language of section 1245, while omitting reference to property subject to amortization, is broad enough to cover it. The language "property of a character subject to the allowance for depreciation provided in section 167" appearing in section 1245(a)(3) is identical to portions of the wording of sections 1221, 1231 and 1239.

The Tax Court recently decided the question whether a leasehold is "property of a character subject to the allowance for depreciation provided in section 167."⁴³ In that case, the taxpayer, an individual, sold a ten year lease-

39. The possible statutory ambiguity was pointed out by tax committees of various bar associations. See, e.g., Tax Committee of the Bar Ass'n of the City of New York, Senate Hearings, pt. 7, at 3022; Report, Section of Taxation, American Bar Ass'n, Senate Hearings, pt. 6, at 2361. The statement of the Hon. Douglas Dillon, Secretary of the Treasury, submitted to the Senate Finance Committee contains the following sentence:

The House bill also should be amended to provide for the treatment as ordinary income of gain on the sale of depreciable property to the extent of prior deductions for amortization of interests in depreciable property, in order to prevent avoidance of this section by the use of leaseholds of depreciable property.

Senate Hearings, pt. 1, at 89.

It is not clear whether this remark, following as it does a proposal to extend the recapture rule to real estate, suggests that the amendment is necessary in connection with real estate only, or is necessary in connection with the existing personal property rules of section 1245.

The view expressed in this paper that recapture applies to amortization in lieu of depreciation appears to be contrary to the conclusion reached in Rustigan, *The Taxation of Depreciable Property*, 40 TAXES 907, 910 (1962).

40. "The ordinary income treatment provided by this section [1245] will be applied upon the sale of all property the acquisition of which could have resulted in an investment credit (§ 38 of the Code as added by this bill)." H.R. REP. No. 1447 at 69 and S. REP. No. 1881 at 97.

41. H.R. REP. No. 1447 at 69 and A108-9; S. REP. No. 1881 at 97 and 282.

42. See statute reproduced in note 38 *supra*; S. REP. No. 1881 at 154; Proposed Treas. Reg. §§ 1.46-3(e), 1.48-1 (March 28, 1963).

43. Tom S. Baker III, 38 T. C. 9 (1962).

hold to a wholly owned corporation and reported his profit as capital gain. The Commissioner successfully contended that section 1239 applied, so that the sale of the depreciable property to the controlled corporation produced ordinary income. The court considered at some length and rejected the taxpayer's contention that the leasehold was not within the scope of section 1239 because it was subject to allowances for amortization rather than depreciation.⁴⁴ The reasoning of the opinion would seem equally applicable to construction of section 1245. On balance, then, it seems reasonably clear that property subject to amortization in lieu of depreciation is not exempt from the recapture rules of section 1245.

V. CLASSIFICATION OF PROPERTY UNDER SECTION 1245

Delineating the scope of section 1245 involves classifying property subject to depreciation by various criteria in order to classify property subject to the recapture rule under section 1245. The broadest classification is the division between (a) personal property (whether tangible or intangible), and (b) "other property" (*i.e.*, realty). Under section 1245, if property is classified as personal property, the recapture rule is applicable without further inquiry. However if the property in question is classified as realty, further inquiry becomes necessary. If the real property is classified as intangible, the recapture rule does not apply. Also tangible realty classified as a building or structural component is eliminated from the recapture rule. Tangible non-building realty which meets the specifications of section 1245(a)(3)(B) (*i.e.*, integral part of manufacturing, etc. or research facilities) is subject to the recapture rule of section 1245; if it does not meet these specifications, it is not subject to the recapture rule.

A schematic diagram of section 1245's applicability to classes of property is presented in figure A. The area enclosed by the large square represents all types of depreciable property; the area enclosed by the circle meets the use test of section 1245(a)(3)(B) (integral part of manufacturing, etc. or research facilities); the stippled area represents buildings and structural components and the crosshatched area represents property subject to the recapture rule of section 1245. The horizontal line (A-B) divides the square into personal property and real property. Everything above the line A-B is personal

44. A similar issue was raised by taxpayer, but rejected in *512 West 56th St. Corp. v. Commissioner*, 151 F.2d 942 (2d Cir. 1945) and *Fackler v. Commissioner*, 133 F.2d 509 (6th Cir. 1943). The courts there held that leases, being property of a character subject to the allowance for depreciation, were not entitled to capital gain treatment prior to the change in law embodying the principle of § 1231. Property "used in the trade or business, of a character subject to the allowance for depreciation provided in § 167" is excluded from the definition of a capital asset under section 1221(2) and is subject to the "capital gain but ordinary loss" rules of § 1231 under § 1231(b)(1). See note 4 *supra*. Compare *Metropolitan Building Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960) (stating that a leasehold was property described in 1939 Code section 117(j), the predecessor of § 1231) with Rev. Rul. 56-531, 1956-2 CUM. BULL. 983 (stating that a leasehold was a "capital asset").

property and therefore subject to recapture under section 1245. The vertical axis C-D divides the square into tangible and intangible property. The area below the line A-B and to the left of the line C-D (i.e., tangible or corporeal realty) is subject to two further subdivisions—(a) buildings and structural components as contrasted with non-building tangible realty, and (b) property meeting the use test of section 1245(a)(3)(B) (integral part of manufactur-

FIGURE A

ing, etc. or research facilities) as contrasted with property not meeting that test. Non-building realty which meets this use test is subject to recapture and the area below the line A-B representing such property is accordingly cross-hatched.

It next becomes necessary to determine what types of property and interests in property come within each classification. Committee reports describing section 1245 contain few illustrations and virtually no discussion concerning what

property fits within the various categories established in the definition of section 1245 property. The reports do state, however, that all property qualified for the investment credit under section 38 is also subject to the recapture rule of section 1245,⁴⁵ and that the language in section 1245(a)(3)(B) (dealing with tangible non-building realty meeting the manufacturing, etc. use test) is intended to have the same meaning as equivalent language appearing in the investment credit provisions.⁴⁶ If it is thus reasonable to assume an intention that under the investment credit provisions and section 1245, an identical content is to be given to the concepts "tangible personal property" and "tangible real property (not including a building or its structural components)" meeting the use test of sections 1245(a)(3)(B)(i) and (ii) (integral part of manufacturing, etc. or research).

Committee reports describing the investment credit contain a detailed discussion of property qualifying for the credit, including informative examples.⁴⁷ In addition, proposed regulations under the investment credit provisions describe in even greater detail what property qualifies for the credit.⁴⁸ Since this body of material assists in defining certain section 1245 property, it is unnecessary here to dwell on such matters as the definition of building and structural components (*i.e.*, the placement of the line E-F on Figure A) or on the use test of section 1245(a)(3)(B) (*i.e.*, the area of the circle on Figure A). However, the Committee reports on the investment credit and the proposed investment credit regulations do not deal with the classification as between realty and personalty of property regarded as intangible for purposes of the investment credit. This classification is of no significance for the investment credit because the credit does not apply at all to intangible property; yet the distinction is of considerable importance for section 1245 because the recapture rule applies to intangible personalty, but does not apply to intangible realty.

Certain types of property interests, such as easements and riparian rights,⁴⁹ seem clearly within the scope of intangible realty, and even though depreciable,⁵⁰ should not be subject to the recapture rules of section 1245. In other instances, however, questions may well arise in allocating property between intangible realty and intangible personalty for the purposes of section 1245. It would presumably be in the interest of the fisc to broaden the scope of intangible personalty and narrow the scope of intangible realty (*i.e.*, push line

45. See n. 40 *supra*.

46. Compare INT. REV. CODE OF 1954 § 48(a)(1)(B) (reprinted note 38 *supra*), with INT. REV. CODE OF 1954 § 1245(a)(3)(B) (reprinted in Appendix). "The language in clauses (i) and (ii) in § 1245(a)(3)(B) is intended to have the same meaning as when used in clauses (i) and (ii) in § 48(a)(1)(B). . . ." H.R. REP. NO. 1447 at A109; S. REP. NO. 1881 at 282.

47. H.R. REP. NO. 1447 at A17-19; S. REP. NO. 1881 at 153-6.

48. Proposed Treas. Reg. § 1.48-1 (March 28, 1963).

49. Cf. Rev. Rul. 57-445, 1957-2 CUM. BULL. 568.

50. *Union Elec. Co. v. Commissioner*, 177 F.2d 269 (8th Cir. 1949); *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960).

O-B in Figure A towards the bottom of the square) thereby expanding the reach of the recapture provisions of section 1245. This would not generate any corresponding revenue loss by expanding the type property subject to the investment credit, which applies only to tangible property.

Leaseholds. Perhaps the most important question in determining whether intangible property is realty or personalty for purposes of section 1245 will arise in characterizing leasehold interests in real property.⁵¹ Such interests, for most purposes of local law, are regarded as a single property denominated as "chattels real" and treated as personal property;⁵² even under the federal tax law,⁵³ leasehold interests in real estate are sometimes regarded as a single property which is not considered realty.

Some Code provisions in force prior to 1962 distinguish between realty and personalty with respect to leaseholds in real estate. In construing these statutory provisions, there has been a tendency to regard a leasehold estate in land and improvements as a single "property" and to characterize the estate as realty or personalty depending on the length of the lease. For example, under Code section 4361 a stamp tax is imposed on instruments transferring "any lands, tenements, or other realty." Regulations section 47.4361-1(a)(3) and (4) states:

(3) For purposes of the tax imposed by section 4361, the determination of what constitutes "realty" is not controlled by the definition or scope of that term under State law. State law determines the character of the rights conveyed by an instrument, but whether such conveyance constitutes a conveyance of "realty" is to be determined under Federal law.

(4) For purposes of the regulations in this part—

(i) The term "realty" includes—(a) Those interests in real property which endure for a period of time, the termination of which is not fixed or ascertained by a specific number of years, such as an estate in fee simple, life estate, perpetual easement, etc., and

(b) Those interests enduring for a fixed period of years but which, either by reason of the length of the term or the grant of a right to extend the term by renewal or otherwise, consist of a bundle

51. See, e.g., Report of Tax Section, New York State Bar Ass'n, Senate Hearings, pt. 8, at 3834.

52. See, e.g., N.Y. GEN. CONST. LAW §§ 38-40, and N.Y. REAL PROP. LAW §§ 30, 33 and annotations thereunder.

53. It is clear that local law definitions do not apply for purposes of the investment credit. H.R. REP. No. 1447 at A17-8; S. REP. No. 1881 at 154. Proposed Treas. Reg. § 1.48-1(c) provides in part:

Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property.

of rights approximating those of the class of interests mentioned in
(a) of this subdivision.
(ii) ...

Another example occurred under Code section 2033, prior to its amendment in 1962. That section stated that a U.S. citizen or resident was not subject to estate tax on "real property" located outside the United States. In *Estate of Margaret Thaw Carnegie de Perigny*,⁵⁴ the Tax Court held that a 99 year lease in Kenya exchangeable at the option of the decedent for a 999 year lease was real property within the meaning of this estate tax section.

Code sections 1221 and 1231 also contain the terms "real property." Rev. Rul. 60-4,⁵⁵ held that a leasehold which at the time of sale had at least 30 years to run was real property within the meaning of section 1231. The Revenue Ruling relied by analogy on Regulations section 1.1031(a)-1(c) which by illustration provides that a leasehold in real estate for more than 30 years is equivalent to a fee for purposes of applying the non-recognition provision to gain or loss on exchanges of like property. These constructions of Code sections 4361, 2033 and 1231 suggest that leaseholds of real estate of more than a fixed period (30 years, perhaps) should be deemed realty, and that leaseholds of real estate of shorter duration should be deemed personalty.

An analysis of the policy of section 1245 and its interrelationship to the investment credit provisions strongly suggests, however, that these earlier interpretations should be disregarded in determining what constitutes realty or real estate for section 1245 purposes. Rather, the leasehold should not be regarded as a single property, and resort should be made to the various physical properties to which capital investment is allocable for tax purposes in order to determine characterization as realty or personalty for purposes of section 1245. The character of the leased property to which the taxpayer's capital investment is allocated should be determined as though the taxpayer-lessee had fee ownership of the property, in the same manner as is done for purposes of the investment credit.

Capital investments in leaseholds of improved real property are allocated to separate improvements in order to determine the period of depreciation and to test whether the capital outlay qualifies for the investment credit. Such separate allocation is required whether or not the lessee's capital investment arises because of improvements made by him, or by reason of his acquisition of the leasehold from a prior lessee who made the improvements. In other words, for purposes of both depreciation and the investment credit, a capital investment in a leasehold in improved real estate is regarded as a bundle of separate capital investments in the various improvements, and not as a capital investment in a single leasehold asset.

A leasehold estate viewed as a single item of property cannot be regarded as tangible property also be viewed as intangible property. Failure to fragment capital investments in leaseholds of improved real estate for purposes of sec-

54. 9 T. C. 782 (1947), *non acq.* 1948-2 CUM. BULL. 5.

55. 1960-1 CUM. BULL. 303.

tion 1245 would run counter to a clearly expressed legislative intent. The adoption of a rule which characterizes all leaseholds as intangible personalty, and therefore subject to section 1245, would disregard congressional intent to give the same content to section 1245(a)(3)(B) as is given to the equivalent language in section 48(a)(1)(B), the investment credit provision. Similarly, a rule which characterizes a leasehold estate as realty for purposes of section 1245 if the term of the lease were a fixed period (*e.g.*, 30 years) also would run counter to the explicit congressional intent that section 1245 be applicable to all property subject to the investment credit; such a rule would exempt from the recapture provisions some leasehold improvements which qualify for the investment credit, but are erected on a leasehold of a longer duration than the fixed period.

It should be noted that a taxpayer can make a capital investment in a leasehold estate under circumstances where none or only a part of his capital investment is allocable to improvements. Such cases arise when the value of occupying the land is greater than the ground rent provided in the original lease (whether the property is improved or unimproved), and a taxpayer purchases the original lessee's interest in the leasehold estate. Rev. Rul. 61-217 held that the taxpayer's cost in this instance is analogized to an investment in land. Section 1245 should have no application to such a leasehold since the leasehold in which the taxpayer has invested is equated to the land itself which is not depreciable, even though the taxpayer's leasehold interest in the land is depreciable. All inquiries regarding whether a capital investment in leasehold property qualifies under the depreciation recapture section must be directed to the qualities possessed by the underlying property to which the capital investment is allocated for purposes of depreciation or amortization.

VI. FRAGMENTATION OF SECTION 1245 PROPERTY AND SALES OF A BUSINESS

The Internal Revenue Code, which brings section 1245 potential into ordinary income on a variety of transfers which heretofore had not been taxable events, has no comparable provision for recognizing previously "unrealized" loss on section 1245 property. A simple example illustrates this. Assume Corporation X acquired after 1961 two items of depreciable property used in its trade or business which qualify as section 1245 property:

	Cost	Depreciation Allowed	Adjusted Basis	Market Value	Section 1245 Potential
Asset A	\$10,000	\$4,000	\$ 6,000	\$ 9,000	\$3,000
Asset B	10,000	4,000	6,000	3,000	(3,000)
Total	<u>\$20,000</u>	<u>\$8,000</u>	<u>\$12,000</u>	<u>\$12,000</u>	<u>0</u>

If Asset A is sold or distributed as a dividend, Corporation X will have to include \$3,000 in ordinary income under section 1245. If Asset B is sold by Corporation X, there will be a \$3,000 loss of a character to be determined under section 1231; but the corporation will have no deductible loss if Asset B is distributed as a dividend.

Suppose that Corporation X is to be liquidated under section 331 or that all of its assets are to be sold pursuant to a plan of liquidation under section 337. Literally, the statute might require that the section 1245 potential be allocated to each asset for which a separate depreciation account was maintained, or perhaps to each asset within a group of assets accounted for at a composite rate of depreciation. Such a construction would produce a tax on those assets which had a value in excess of basis without allowing a loss on those assets which had a value less than adjusted basis.⁵⁶ Such a result seems unintended.

The Treasury should adopt a rule that section 1245 will be applied to each group of assets (whether or not separate depreciation accounts have been established) sold or transferred at one time or in accordance with a single plan of liquidation. Such a rule would dictate that the section 1245 potential be measured on an aggregate basis as to all assets sold to a single purchaser, and as to all assets sold and distributed under a section 337 plan of liquidation, as well as to all assets distributed under a section 334(b)(2) liquidation.⁵⁷

In cases involving the sale of a business, the Revenue Service should adopt the principle that generally it will not disturb a negotiated allocation of price to section 1245 assets.⁵⁸ Under normal conditions, the conflicting interests of the negotiating buyer and seller should produce a fair allocation.⁵⁹ Also, in a liquidation to which section 334(b)(2) is applicable, the Service should permit the distributee a reasonable range of allocation of price to section 1245 property. If the distributee is willing to take over the liquidating corporation's

56. In *Commissioner v. Whitney*, 169 F.2d 562 (2d Cir. 1948), a transfer of securities to a controlled corporation was fragmented so that no loss was recognized on those specific securities which had declined in value while gain was recognized on those which had a value greater than basis.

57. Precedent for this construction can be found in *Treas. Reg. § 1.357-2* (1955), as amended, T. D. 6528, 1961-1 CUM. BULL. 79, which provides that in measuring the gain arising in a § 351 transaction by reason of the assumption of liabilities in excess of basis, the cost basis of all the properties transferred is to be taken into account even though only some of the properties are subject to liabilities.

It has been pointed out that on an exchange of properties, § 1245 property transferred should be matched to the extent possible against § 1245 property received. Report of American Bar Ass'n Section of Taxation, Senate Hearings, pt. 6, at 2361; Report of Committee on Taxation, Bar Ass'n of the City of New York, Senate Hearings, pt. 7, at 3022.

58. An analogous problem arises under the partnership provisions where allocation is important to both a retiring partner and the partnership. *Treas. Reg. § 1.736-1(b)* (1956) provides that generally a valuation reached in an arm's length transaction will be regarded as correct.

59. Cf. *Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959).

basis for section 1245 property, the field agents generally ought not to attempt to increase the value of section 1245 property so as to produce a tax to the liquidating corporation. The Revenue Service should seek to impose a tax on the distributing corporation only if the distributee claims a stepped-up basis. In short, the matter should be treated in about the same way that the field agents now treat inventory valuations on sales of businesses.

Because of the tax implications of the allocation of purchase price, section 1245 will play an important role in negotiations and contract drafting concerning sales of businesses. Where the purchaser acquires section 1245 assets in a taxable transaction, the contract should apportion the potential tax liability under section 1245 between buyer and seller.

Contracts for the sale of a business contemplating the transfer of either the business assets or controlling shares frequently refer to an interim balance sheet of the business which reflects its financial condition on a date somewhere between the contract date and the close of the preceding taxable year. The contract may provide that the purchaser bears the tax liability in the amount disclosed on and attributable to operations prior to the balance sheet date, plus tax liabilities accruing as a result of ordinary business conducted between the balance sheet date and the closing. Such contracts frequently except from the purchaser's responsibility taxes arising out of the "transactions contemplated by the agreement." Contract language of this sort should probably be extended to deal specifically with (1) depreciation taken between the end of the preceding taxable year and the balance sheet date, (2) depreciation taken between balance sheet date and closing date, and (3) tax liability under section 1245. Without specific treatment in the contract, the expectations of the parties could be upset if the tax reserve shown on the balance sheet on a date in the middle of a taxable year were insufficient to cover taxes "attributable" to operations prior to the balance sheet date, especially when the tax is increased because depreciation deductions are disallowed under Rev. Rul. 62-92⁶⁰ or recaptured under section 1245. Care should be exercised to make certain that the rights and obligations of the parties do not, because of thoughtless draftsmanship, change, depending on whether depreciation in the final year is disallowed under the principle of *Cohn* case rule and Rev. Rul. 62-92 or whether depreciation is allowed but recaptured under section 1245.

VII. PARTNERSHIPS

The integration of section 1245 with the partnership tax law presents special problems.⁶¹ As a companion provision to section 1245, section 751 of the

60. 1962-1 CUM. BULL. 29.

61. Generally speaking, no gain or loss is recognized either to the partner or to the partnership on contributions or distributions of property, and gains resulting from the sale of a partnership interest are treated as capital gain. There are exceptions to these general

partnership provisions was amended to include the section 1245 potential within its definition of unrealized receivables for purposes of its own provisions (dealing with disproportionate distributions of partnership property and sales of partnership interests), and for purposes of section 731 (providing for recognition of capital loss if only unrealized receivables and inventory are distributed in liquidation of a partner's interest), section 736 (providing for ordinary income treatment to cash received in liquidation of a partnership interest attributable to unrealized receivables), and section 741 (keying sales of partnership interests to the fractionating rule as to unrealized receivables and substantially appreciated inventory provided by section 751). True unrealized receivables—for example, cash basis accounts receivables arising from the rendition of personal services—are defined as such for purposes of the entire subpart of the Code dealing with partnerships. The committee reports offer no explanation why section 1245 potential is to be treated as unrealized receivables in the particular sections specified. To prevent the circumvention of section 1245's policy through the use of partnerships, it is necessary to include section 1245 potential as either unrealized receivables or substantially appreciated inventory. The reports, however, do not explain why it was decided to designate the section 1245 potential as an unrealized receivable rather than as substantially appreciated inventory.⁶²

One difference arising from the classification of section 1245 potential as unrealized receivables rather than substantially appreciated inventory occurs when a partnership distributes cash under section 736 to a retired partner in liquidation of his partnership interest. The payments are treated as ordinary income to the retired partner and are deductible by the firm. If the section 1245 potential had been denominated as substantially appreciated inventory, the cash payments to the retired partner would have remained ordinary income to him under sections 736(b)(1) and 751(b); the partnership, however, would not have been allowed to deduct the payments, but would have been required to add them to the cost basis of the retained section 1245 property. The draftsmen may have intended to mitigate the harshness of section 1245 by giving the partnership an immediate deduction corresponding to the ordinary income realized by the retired partner.

rules where the partnership holds "unrealized receivables" or "inventory items" which have "appreciated substantially in value," generally more than 20%. "Inventory items" are defined to include not only stock in trade, but also any other asset (*e.g.*, § 306 stock or stock of a collapsible corporation) which would produce ordinary income on sale. Special rules are provided for partnerships holding unrealized receivables and substantially appreciated inventory in order to prevent shifting of ordinary income between taxpayers and to prevent transmutation of ordinary income into capital gain. It seems likely that even in the absence of any amendment to § 751, § 1245 assets would have constituted substantially appreciated inventory if the percentage of value tests were met.

62. It is interesting to note that foreign investment company stock (under § 1246) was treated under the 1962 Act as substantially appreciated inventory. Section 751(d)(2)(C) of 1962 Act.

The death of a partner, however, could bring about a result that was unintended. The statute as written may be construed to deny the estate of a deceased partner the benefit of a step-up in basis on its share of section 1245 property held by the partnership. The benefit of a stepped-up basis would have been available to the estate if the decedent had held the section 1245 property individually, or if, contrary to the statute as drafted, the section 1245 potential had been characterized as substantially appreciated inventory rather than unrealized receivables. The possible denial of a stepped-up basis under the statute as drafted arises because it seems clear that a step-up in basis would be denied by the Revenue Service to the estate of a deceased partner with respect to payments in liquidation of his interest attributable to such unrealized receivables as cash basis accounts receivable arising from personal services rendered by the partnership. If unrealized receivables of this type held by the partnership do not qualify for a step-up in basis to the decedent's estate, it may be difficult to obtain the benefit of a stepped-up basis with respect to the section 1245 potential which is also characterized as an unrealized receivable.

On the other hand, the draftsmen of the depreciation recapture provision may have intended to deny a step-up in basis on the death of a partner by analogy to the tax consequences resulting on the death of a stockholder of a closed corporation. Although the stockholder's estate would receive a stepped-up basis for the stock, the section 1245 potential at the corporate level would remain subject to tax upon liquidation of the corporation.

As noted above, the characterization of section 1245 potential as an unrealized receivable does not pertain to all provisions of the partnership tax law. Draftsmen of the regulations might well seize upon the omission of reference to section 753 (providing that section 736(a) payments are income in respect of a decedent) as a ground for allowing the estate of a decedent partner the benefit of a step-up in basis with respect to his share of section 1245 potential.

Another question to be considered is whether transfers of partnership interests not involving sales or exchanges bring section 1245 potential into income. Consider, for example, a corporation in the business of leasing automobiles. On a liquidation of the corporation under section 331 or section 334(b)(2), the distributing corporation would be taxed on the section 1245 potential. If, however, the corporation were in a partnership or joint venture with another entity and the partnership or joint venture were in the automobile leasing business, the section 1245 potential inherent in the partnership assets would not seem to be brought into account on a liquidation of the corporation and distribution of the partnership interest under the statute as drafted. This result follows because, a distributing corporation generally does not realize gain on the distribution of its property and the overriding rules of section 1245 were not made applicable to transfers of partnership interests since partnership interests were not denominated section 1245 property. Under normal treatment, the shareholder of the corporation would obtain a stepped-up basis

for the partnership interest distributed during corporate liquidation and could then derive the corresponding tax benefit when the partnership made the election provided by section 754.

It is doubtful that the draftsmen of section 1245 would have intended such a result. Perhaps this "loophole," if it does exist, can be closed by the Treasury adopting the position that any disposition of a partnership interest will bring the transferring partner's share of section 1245 potential into account if a similar disposition of section 1245 property held individually by a transferor would have brought the section 1245 potential into account. The Revenue Service took a somewhat similar position in Rev. Rul. 60-352,⁶³ holding that a partner recognized income on a charitable gift of an interest in a partnership which held installment receivables. The fact that section 1245 potential has been classified as unrealized receivables rather than substantially appreciated inventory could be cited by the Treasury to support the taxation of all dispositions of partnership interests involving section 1245 potential.

VIII. POLICY OF SECTION 1245

Apart from the question of statutory construction, there is a substantial question whether Congress acted wisely and fairly in enacting section 1245. Doubtless, there exist many cases in which deductions for depreciation in the early years of an asset's life are greater than the reasonably anticipated loss in value of property (particularly where accelerated methods of depreciation are employed), even assuming no change in general economic conditions or in economic conditions relating to the particular property in question. In such cases, it is reasonable to tax as ordinary income amounts representing the excess portion of depreciation allowances previously deducted against ordinary income.

In some instances, however, where an increase in value of depreciable property is fortuitous, it traditionally has been regarded as a proper occasion for imposing a capital gain tax. *Fribourg Navigation Company*⁶⁴ presented such a situation. The court there held that depreciation deduction should be disallowed under Rev. Rul. 62-92 in the year of sale when the February 1957 sale of a liberty ship produced a substantial profit due to the increase in the economic value of freighters induced by the closing of the Suez Canal in 1956. No question was presented as to the proper initial determination of length of life or salvage value of the ship since an advance ruling had been obtained from the Revenue Service. Section 1245 would, of course, apply to such cases in the future.

Possible distinctions in the proper application of the recapture rule can be suggested by an illustration. Assume that a section 1245 asset costing \$600,000

63. 1960-2 CUM. BULL. 208.

64. 31 P-H Tax Ct. Mem. 1698 (1962) (currently on taxpayer's appeal to the Court of Appeals for the Second Circuit).

has a 10 year life and a \$50,000 salvage value, and is depreciated under the sum of the years-digits method:

	<i>Cost</i>	<i>Depreciation</i>		<i>Remaining Basis</i>	<i>Anticipated Fair Market Value</i>	<i>Actual Fair Market Value</i>
		<i>Annual</i>	<i>Cumulative</i>			
1.	\$600,000	\$100,000	\$100,000	\$500,000	\$545,000	\$545,000
2.	600,000	90,000	190,000	410,000	490,000	490,000
3.	600,000	80,000	270,000	330,000	435,000	435,000
4.	600,000	70,000	340,000	260,000	380,000	380,000
5.	600,000	60,000	400,000	200,000	325,000	325,000
6.	600,000	50,000	450,000	150,000		600,000
7.	600,000	40,000	490,000	110,000		
8.	600,000	30,000	520,000	80,000		
9.	600,000	20,000	540,000	60,000		
10.	600,000	10,000	550,000	50,000		
			550,000			

Assuming a decline in fair market value which follows on a straight-line basis, it seems fair to apply section 1245 to recapture the excess of the sum-of-years-digits depreciation over normal decline in market value reflecting exhaustion of useful service life. If, however, a change in economic conditions (such as the closing of the Suez Canal) raises the value of the asset to \$600,000 at the end of the sixth year, it does not seem consistent with traditional theory of capital gain to apply the recapture rule to the portion of the \$450,000 (\$600,000 selling price less \$150,000 remaining basis not yet depreciated) gain arising from the fortuitous increase in economic value.

Suppose that the asset had been sold at the end of the fifth year for its then market value of \$325,000. The original owner would properly be required to report the gain of \$125,000 (\$325,000 selling price less \$200,000 remaining basis) as ordinary income under section 1245 since the entire \$125,000 gain represents depreciation deductions taken in excess of expected economic exhaustion. The new owner could then sell the asset at the end of the sixth year for \$600,000 and \$275,000 of his gain (selling price of \$600,000 less his cost basis of \$325,000) would not be denied treatment as capital gain even under section 1245. Only his subsequent depreciation deductions will be recaptured under section 1245. The same change in economic conditions occurred whether the original owner retained or sold the property at the end of the fifth year, yet the operation of section 1245 produces an inconsistent result. If the original owner held the property until the sale for \$600,000, his entire gain would have been taxed at ordinary income rates under section 1245. On the other hand, an intermediate purchaser who held the property for only one year, might enjoy a large capital gain. The lack of consistency in the application of

section 1245 shown by the hypothetical is given added dimension when one compares the divergent tax consequences that would follow transfers in the fifth and sixth years not involving changes in the beneficial ownership of the property of the type suggested in the hypothetical, such as an arms length bona fide sale to a related person or a corporate liquidation.

One possible solution to the inconsistencies pointed out above would be the imposition of the ordinary income tax on the gain arising from or inhering in depreciable property (not limited to recapture of depreciation deductions) in all instances where section 1245 now imposes a tax on the section 1245 potential. Generally speaking, this would tax all transfers (other than transfers on death) with respect to which the transferee acquires a new basis. The virtue of such a rule would be the equal (albeit harsh) treatment of taxpayers in equivalent economic positions; moreover, the rule would prove advantageous to the fisc since ordinary deductions for depreciation taken by taxpayers as a group would be matched (or preceded) by ordinary income taxed to taxpayers as a group on the production and sale of depreciable property. Such a rule would naturally strike at the base of the capital gain tax. Continuation of capital gain treatment for sales of items such as stock could be justified on the grounds that holding or disposing of stock does not develop ordinary income deductions. Fairness might require that transfers which now bring section 1245 potential into income be considered taxable events occasioning the imposition of a capital gain tax on transfers of stock and also that charitable deductions be limited to the cost basis of the donated stock in a way paralleling the current limitations on charitable deductions of section 1245 property.⁶⁵

An alternative to the elimination of capital gain on all sales of depreciable property could be constructed which would preserve capital gain treatment in situations such as the Suez Canal closing. By segregating the portion of gain attributable to depreciation allowed in excess of the decline in value reflecting normal exhaustion of useful life, this solution isolates the gain arising from the unanticipated increased economic value of the asset.⁶⁶

The decline in the value of an asset in any year, which reflects the consumption of useful service life, may be measured by the loss of one year's useful service life at the end of an asset's life. A depreciable asset may be expected to generate a stream of income over its useful service life, and the present value of the asset is the discounted value of the stream of income plus the asset's salvage value. Utilization of the asset for one year reduces by one year the period during which the stream of income may be expected, but the discounting process attaches less value to the last year of the stream of income in comparison to earlier years. Since it is this value which has been exhausted, under this valuation theory the value of an asset is reduced in its early life by an amount less than straight-line depreciation. This method of

65. For an interesting summary of how the "recapture of depreciation" problem is handled in other countries, see Senate Hearings, pt. 1, at 396-416.

66. Exhibit VI to Secretary Dillon's testimony, Senate Hearings, pt. 1, at 357.

depreciation is referred to as sinking fund depreciation.⁶⁷ The best approach may be to limit recapture of depreciation deductions on all depreciable property (buildings and leaseholds as well as personal property) to the amount by which depreciation actually allowed exceeds the amount allowable under the sinking fund method (assuming for simplicity a single, perhaps 5 per cent rate of interest).⁶⁸ This rule would deal in an economically rational manner with all taxpayers, and it would eliminate the inconsistent results which section 1245 may produce when changed economic conditions have caused substantial appreciation in value.

Recapturing as ordinary income the excess of depreciation allowed over sinking fund depreciation would also eliminate tax avoidance possibilities available under present Code provisions which include in the depreciable basis of

67. Sinking fund depreciation as referred to in this paper contemplates an addition to the reserve for depreciation each year in an amount calculated as follows:

(a) Determine the amount, which if deposited annually, would grow with additions of compound interest to an aggregate sum equal to the amount to be depreciated over the useful life of the property.

(b) The addition to the reserve for depreciation each year is the amount determined in (a) above plus interest during the year on the amounts previously accumulated.

No accumulation of cash is contemplated and the deposit and interest calculations are merely for purposes of computing depreciation. Standard compilations of compound interest tables, such as "Financial Compound Interest and Annuity Tables" published by Financial Publishing Company (1942) provide both formulas and tables. The formula for determining the annual amount D which would be required to be deposited is

$$D = B \left[\frac{i}{(1+i)^n - 1} \right]$$

and the formula for determining the accumulated depreciation R at the end of any period is

$$R = D \left[\frac{(1+i)^n - 1}{i} \right]$$

where B is the amount to be depreciated, n is anticipated useful service life and i is the periodic rate of interest. The compound interest tables, of course, supply values for

$$\frac{i}{(1+i)^n - 1}$$

(the amount to be deposited periodically for n periods at i rate of interest which will accumulate to \$1) and

$$\frac{(1+i)^n - 1}{i}$$

(the amount to which \$1 deposited at the end of each period for n periods at i rate of interest will grow) for various periods and rates of interest.

68. Set forth below is a table illustrating the percentage of entire basis to be depreciated which would be accumulated at the end of 5 year periods for assets having useful service lives of 10, 20 and 40 years. The table shows the percentage of depreciation accumulated under four methods of depreciation: straight line, sum of the years-digits, 5% sinking fund, and 10% sinking fund. For example, if the property had a 20 year life, the straight line method would accumulate 75% of total depreciation by the end of the 15th year, while the

property, mortgages to which property is subject as well as the owner's equity. Assume, for example, that a newly organized corporate taxpayer leases unimproved real estate on which it plans to construct a building meeting the specifications of a sublessee with a prime credit rating. The prospective subtenant agrees to sublease the building when completed on a net sublease basis. Most, or all, of the cost of the building is covered by an institutional mortgage, requiring regular payments of blended principal and interest totaling an amount less than the net rent under the sublease; most, or all, of the balance of the sublease rentals are applied to pay the ground rent. Assume, finally, that upon the building's completion the corporate taxpayer transfers the leasehold estate to an individual who does not thereby become liable either on the ground lease or on the mortgage.

Under present law it is possible that the individual who acquires the leasehold estate from the corporation could take depreciation deductions based on the cost of the building including the mortgage. There may be little or no cash flow to the individual because mortgage payments and ground rent are almost equal to rent received under the sublease, but he still may enjoy a favorable economic situation; during the early years of the transaction the depreciation allowances (which consume no cash, but are deductible for tax purposes) may exceed the mortgage amortization payments (which consume cash, but are not deductible for tax purposes). Of course, over the life of the property, the mortgage amortization (disregarding return of any capital invested) will equal depreciation, but the benefit of depreciation deductions in excess of mortgage amortization payments taken in the early years remains. The unpaid mortgage principal will exceed the adjusted basis of the building so long as there has been a cumulative excess of depreciation deductions over amortization payments measured from the start of the transaction. Upon a transfer of the leasehold estate with a mortgage in excess of basis, the individual must recognize gain to the extent that the sum of the cash received plus the amount of the mortgage remaining unpaid exceeds the adjusted basis

sum of the years-digits method would accumulate 93% and the 10% sinking fund method would accumulate only 56%.

10 year life					20 year life				40 year life			
Year	Straight Line	Sum of Years - Digits	Sinking 5%	Fund 10%	Str. Line	Sum of Years - Digits	Sinking 5%	Fund 10%	Str. Line	Sum of Years - Digits	Sinking 5%	Fund 10%
5	50	73	44	38	25	43	17	11	12.5	23	5	1
10	100	100	100	100	50	74	38	28	25	43	10	4
15					75	93	65	56	37.5	60	18	7
20					100	100	100	100	50	74	27	13
25									62.5	85	39	22
30									75	93	55	37
35									87.5	98	75	61
40									100	100	100	100

of the property. If such gain may properly be reported as capital gain in its entirety, it could be said that tax avoidance resulted from the circumvention of the recapture principle.

A rule requiring recapture of depreciation to the extent depreciation allowed exceeds sinking fund depreciation would produce a better result because the recaptured depreciation would be substantially equal to the excess of the unpaid mortgage balance over the adjusted basis of the property at the time the leasehold was disposed of. The reduction of the amount of outstanding principal due on a mortgage which is liquidated by equal blended payments applied first to interest and then to principal, is identical to the reduction in basis of property under the sinking fund method of depreciation where (1) the basis to be depreciated is equal to the original mortgage principal, (2) the length of life of the property is equal to the term of the mortgage, and (3) the interest rates are the same. The sinking fund method of depreciation, in other words, tends to match depreciation with payments of principal on an equivalent mortgage.

SUMMARY

Most of the ambiguities in section 1245 can be resolved by regulations. The chief impact of the new section flows from the expansion of the scope of the ordinary income tax at the expense of the capital gain tax and from the treatment of specified transactions, which previously did not bring income into account, as taxable events.

The rules for recapturing depreciation now contained in section 1245 can probably best be defended on the ground of administrative convenience. Prior to the enactment of section 1245, substantial and time consuming disputes between taxpayers and auditing agents arose during the determination of rates of depreciation and salvage value. Revenue agents were understandably reluctant to permit rapid write-offs of depreciable property and to allow low, assumed salvage values when they were aware that gains on the dispositions of such property would be taxed at capital gain rates. Taxpayers and industry representatives, on the other hand, had been urging liberalization of depreciation rates and acceptance of low salvage value, on the theory that depreciation allowances were inadequate under then existing rules and practice. The rules contained in section 1245 may assist in resolution of this conflict. It can be expected that auditing agents will be far more likely to agree with a taxpayer's computation of depreciation and salvage if "over-depreciation" is subject to recapture at ordinary income rates. Viewed against this background, the recapture rules of section 1245 were designed to meet the practical administrative problem faced by the Treasury and taxpayers. Since the portion of a taxpayer's gain attributable to amounts realized above the original cost basis of property cannot represent "over-depreciation," it was not thought necessary to tax such gains at ordinary income rates.

No attempt was made in section 1245 to separate "over-depreciation" from market appreciation. Whether the fairness which might be achieved by at-

tempts to strain out market appreciation is worth the administration difficulties which this distinction produces is a question which Congress must decide. It seems clear that any "strain out" rule must, as a minimum, be reasonably easy to administer and involve relatively few factual questions. The rule suggested in this article for recapturing the difference between sinking fund depreciation and depreciation actually allowed or allowable may be a satisfactory method for dealing with the problem.

APPENDIX

SEC. 1245. GAIN FROM DISPOSITIONS 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, 1962, 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.

(2) **RECOMPUTED BASIS.**—For purposes of this section, 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. For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation, or for amortization under section 168, for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

(3) **SECTION 1245 PROPERTY.**—For purposes of this section, the term "section 1245 property" means any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

(A) personal property, or

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constituted research or storage facilities used in connection with any of the activities referred to in clause (i).

(b) EXCEPTIONS AND LIMITATIONS.—

(1) **GIFTS.**—Subsection (a) shall not apply to a disposition by gift.

(2) **TRANSFERS AT DEATH.**—Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

(3) **CERTAIN TAX-FREE TRANSACTIONS.**—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a) (1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(4) **LIKE KIND EXCHANGES; INVOLUNTARY CONVERSIONS, ETC.**—If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a) (1) shall not exceed the sum of—

(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

(5) **SECTION 1071 AND 1081 TRANSACTIONS.**—Under regulations prescribed by the Secretary or his delegate, rules consistent with paragraphs (3) and (4) of this subsection shall apply in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to exchanges in obedience to SEC orders).

(6) **PROPERTY DISTRIBUTED BY A PARTNERSHIP TO A PARTNER.**—

(A) **IN GENERAL.**—For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) **ADJUSTMENTS ADDED BACK.**—In the case of any property described in subparagraph (A), for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

(ii) the amount of such gain to which section 751(b) applied.

(c) **ADJUSTMENTS TO BASIS.**—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

(d) **APPLICATION OF SECTION.**—This section shall apply notwithstanding any other provision of this subtitle.