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COMMENTS

GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY—SECTION 1245

I. BASIC PURPOSE OF SECTION 1245

The Revenue Act of 1962, as passed by Congress on October 2, 1962, was designed to "eliminate certain defects and inequities, and for other purposes."[1] One of the primary objects of the Act was accomplished through the incorporation and passage of section 1245.[2]

A. *Basic Design*

Section 1245 will largely eliminate the capital gain rate advantage on sales of depreciable property other than buildings.[3] This advantage was a windfall enjoyed by taxpayers for over 20 years,[4] permitting them to take ordinary deductions for depreciation against their taxable income, while reporting the net proceeds from the disposition of this kind of property as income subject to preferential capital gains rates.

The essence of section 1245, as set forth in subsection (a),[5] is that gain from any disposition of "section 1245 property" is to be taxed as ordinary income to the extent of deductions taken for depreciation (and

1. Introduction to the Revenue Act of 1962, 76 Stat. 960 (1962).

2. INT. REV. CODE OF 1954, § 1245.

3. The Treasury Department attempted to have the original § 1245 cover all depreciable property, including buildings. *Cf.* Secretary Dillon's Explanation of the President's Recommendations Contained in His Message on Taxation, as submitted May 3, 1961 in connection with Hearings of the Ways and Means Committee. The Treasury Department has renewed this effort to have buildings included in § 1245, and if Congress follows the current recommendations of the President and the Treasury, the revenue bill of 1963 will greatly reduce this advantage for buildings also. *Cf.* The President's Special Message on Tax Reduction and Reform, presented to Congress on Jan. 24, 1963, § VI(C)(5)(a); Technical Implementation of the President's Recommendations Contained in His Message on Taxation, as submitted with Secretary Dillon's Statements to the Ways and Means Committee on Feb. 6, 1963, § XVIII (C)(1)(a). The proposal would tax as ordinary income 100 per cent of building gain matched by post-1962 depreciation for a building owned for six years or less; the precentage taxed as ordinary income would progressively reduce for buildings owned more than six years, and would become zero after 14 1/3 years of ownership. The proposal would also require buildings to be depreciated under the straight-line method, thus eliminating accelerated depreciation. Since the proposal uses the words "real estate," it may intend the foregoing treatment for some elements of what is now § 1245 property.

4. Prior to the 1962 enactment of § 1245, the capital gain rate advantage had applied to sales of depreciable assets since 1942. Section 151 of the Revenue Act of 1942 amended the Internal Revenue Code of 1939 to add § 117(j), which gave long-term capital gain treatment to net gains from sales of depreciable or real property used in business and held more than six months, while net losses from such sales were deductible as ordinary loss. This provision became the present § 1231 of the Internal Revenue Code of 1954.

5. INT. REV. CODE OF 1954, § 1245(a).

for amortization of emergency facilities under Code Section 168) allowed after 1961.

B. *Past Abuses and Their History*

The tax treatment of gains and losses realized from the sale, exchange, or other disposition of depreciable assets used in a trade or business, prior to the enactment of section 1245, had been substantially the same since 1942.[6] It was the source of much litigation, which was necessary to curb abuses by taxpayers who could not be satisfied with limiting their tax benefits to those provided by the spirit of existing benefit provisions. Most of the litigation involved excessive depreciation and the interpretation of ambiguous wording of the Internal Revenue Codes.

The automobile dealers' cases[7] were among the most notable in this area. They involved accelerated depreciation of rental and demonstrator autos over a shorter period of time than their actual useful lives in the taxpayers' trades or businesses, with resultant gains on ultimate disposition. These gains were treated by the taxpayers as capital gains under section 1231 of the Internal Revenue Code.[8] Gains were further increased by the taxpayers' failure to provide adequate provision for salvage value in computing depreciation, as required by section 167.[9] The Supreme Court, in the *Massey*, *Evans* and *Hertz* cases,[10] partially closed this loophole by settling the ambiguity in the meaning of the words "useful life" and "salvage value" in the Government's favor. The Court defined "useful life" to be the useful life of an asset in the particular taxpayer's trade or business, as opposed to the generally longer economic life of the asset. It defined "salvage value," for purposes of computing depreciation, as the resale value at the time of disposal, and not merely as junk value. Thus, auto dealers, who dispose of rental fleets and demonstrator autos in less than three years, are denied the use of accelerated depreciation methods.[11] In addition, where their experience

6. See note 4, *supra*.

7. 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); Bruce-Flournoy Motor Corp. v. United States, 62-2 U.S. TAX CAS. 9695 (E.D. Va. 1962); Capital Automobile Co. v. United States, 59-2 U.S. TAX CAS. 9680 (N.D. Ga. 1959); Lynch-Davidson Motors, Inc. v. Tomlinson, 172 F. Supp. 101 (S.D. Fla. 1958); North Florida Motor Co. v. Tomlinson, 56-1 U.S. TAX CAS. 9133 (S.D. Fla. 1956); Fields v. Grandquist, 134 F. Supp. 624 (Ore. 1955); Latimer-Looney Chevrolet, Inc., 19 T.C. 120 (1952).

8. INT. REV. CODE OF 1954, § 1231. This section permits taxpayers to treat gains on the sale of certain types of depreciable assets used in their trade or business as capital gains. This treatment is allowed despite the fact that prior depreciation deductions on the property were used to reduce ordinary income. Therefore, under § 1231, prior to the enactment of § 1245, it was advantageous to a taxpayer to depreciate an asset as quickly as possible in order to reduce ordinary taxable income, and later dispose of the asset at a gain which was subject only to capital gains rates.

9. INT. REV. CODE OF 1954, § 167.

10. See note 7 *supra*.

11. Treas. Reg. § 1.167(c) (1956) provides limitations on the use of the declining

rating shows that the average price from the ultimate sale of the autos approximates a relatively constant percentage of cost, salvage value will be deemed to be equivalent to the amount realized. However, even these decisions did not altogether deter a taxpayer from depreciating an asset faster than its actual life and subsequently realizing capital gains on its disposition. Useful life, by its very nature, is an unpredictable variable. In many instances, especially in cases involving assets with relatively long useful lives, the Commissioner has been presented with an accomplished fact long after the statute of limitations[12] has run on correcting depreciation.

A further attempt by the Commissioner to close the loopholes surrounding the tax treatment of assets sold under the provisions of section 1231 was successful in the *Cohn*[13] case. The holding of that case, and a later Revenue Ruling promulgated as a result of it,[14] provided that capital gain treatment would be disallowed to the extent of depreciation deductions taken in the year of sale of an asset. Or, to put it another way, depreciation deductions would be denied in the year of sale, to the extent that the sales price of the asset exceeded its adjusted basis at the close of the previous taxable year. The theory of this holding was that salvage value, being the resale value at time of disposal, was definitely ascertainable as of the close of the taxable year in which the asset was sold. Since the Regulations provided that under no method of depreciation could an asset be depreciated below a reasonable salvage value,[14a] any depreciation in the year of sale in excess of the resale value was obviously depreciation below a reasonable salvage value. But even this interpretation conclusively closed the door to excessive depreciation only in the year of disposition of an asset.

Other problem areas involved the definition of a "depreciable asset used in a trade or business";[15] the most frequent problem was the question of whether an item was properly classified as "inventory" or "stock-in-trade," and hence non-depreciable.[15a] Again the automobile dealers

balance method, the sum-of-the-years'-digits method, and certain other methods authorized by INT. REV. CODE OF 1954, §§ 167(b)(2), (3) and (4). These methods are only applicable to tangible property having a useful life of three years or more.

12. Except in exceptional circumstances, such as fraud or substantial omission of gross income, income taxes must be assessed within three years after the return is filed. INT. REV. CODE OF 1954, § 6501(a).

13. Cohn v. United States, 259 F.2d 371 (6th Cir. 1958). This decision was followed in Fribourg Navigation Co., Inc., — CCH Tax Ct. Mem. 7194 (1962).

14. Rev. Rul. 62-92, 1962 INT. REV. BULL. No. 26, at 9.

14a. Treas. Reg. § 1.167(a)(1)(a) (1956).

15. INT. REV. CODE OF 1954, § 1231, provides capital gain treatment only for depreciable assets used in a trade or business and held for more than six months.

15a. Whether leased personal property is held "primarily" for sale is a question of fact. In a case in which the taxpayer was in the business of selling water coolers or leasing them under standard rental agreements, the court held that "primarily" means "essential"

were involved in litigation. The result has been to distinguish certain types of autos.[16] New and used car sales from a dealer's inventory always result in ordinary income. "Company cars," those used for errands of the dealer's business and actually appropriated from stock in trade, are generally treated as section 1231 assets. A demonstrator auto is generally treated as stock-in-trade, since it is withdrawn from inventory only for temporary use in the trade or business, cost being primarily recoverable through a subsequent sale rather than through normal depreciation.[17]

There are many other industries in which the question of "inventory v. depreciable asset" has been a constant source of difficulty for the Government. These include the auto rental industry, the uniform and linen supply businesses, the hotel industry, and various other industries where inventory type items are rented to or used by the public. When the taxpayer expenses an inventory item at the time it is put into use, it has been to the Government's advantage to argue that the item *is* a depreciable asset. At this point, the taxpayer might concede that the property is depreciable, but will contend that the article is still properly treated as an expense item at the time it is put into use. This contention will be based on the argument that the article has a useful life of less than one year, notwithstanding the fact that the useful life straddles two or more accounting periods. Examples of these items include truck tires,[18] linens, silverware, uniforms and small tools. If there is a sale of the principal asset to which the item is attributable, such as a truck, laundry,

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or "substantial," rather than "principal" or "chief." When the taxpayer contended that, since its sales of rented water coolers comprised only two per cent of its total sales, such coolers could not have been held primarily for sale, the court was not satisfied. Continuity and frequency of sales is only a single factor and is not determinative. S.E.C. Corp. v. United States, 241 F.2d 416 (2d Cir. 1957).

Returnable containers have presented a similar problem. If the seller retains title to returnable containers in which goods are packed, and bills them to the customer, who is credited with the billed price upon their return in good condition, only the percentage of containers which experience indicates will not be returned represents income. The income is ordinary income. Rev. Rul. 58-77, 1958-1 CUM. BULL. 118; La Salle Cement Co. v. Commissioner, 59 F.2d 361 (7th Cir. 1932). However, if title to containers will pass to the purchaser upon the sale of goods in such containers, a different rule applies. In these cases, containers in the seller's possession and those in transit or with merchandise on consignment should be inventoried. Those billed to the customer would be included in their entirety in gross sales, and those brought back would be included in purchases. Ralph Ferguson, 11 CCH Tax Ct. Mem. 213 (1940). In the cases where the seller retains title, it would appear that the containers which do not represent income would be assets subject to depreciation, whether they are on the seller's floor, in transit, or in the possession of the purchaser.

16. Duval Motor Corp. v. Commissioner, 264 F.2d 548 (5th Cir. 1959).

17. Rev. Rul. 60-15, 1960-1 CUM. BULL. 22, *modifying* Rev. Rul. 54-222, 1954-1 CUM. BULL. 19.

18. The cost of tires and tubes purchased on new commercial trucking equipment and used in motor freight transportation is deductible as a business expense in full in the taxable year of purchase and payment (or accrual) if, in such use, the equipment is consumable within that year or its average useful life is less than one year, even though it extends in part into the next taxable year. Rev. Rul. 59-249, 1959-2 CUM. BULL. 55.

restaurant, hotel or factory, the taxpayer will generally attempt to claim capital gains treatment on the whole sale.

C. *More Recent Loopholes Closed*

Besides the normal, long-standing accelerated depreciation methods,[19] the Technical Amendments Act of 1958 provided additional first year depreciation on certain types of tangible, depreciable personal property.[20] If elected, this additional first year depreciation allowed a taxpayer to deduct ten per cent of the cost of an asset in the year of purchase, without regard to salvage value.

Also, in response to a clamor from industry for more liberalized depreciation methods, the Commissioner issued Revenue Procedure 62-21,[21] which provided longer useful life guidelines which the Treasury Department would accept for most assets, provided that they are found to be justified by a taxpayer's future experience.

Further, the Revenue Act of 1962 provided a direct credit (against taxes due) for investment in certain types of newly acquired property,[22] for the first time in the history of United States taxation.[23]

In order to close these "loopholes," and to prevent further exploita-

19. See note 11 *supra*.

20. INT. REV. CODE OF 1954, § 179, permits businesses (not including trusts) to elect to write off 20% of the cost, up to $10,000.00 ($20,000.00 on a joint return) of tangible personal property, in the year of acquisition, in addition to the regular depreciation allowance for property acquired for use in the taxpayer's trade or business, or to hold for the production of income.

21. Treasury Release No. I.R.-517, July 11, 1962, embodying I.R.S. Publication #456. These new depreciation guidelines and rules were issued by the Commissioner and superseded Bulletin "F," which had been in effect for almost twenty years. These new and shorter guidelines apply to about 75 broad classes of assets rather than to specific items. Generally, if a taxpayer uses these guideline lives for guideline classes and uses retirement and replacement practices in connection with the assets which are consistent with the class lives used, he will meet the objective tests set out in these new procedures and his depreciation allowances will not be disturbed. This is in keeping with the announced policy of the Internal Revenue Service not to disturb the depreciation deductions taken by a taxpayer unless there is "clear and convincing basis for a change." I.R. Mim. No. 183, 1953-1 CUM. BULL. 43 and Rev. Proc. 57-18, 1957-1 CUM. BULL. 748.

22. INT. REV. CODE OF 1954, §§ 38, 46 and 48. A credit against the tax is allowed for taxable years ending after 1961, up to 7% of the qualified investment in certain types of tangible personal property acquired after that date.

23. It is presumed that the effect was not made retroactive to the extent of including depreciation prior to 1961 within this stop-gap provision for various reasons. Presumably this would come within Congress' self-imposed restrictions against making revenue provisions retroactive when they have the effect of disrupting present tax planning and increasing the tax burden on certain taxpayers. Also, making the statute effective *in futuro* has only a cushioning effect and thus does not adversely affect prior financial and tax planning.

S. Rep. No. 1881, 87th Cong., 2d Sess. 95 (1962), amended the House bill (which applied to depreciation occurring in 1962 and subsequent years) to apply only to sales, exchanges or other dispositions occurring during taxable years beginning after December 31, 1962. The house receded on this point. Conf. Rep. No. 2508, to accompany H.R. Rep. No. 10650, Amendment No. 128, 87th Cong., 2d Sess. 36 (1962).

tion which might result from the newly enacted rules for investment credits for newly acquired property and the liberalized depreciation guidelines, gains from the sales of certain depreciable assets will be treated as ordinary income under section 1245, to the extent of post-1961 depreciation allowed.

II. BASIC STRUCTURE OF SECTION 1245

A. *General Rule*

1. COMPUTATION OF GAIN

In general, 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.[24]

2. RECOMPUTED BASIS

In simple terminology, recomputed basis is, generally, the adjusted basis of section 1245, plus any depreciation and emergency-facility amortization deductions for periods after 1961. In addition, the amount of any depreciation or amortization to be added back to the adjusted basis is not necessarily the larger of the amount "allowed or allowable."[25] If a taxpayer can prove that the amount allowed is less than the amount allowable, only the amount actually allowed is added back to the adjusted basis of the asset. The burden of proof is on the taxpayer to establish, by adequate records or other sufficient secondary evidence, that the amounts actually allowed were, in fact, less than the amounts allowable.[26]

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24. INT. REV. CODE OF 1954, § 1245(a)(1).

25. The "allowed or allowable rule" refers to INT. REV. CODE OF 1954, § 1016(a)(2), which provides that the basis of property shall be reduced by an amount equal to the deductions allowed against taxable income, but not less than the amount allowable. However, such reduction in basis is limited by the relief provisions of INT. REV. CODE OF 1954, § 111(a) and (b)(4), which provide for a "recovery exclusion" from gross income for amounts received upon subsequent disposition of the asset, but only to the extent that such prior depreciation attributed to the asset did not result in a "tax benefit." For the purposes of this section, a "tax benefit" means a reduction of the taxpayer's taxable income for the period to which the depreciation is attributed.

"Allowed or allowable" depreciation in a taxable year is the amount to be used for adjusting basis for gain or loss or depreciation for subsequent years, regardless of any statute of limitations applicable to the year of deduction. I.T. 2944, XIV-2 CUM. BULL. 126 (1935).

26. INT. REV. CODE OF 1954, § 1245(a)(2). It is not clear just what will be accepted as adequate proof in this type of situation. It will be extremely difficult for the taxpayer to prove amounts "allowed or allowable" on assets held for very long periods of time.

3. DEFINITION OF SECTION 1245 PROPERTY

In general, section 1245 property includes property (other than livestock) subject to depreciation allowed or allowable after December 31, 1961.[27] In addition, such property must be either (1) personal property (tangible or intangible), or (2) other tangible property (except buildings or their structural components) with an adjusted basis resulting from depreciation or section 168 amortization[28] allowed or allowable for periods after 1961, used for specified activities[29] during that period.

B. *Exceptions and Limitations*

The general rule regarding gain from the disposition of section 1245 property is subject to several important exceptions and limitations. These are based upon sound legislative reasoning, and they are discussed below.

1. GIFTS AND TRANSFERS AT DEATH

The general rule shall not apply to dispositions by gift,[30] nor to transfers at death (except as provided in section 691 relating to income in respect of a decedent).[31]

This means that ordinary income does not result to a donor of section 1245 property.[32] However, the ordinary income potential carries over to

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Presumably the taxpayer's copies of his prior tax returns should be "sufficient evidence" for this purpose. The problem of proof may be even more difficult when the deductions in dispute relate to a period during which a predecessor held the property. This is because § 1245 property need not be subject to the allowance for depreciation in the hands of the taxpayer, if it was subject to the allowance in the hands of a prior holder, and this allowance was taken into account in determining the adjusted basis in the hands of the taxpayer.

27. INT. REV. CODE OF 1954, § 1245(a)(3).

28. INT. REV. CODE OF 1954, § 168, provides special accelerated amortization for emergency facilities specially constructed in connection with defense projects. This method must be elected by the taxpayer and authorized by the Treasury, and will generally result in the facility being amortized over a maximum period of sixty months.

29. The "specified activities" referred to in INT. REV. CODE OF 1954, § 1245(a)(3)(B) includes the use of such property

> (i) . . . 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).

30. INT. REV. CODE OF 1954, § 1245(b)(1).

31. INT. REV. CODE OF 1954, § 1245(b)(2). Section 691 of the Code relates to income in respect of a decedent. Thus, where a sale of § 1245 property occurred before the death of decedent, and the income is treated as income in respect of a decedent under § 691, ordinary income would be recognized. Section 691 generally refers to situations where a taxable event has *occurred* prior to the death of the decedent, but for various reasons, such as the election to use the installment method of reporting, not all of the taxable income has been *realized* prior to the death of the decedent and the distribution of his estate.

32. However, there is an exception to this exception. If a gift of § 1245 property is made to a charitable organization, the donor's charitable contribution deduction is reduced by the amount which would have been treated as ordinary income if the property had been sold at its fair market value, determined at the time of such contribution.

the donee of such property, and the donee will be subject to the general rule if he makes a disposition of the property which is not within the exceptions and limitations provided. In other words, a gift of section 1245 property does not change the character of the property; it remains section 1245 property, and retains its "taint" in the hands of the donee.

Although the general rule is similarly inapplicable to transfers of section 1245 property at death, the basis of the property in the hands of a legatee or devisee is somewhat different than in the case of a donee. The ordinary income potential of section 1245 property, resulting from depreciation allowed or allowable to a decedent, will not carry over to a legatee or devisee. The legatee or devisee will receive the property "untainted." This necessarily follows since no depreciation deductions are reflected in the legatee's basis in the property.[33]

2. TAX FREE TRANSACTIONS, LIKE KIND EXCHANGES AND INVOLUNTARY CONVERSIONS, AND TRANSACTIONS PURSUANT TO CERTAIN GOVERNMENTAL ORDERS

In transfers under certain code sections[34] involving tax-free transactions in which the transferor's basis in the transferred property is carried over to the transferee, no ordinary income is realized by the transferor under section 1245.[35] However, if in these transactions any gain is recognized to the transferor, as where the exchange is accompanied by "boot,"[36] ordinary income may be realized to the extent of the recognized gain. This exception does not apply to dispositions of property to tax-exempt organizations, other than tax-exempt cooperatives.[37]

INT. REV. CODE OF 1954, § 170(e) (amending § 170 to redesignate sub-sections (e) and (f) as (f) and (g), respectively, as provided by § 13(d) of the Revenue Act of 1962).

33. A legatee's or devisee's basis is, generally, either the valuation at the date of the decedent's death, or at an alternate valuation date provided under § 2032. INT. REV. CODE OF 1954, § 1014.

34. The Code sections referred to are the following sections of the 1954 Internal Revenue Code: (1) section 332, tax-free distributions to a corporation upon the complete liquidation of a subsidiary; (2) section 351, transfers to a controlled corporation for stock or securities; (3) section 361, transfer of property by a corporation which is a party to a reorganization, the transfer being in pursuance of a plan or reorganization and made solely for stock or securities in another corporation also a party to the reorganization; (4) sections 371(a) and 374(a), transfers in certain receivership and bankruptcy proceedings; (5) section 721, contributions to a partnership in exchange for a partnership interest; and, (6) section 731, distributions of a partnership in complete or partial liquidation (except for the special partnership treatment for distributions by a partnership to a partner under § 1245(b)(6), amending § 751(c)).

35. INT. REV. CODE OF 1954, § 1245(b)(3).

36. "Boot" is a word used in tax terminology to describe non-qualifying property in an otherwise non-taxable exchange. Gain will generally be recognized to the extent of this non-qualifying property received.

37. The reason that § 1245 gains are recognized when there is a transfer to tax-exempt organizations (other than cooperatives) is that a later disposition of the property by these organizations would not result in any ordinary income because of any post-1961 depreciation allowances.

Tax-exempt farmer's cooperatives, as described in INT. REV. CODE OF 1954, § 521, are excluded from this exception, as they are not completely tax exempt, and gain may be

Another exception to the general rule involves the voluntary disposition of property in like-kind exchanges (exchanges solely in kind)[38] or through an involuntary conversion[39] of property. Generally, no gain is recognized, in whole or in part, in either of these situations. However, in those instances in which any gain *is* recognized under either of these circumstances, and section 1245 property is involved, section 1245 gain may be recognized to the same extent. If any property (on which gain is not recognized) in addition to the section 1245 property is received in the same exchange or conversion, and does not qualify as section 1245 property, section 1245 gains may be increased to the extent of the fair market value of such property.[40]

Certain sales or exchanges pursuant to compliance with the orders of the Securities Exchange Commission or the Federal Communications Commission also come under an exception to the general rule.[41] Under sections 1071[42] and 1081,[43] these sales or exchanges are given special

recognized upon ultimate disposition of the § 1245 asset by the cooperative or its patrons.

> In explaining this provision, the Senate Finance Committee stated in its report that "no implication is intended" as to whether a transfer to such an exempt organization could or could not qualify for nonrecognition under the sections of the Code set forth in the exception. Apparently the Service contends that the nonrecognition provisions of the Code do not apply to transactions involving charitable organizations. The drafters of Section 1245 evidently considered it desirable to eliminate any doubt on the question insofar as Section 1245 was concerned. At the same time, they did not want to provide any support for an argument that, because the point was covered in Section 1245, transfers to an exempt organization could qualify by implication for nonrecognition in situations where Section 1245 was not involved. Rustigan & Melvoin, *1962 Act: Important Changes in Tax Planning Required by Depreciation Recapture Rule*, 17 J. TAX. 322, 324 (1962).

38. INT. REV. CODE OF 1954, § 1031(a), provides for nonrecognition of gain from exchanges of property held for productive use or investment for similar property.

39. In general, if property, as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation (or threat or imminence thereof) is compulsorily or involuntarily converted, no gain is recognized upon the conversion to the extent that the proceeds received are expended in the acquisition of similar property within a prescribed period of time. INT. REV. CODE OF 1954, § 1033.

40. INT. REV. CODE OF 1954, § 1245(b)(4). The rationale behind the recognition of gain to the extent of non-section 1245 property received is sound. Otherwise, a taxpayer could, under § 1033(a)(3)(A), replace the property involuntarily converted by purchasing stock in the acquisition of control of a corporation owning the requisite similar replacement property. Since the stock thus acquired is nondepreciable property, it would not qualify as § 1245 property. If this rule did not apply, the taxpayer would be able to convert part of his nonrecognized gain into a nondepreciable capital asset on which he would realize capital gain or loss, rather than ordinary income, on a subsequent disposition of the asset. This would have permitted a circumvention of the intent and purpose of § 1245.

41. INT. REV. CODE OF 1954, § 1245(b)(5).

42. INT. REV. CODE OF 1954, § 1071, provides for the nonrecognition of gain or loss when a sale or exchange of property is certified by the Federal Communications Commission to be necessary or appropriate to effectuate new or changed policies of the Commission. In these cases, the taxpayer may elect to treat the sale or exchange as an involuntary conversion under § 1033 of the Code. In addition, a taxpayer may elect to have his basis in any depreciable property remaining in his hands immediately after the sale or exchange or acquired in the same taxable year.

43. INT. REV. CODE OF 1954, § 1081 provides rules for the nonrecognition of gain

treatment to cushion the tax impact on forced sales. This is accomplished by allowing a taxpayer to apply any gain from a forced disposition in reduction of his basis on certain types of property, in lieu of recognition of the gain. In cases in which the property disposed of is non-depreciable, and hence does not qualify as section 1245 property, a severe inequity would be created if the gains were applied in reduction of the basis of property qualifying as section 1245 property, without a corresponding relief provision. Otherwise, the result would be to convert the capital gain realized on the original sale or exchange into ordinary income upon a later disposition of property whose basis was reduced by the gain. Therefore, Congress has treated transactions arising under sections 1071 and 1081 in a manner consistent with the treatment accorded certain tax-free transactions, like-kind exchanges, and involuntary conversions of property.[44]

3. PARTNERSHIP DISTRIBUTIONS

Another broad category of exceptions to the general rule of section 1245 involves property distributions by a partnership to a partner. The basis to the distributee partner is determined by reference to the partnership's adjusted basis.[45] For the purposes of this section, "recomputed basis" is computed by adding back the amount of any gain (to the extent of depreciation taken for periods after 1961 by the partnership, or any earlier transferor from whom the partnership acquired property without realization of gain) which would have been realized if the property had been sold at its fair market value immediately prior to its distribution to the partner.[46] However, the amount to be added back is reduced by the amount of any section 751(b)[47] gain.[48] The foregoing rules apply only to the extent that a partner is considered as receiving his share of property representing ordinary income gains to the partnership.[49]

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or loss to the transferor of stock or securities in obedience to orders of the Securities and Exchange Commission. Gain is recognized to the extent of nonexempt property or money received in such a distribution or exchange. The nonrecognized gain is applied to reduce the basis of certain categories of property, in the order and manner prescribed by INT. REV. CODE OF 1954, § 1082.

44. INT. REV. CODE OF 1954, § 1245(b)(5) does not specify the exact manner of granting such relief. It merely provides that

> 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 . . . or section 1081 . . . .

It is expected that the Commissioner will prescribe rules to make consistent the § 1245 treatment of distributions and exchanges under §§ 1071 and 1081.

45. Int. Rev. Code of 1954, § 1245(b)(6)(A).

46. Int. Rev. Code of 1954, § 1245(b)(6)(B)(i).

47. INT. REV. CODE OF 1954, § 751(b) relates to the receipt by a partner of unrealized receivables or appreciated inventory items in exchange for an interest in other partnership property, and to the receipt of other property in consideration of the release of interests in unrealized receivables or appreciated inventory items.

48. INT. REV. CODE OF 1954, § 1245(b)(6)(B)(ii).

49. Section 13(f) of the Revenue Act of 1962, amends INT. REV. CODE OF 1954, § 751(c), relating to the definition of "unrealized receivables," as follows:

C. *Methods of Applying Section 1245*

1. IN GENERAL

The Secretary of the Treasury or his delegate (the Commissioner of Internal Revenue) is authorized to prescribe regulations that he may deem necessary to provide for adjustments to the basis of property to properly reflect section 1245 gains.[50]

For one thing, this will be necessary to prevent double taxation at ordinary income rates of section 1245 gains. This would be especially applicable in the case of a corporate distribution of section 1245 property to a corporate shareholder. The basis of the property in the hands of the distributee shareholder is usually the fair market value or the adjusted basis of the distributing corporation, whichever is lower.[51] Since section 1245 gains may be recognized to the distributor in these cases,[52] the distributee should be permitted to increase its carryover basis. If this is not done, the distributee might be taxed on the same gain when it later sells the property.

2. SPECIAL RULES APPLICABLE TO SECTION 1245

In addition to those auxiliary amendments already considered,[53] Congress also has included a number of other amendments to existing Code sections for the purpose of implementing section 1245.

Section 1245 gains will result from three types of corporate distributions, even though capital gains on these distributions are not recognized:[54]

(1) Where the property is distributed as a dividend under section 311;[55]

> For purposes of this section and sections 731, 736, and 741, such term also includes section 1245 property . . . , but only to the extent of the amount which would be treated as gain to which section 1245(a) would apply if (at the time of the transaction described in this section or section 731, 736, or 741, as the case may be) such property had been sold by the partnership at its fair market value.

Thus, to the extent of potential § 1245 gains, ordinary income will be realized in the sale of a partnership interest, in distributions to a retiring or deceased partner, and in distributions to a partner who receives more or less than his proportionate share of property on which § 1245 gains might have been realized if the partnership had sold the property.

50. INT. REV. CODE OF 1954, § 1245(c).

51. INT. REV. CODE OF 1954, § 301(b)(1)(B).

52. The instances in which gains may be recognized to the distributor corporation are discussed in section II(C)(2) of this paper *infra*.

53. Relative to charitable contributions and partnership distributions of § 1245 property.

54. The theory behind this treatment was to collect the tax at the corporate level on unrealized appreciation in value of § 1245 assets where the transferee gets a different basis for the property than the transferor had. These provisions are included in § 13(f) of the Revenue Act of 1962.

55. INT. REV. CODE OF 1954.

(2) Where the property is distributed in partial or complete liquidation under Section 336;[56] and

(3) Where, in a plan of complete liquidation, a corporation sells section 1245 property and completes the liquidation within a twelve-month period under section 337.[57] In addition, if the corporation sells section 1245 property on the installment method, and then elects to liquidate under section 337 before it has reported all of the gains because of installment notes remaining uncollected at the date of liquidation, the corporation will realize the same amount of ordinary income as it would have reailzed on a cash sale of the notes.[58]

Congress also amended the Code to remove any restrictions upon an immediate election by a taxpayer to change from the declining balance or the sum-of-the years'-digits method to the straight line method of depreciation.[59] This provision was intended to provide taxpayers who are using accelerated methods with an opportunity to change to more conservative standards, and thus to avoid the possibility of ordinary income resulting from sales of their section 1245 assets.

A provision with a purpose diametrically opposed to the foregoing one permits a taxpayer to reduce the amount of salvage value which is required under various methods of depreciation.[60] However, this reduction cannot exceed ten per cent of the basis of the depreciable property, and applies only to personal property other than livestock, with a useful life of three years or more, acquired after the date of enactment of the Revenue Act of 1962.[61] This provision will permit a taxpayer who prefers a more liberal write-off the opportunity to make one, and section 1245 assures the Government that it will not suffer from the loss of revenue previously engendered by section 1231 standing alone.

56. *Ibid.*

57. *Ibid.*

58. This rule also applies when similar installment notes are distributed in a liquidation in which the basis of the property to the receiving shareholder is determined under INT. REV. CODE OF 1954, § 334(b)(2). This involves the purchase of 80% of the stock of one corporation by another corporation, followed by the immediate liquidation of the acquired corporation.

Sectin 13(f)(2), (3), (4) and (5) of the Revenue Act of 1962 thus amends the following sections of the 1954 Internal Revenue Code: §§ 301(b), (d), 312(c)(3), 341(e), 453(d)(4)(A), (B).

59. INT. REV. CODE OF 1954, § 167(e), as amended by § 13(b) of the Revenue Act of 1962.

60. INT. REV. CODE OF 1954, § 167(f)(1), as amended by § 13(c) of the Revenue Act of 1962. This rule modifies the previous limitations on salvage value discussed earlier in this article. It does not affect the declining balance method of depreciation nor the "bonus" first year depreciation (note 20 *supra*), since salvage value is not a factor in either of these computations. Nor does this rule reduce the salvage value for the purpose of applying the rule that an asset may not be depreciated below a reasonable salvage value under the declining balance method, since it is only applicable to methods under which salvage is taken into account in computing depreciation deductions.

61. INT. REV. CODE OF 1954, § 167(f)(2), as amended by § 13(c) of the Revenue Act of 1962.

Another modification of an existing Code section involves percentage depletion. For percentage depletion allowance purposes, the taxable income from the property is increased by the amount of section 1245 gains allocable to the property, thus increasing the depletion allowance.[62]

III. EFFECT OF SECTION 1245

A. *Purposes Accomplished*

In its final form section 1245 will close a loophole estimated to have cost the Government one hundred million dollars annually.[63] It has permitted the Government, anticipating its ultimate passage by Congress, to issue new guidelines permitting taxpayers greater flexibility in choosing the method and useful life to be used in depreciating business assets.[64] It has also been a factor in Congress' decision to permit an investment credit[65] and more liberal salvage values.[66]

Equally as important as the effect of converting amounts previously taxed as capital gains under section 1231 into ordinary income is the effect of section 1245 on previously unrecognized gains. It overrides a variety of provisions of the Code which provided for nonrecognition of gain, thereby imposing a tax at ordinary income rates in situations where tax has never been collected before.[67] The most striking of these inroads relates to the limitation requiring that the amount of a charitable contribution be reduced by the amount which would have been treated as gain under section 1245 if the property had been sold at its fair market value on the date of the gift.[68] The only limitation which the Treasury had heretofore been able to impose in this area was a rule requiring tax-

62. INT. REV. CODE OF 1954, § 613(a), as amended by the Revenue Act of 1962. This amendment provides that the deductible expenses of mining shall be decreased by § 1245 gains allocable to the property in computing the taxable income from mining for depletion purposes. The allowance for percentage depletion is limited to fifty per cent of the taxpayer's taxable income from the property, computed without allowance for depletion. It should be noted however, that this amendment does not affect the computation of the *gross income* from the property, to which the applicable percentage rate (*e.g.*, 27½ per cent for oil and gas wells, 23 per cent for sulfur and uranium) is applied.

63. S. REP. No. 1881, 87th Cong., 2d Sess. 139, *Supplemental and Minority Views of Senators Paul Douglas and Albert Gore*, includes a table indicating that the original proposals of President Kennedy on April 20, 1961, which would have included *both* real and personal property under § 1245, would have resulted in an approximate revenue gain of $200 million. However, both the House and Senate Bills removed real estate from the application of the provision, and the table further indicates that the revenue decrease from this deletion would amount to $100 million, as compared to the President's original proposal, thus producing a net revenue increase of only $100 million.

64. See note 21 *supra*.

65. INT. REV. CODE OF 1954, § 38, allows an investment credit against the tax in an amount up to seven per cent of the cost of the property, as computed under INT. REV. CODE OF 1954, § 46. The depreciable basis of the property is reduced by the amount of the investment credit under INT. REV. CODE OF 1954, § 48(g).

66. See note 60 *supra*.

67. See notes 34 & 54 *supra*.

68. See note 30 *supra*.

payers to eliminate the cost and expenses of producing or acquiring inventory property when such property is thereafter donated to charity.[69] Another weapon used by the Commissioner to curb tax abuse has also been strengthened by another of these inroads, which involves section 337 liquidations. As previously noted,[70] section 1245 will now require a corporation being liquidated under section 337 to pay ordinary income taxes on the ordinary income element of any section 1245 property distributed during the twelve month period.[71] This provision serves to strengthen the Service's position that section 337 did not apply to the sale of certain supplies and tools which perviously had been "written off."[72]

Section 1245 will also negate the need for the *Cohn* rule,[73] and will eliminate the problems encountered by the Government under the *Massey, Evans* and *Hertz*[74] type situations. The only difficulty of this nature still remaining applies to cases of accelerating depreciation on assets and expensing of depreciable assets as inventory, for the purpose of shifting income to periods in which a taxpayer is in a lower tax bracket. The question of whether an item is properly to be classified as inventory or as a depreciable asset will be of little consequence, since ordinary income will result in either case. However, the problem with assets of an undefinable nature, as truck tires,[75] uniforms and small tools, whose useful life in a trade or business is less than one year at the time they are put into use, will be greatly magnified. For example, if a taxpayer is permitted to expense an item in full at the time it is put into use, it will not be, per se, a "depreciable" asset, and thus would not come within the provisions of section 1245.[76]

69. Treas. Reg. § 1.170-1(c) (1958).

70. Revenue Act of 1962, Section 13(f).

71. The primary purpose of INT. REV. CODE OF 1954, § 337, is to permit a corporation to dispose of its assets in substantially a lump sum without the imposition of any corporate income tax on the disposition, if the liquidation is carried out within a twelve month period. Capital gains or losses are recognized only at the shareholder level at the time the proceeds from the corporate disposition of assets are distributed to the stockholders.

72. Rev. Rul. 61-214, 1961-2 CUM. BULL. 60.

73. See note 13 *supra*.

74. See note 7 *supra*.

75. See note 18 *supra*.

76. Presumably the Revenue Ruling cited in note 72 *supra* would also apply to these items if a § 337 liquidation were involved.

One difficulty the Government is faced with in combatting these situations was created by Congress. In effect, if the Government discovers a situation where a taxpayer is expensing items which the Government wishes to contend are properly inventory type items, and the taxpayer agrees to the Government's proposed change in the taxpayer's accounting method, a change of accounting method has been initiated by the Commissioner. Accordingly, INT. REV. CODE OF 1954, § 481, requires that the Commissioner allow the taxpayer an initial basic inventory equivalent to the dollar value of the type of items involved which were on hand at the close of the first accounting period ending after the enactment of the 1954 Code. Thus, having previously expensed such items in full, the taxpayer is granted an unwarranted windfall by restoring the items to inventory. This factor must naturally be weighed by the Government in proposing any change of accounting method.

B. *Problems of Interpretation*

As with any new Code section, many problems of interpretation can be expected to arise. The first of these difficulties will very likely arise in interpreting the meaning of "Section 1245 Property."[77] Most property coming with this term will fall under section 1245(a)(3)(A), which includes all tangible and intangible personal property for which depreciation has been claimed after December 31, 1961. Although the statute does not specifically define "Section 1245 Property" to include sections, other than section 167, under which amortization or depreciation has been claimed, it apparently was intended to include depreciation or amortization claimed under other Code sections.[78] Section 1245(a)(3)(B) completes the definition of "Section 1245 Property," and includes a broad category of "other (tangible) property" not including buildings or their structural components.

The meaning of "personal property" under paragraph (A) is extremely broad, and is not limited to local or common law definitions of the term. Thus, even though some of the assets described by the Senate Committee Report[79] may be termed fixtures under local law (and thus part of a building not subject to section 1245, under paragraph (B) of this provision), they will be personal property under section 1245. It is important to note that leasehold improvements (which are amortizable under section 162) are not covered by section 1245. It is foreseeable that cases may arise where fixtures otherwise taxable under section 1245[80] will

77. As defined in § II(A)(3) of this article *supra*.

78. INT. REV. CODE OF 1954, § 1245(a)(3), refers to "any property . . . which is or has been property of a character subject to the allowance for depreciation provided in section 167 . . . ." However, the same section, in subsection (2), refers to property for which amortization was allowed under § 168. Since such amortization was obviously intended to be included in the definition of § 1245 property, it might be safe to assume that depreciation allowed under INT. REV. CODE OF 1954, §§ 179, 611, will also be encompassed within the definition of "Section 1245 Property."

79. S. REP. No. 1881, 87th Cong., 2d Sess. 97 (1962), provides that § 1245 will apply to all property

> the acquisition of which could have resulted in an investment credit (sec. 38 of the code . . .). However, . . . [it] may also apply to the disposition of property even though the acquisition of this specific property did not result in an investment credit. For example, no investment credit may have been allowed upon the acquisition of the property because (1) its expected useful life was less than 4 years; (2) it was to be used outside of the United States; (3) it was to be used by tax-exempt organizations or governmental units; or (4) it was not new when acquired (and was over the $50,000 limit), etc.

The same report, in § II(c)(4), at 16, defines "Section 38 property," the definition of which, as stated above, is to be used in defining property under § 1245. However, Section 1245 property is limited to *personal* property. The applicable portion of the report states:

> Except for the exclusions noted below, all tangible personal property qualifies as section 38 property . . . . Tangible personal property is not intended to be defined narrowly here, nor to necessarily follow the rules of State law. It is intended that assets accessory to a building, such as grocery store counters, printing presses, individual air conditioning units, etc., even though fixtures under local law, are to qualify . . . .

80. Fixtures may be determined to be personal property for federal tax purposes. See note 79 *supra*.

qualify as leasehold improvements, and thereby escape the ordinary income rules of section 1245.

Most property affected by section 1245 will fall into paragraph (A) of the definition. Once it is determined to fall within this category, it cannot also be considered as coming within the second category under paragraph (B). This will be important in cases where a taxpayer attempts to avoid the full impact of section 1245 by contending that all or part of prior depreciation or amortization deductions were taken during periods when the property was not used as an "integral part" of manufacturing or other activities covered by paragraph (B). This argument will fail if the property has first been determined to be "personal property" under paragraph (A).

The key definitional wording of paragraph (B)(i) involves assets used as an "integral part" of manufacturing, production, extraction, or furnishing of utility services. The definition of the pivotal words "integral part" may lead to inconsistencies in the application of different sections of the Code. For example, it may be contended that an asset is used as an "integral part" of the specified activities and therefore qualifies for the investment credit under section 48(a)(1)(B).[81] On the other hand, for the purposes of taxing gain on the sale of the same asset, it may be argued that the asset was not used as an "integral part," and that therefore section 1245 is inapplicable to tax the gain as ordinary income. The Internal Revenue Service might apply reverse arguments in its interpretation of the same situation.

Another correlation between section 1245 and the new investment credit appears to have produced an unintended loophole in the law. The basis of property with respect to which the investment credit is claimed must be reduced by the amount of the investment credit under section 48(g).[82] However, the investment credit is not the type of adjustment which must be taken into account in determining the "recomputed basis" of section 1245 property. Therefore, although any gain upon disposition of that property will be taxed as ordinary income to the extent of the depreciation taken after 1961, that portion of the gain attributable to the investment credit *may* qualify for capital gain treatment under section 1231.

It is interesting to note that, although buildings and their structural components are excluded from section 1245 treatment, they are also denied eligibility for the special tax benefits conferred by sections 38 and 179,[83] relating to the investment credit and the additional first year

81. See note 29 *supra*.

82. INT. REV. CODE OF 1954.

83. Both of these sections are limited to tangible personal property. INT. REV. CODE OF 1954, §§ 48(a)(1), 179(d)(1).

"bonus" depreciation. This, in some small way, cushions the loss of revenue caused by the buildings exclusion.

As noted earlier, section 1245 does not generally apply to dispositions of property by gift or transfers at death.[84] The only interpretative difficulty that might arise here concerns situations involving part gift and part sale. Where the donee's basis is determined in part by reference to his cost and in part by reference to the donor's adjusted basis, it is not certain to what extent the donor's prior depreciation deductions, which are not recognized to the donor under section 1245 at the time of the disposition by gift, will be included in the purchaser-donee's recomputed basis. It is presumed that the application of section 1245 will be applied pro rata in the same proportion as the sale portion bears to the fair market value of the whole.

Under existing law, there do not seem to be any other apparent interpretative difficulties. However, in view of President Kennedy's proposals to tax gains accrued at the time of gift or death at capital gains rates,[85] some future amendment of section 1245 might be proposed to include such dispositions within its provisions.

Interpretative difficulties in connection with tax-exempt organizations have been discussed earlier.[86]

Another interesting point concerns the relief provisions for certain taxpayers whose percentage depletion deductions are reduced by the "50 per cent of taxable income" limitation under section 613(a).[87] As discussed earlier,[88] this limitation ceiling is, in effect, raised by the amount of section 1245 gain recognized during the year. But, this relief provision applies only to "mines."[89] Since the depletion provisions[90] apply

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84. Section II(B)(1) of this article *supra.*

85. President Kennedy, *Special Message on Tax Reduction and Reform,* H.R. Doc. No. 43, 88th Cong., 1st Sess. 20 (1963). The President believes that this will stimulate the mobility of capital:

> [T]he "lock-in" effect of the present law, due to the ability to avoid all capital gains taxes on assets held until death, will be eliminated. This will result in a sharp increase in transfers of capital assets as individuals feel free to shift to the most desirable investment. *Id.* at 22.

86. See note 37 *supra.*

87. INT. REV. CODE OF 1954, explained in note 62 *supra.*

88. Section II(C)(2) of this article *supra.*

89. Article 13(e) of the Revenue Act of 1962 provides:

> Section 613(a) (relating to percentage depletion) is amended by inserting after the second sentence thereof the following new sentence: "For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property.

It might be presumed that the present administration would favor a broad interpretation of the scope of the amendment. President Kennedy's *Special Message on Tax Reduction and Reform,* H.R. Doc. No. 43, 88th Cong., 1st Sess. 19 (1963), requests a further extension

generally to oil and gas wells and other natural deposits, as well as to mines, the intended scope of the amendment of section 613(a) is not clear.

IV. CONCLUSION—CRITICISMS AND PLAUDITS

It is this writer's opinion that section 1245 is one of most logically sound taxing provisions ever passed by Congress. It permits the Government to "recapture," as ordinary income, amounts previously treated as ordinary deductions against income. It should make enforcement of the tax laws easier, especially with respect to the depreciation provisions. Its chief drawback is that it is not broad enough to be all-inclusive, particularly with respect to real property. However, this drawback should be eliminated, together with the elimination of many of the interpretative difficulties, if President Kennedy is successful in his efforts to have Congress pass his proposed tax reform measures.[91]

The provision with regard to taxing only the amount actually allowed as depreciation at ordinary rates[92] thus disregarding the general rule with regard to depreciation "allowed or allowable," is most equitable.

The amendment with regard to section 613(a)[93] is also justifiable. Prior depreciation deductions may have caused the fifty per cent limitation to come into play, reducing taxable income. It is therefore proper to add the amount of these prior deductions back to taxable income, in order to tax them as ordinary income under section 1245. However, this may provide an unintended windfall since as the provision is written,

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of the principles involved in § 1245, with regard to capital gains on the sale of mineral interests, and says:

> The Congress, in Section 13 of the Revenue Act of 1962, recognized that the owners of depreciable business assets were obtaining an unfair advantage by taking depreciation deductions against ordinary income greater than the actual loss in value, and then, upon the sale of an asset, paying only a capital gains tax on the recovery of these deductions. The Congress, therefore, decided that any gains realized on the sale of such property should be taxed as ordinary income to the extent that the cost of the property had been deducted in the past—still permitting the excess of the sales price over the original cost to be treated as a capital gain. This same rule, which under my capital gains proposals discussed below would be extended to real estate and a variety of other situations, should also apply to mineral property subject to depletion and would increase revenues by $50 million.

90. INT. REV. CODE OF 1954, §§ 611-616, make reference to mines, oil and gas wells, other natural deposits, and timber.

91. President Kennedy, in his *Special Message on Tax Reduction and Reform*, H.R. Doc. No. 43, 88th Cong., 1st Sess. 19 (1963), has requested, under Article VI(C), a revision of the capital gains taxation structure of the Code. One of his proposals, in subsection (5), involves "definitional changes," and says: "Whenever the case for a special subsidy is not compelling, the definitions should be changed to limit capital gains to those transactions which clearly merit such treatment. The details regarding specific proposals in this area will be presented by the Secretary of the Treasury. They will include, but will not be limited to the following: a. Real estate tax shelters . . . ; and b. The tax treatment of restricted stock options . . . ."

92. See note 27 *supra*.

93. INT. REV. CODE OF 1954, discussed in § II(C)(2) of this article *supra*.

taxpayers may benefit from the amendment even though the prior depreciation deductions were claimed in years when the fifty per cent limitation did not apply to reduce depletion deductions.

Although sections 1071 and 1081[94] were designed to cushion the effect of a forced sale of assets in compliance with Government orders, the relief provided was only partial. That is, a taxpayer was permitted to elect to defer his capital gains by reducing his basis in property which usually was subject to depreciation. Thus, he was able to keep his capital gain if he sold the asset or otherwise later exchanged it under section 1231. However, he was permitted to do this only at the expense of the loss of his ordinary depreciation deductions which would have been allowable on the basis so reduced. Thus, these relief provisions approximated the effect of section 1245; section 1245 fairly perpetuating the capital gain originally deferred.

Section 1245 has been criticized[95] on the grounds that it disregards traditional concepts to tax law, such as non-recognition of gain to a distributor corporation; that it taxes corporate liquidations doubly; that it increases the complexity of the tax laws; that it may raise state income taxes under state laws that follow the federal tax law; and that it will discourage transfers of assets and thus act as a drag on the economy. In answer to these criticisms, this writer believes that traditional concepts of tax law should be disregarded whenever it is sound policy to do so, so long as there is no retroactive effect; that there is no inequity in taxing a corporation as well as its shareholders upon a distribution of property, since they are separate and distinct entities; that the federal government cannot be bound, in determining its tax laws, by the future actions and policies to be followed by state taxing authorities; and that any possible hindrance of the mobility of capital can be offset by other means, such as the lower tax rates proposed by President Kennedy in his tax reform program.[96] As far as the complexity of the section is concerned, this is an admitted drawback. However, it is necessitated only by the equal complexity of the sections which it is designed to supplement, and very little criticism is ever heard from taxpayers when a complex relief provision is passed. It is believed that the equities of this section far outweight the arguments advanced by its critics.

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94. INT. REV. CODE OF 1954, discussed in § II(B)(2) of this article *supra*.

95. For a comprehensive criticism of § 1245, see Armstrong, *Capital Gain Treatment Should Be Restored for Depreciable Business Property*, 41 TAXES 175 (1963).

A more objective critique of § 1245 is contained in an article by Rustigan & Melvoin, *1962 Act: Important Changes in Tax Planning Required by Depreciation Recapture Rule*, 17 J. TAXATION 322 (1962).

96. President Kennedy, *Special Message on Tax Reduction and Reform*, H.R. Doc. No. 43, 88th Cong., 1st Sess. 1 (1963).

* While the author is an Internal Revenue Agent, the views expressed in this article are his own, and do not in any way reflect the views and opinions of the Internal Revenue Service.