Tax Consequences of the Purchase and Sale of Depreciable Properties

John P. Miller
Whyte, Hirschboeck, Minahan, Harding, and Harland (Milwaukee, Wisconsin)

Frederick A. Muth Jr.
Marquette University

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.
TAX CONSEQUENCES
OF THE PURCHASE AND SALE OF
DEPRECIABLE PROPERTY

JOHN P. MILLER*
FREDERICK A. MUTH, JR.**

In the 1962 and 1964 Revenue Acts, Congress created two entirely new concepts in the field of federal income taxation: the investment credit and special treatment for gain from the disposition of depreciable property. Due to the unique and novel nature of these new provisions, their detailed mechanics and practical effects should be analyzed in detail.

The investment credit was created by the 1962 Revenue Act which added sections 38, 46, 47, and 48 to the 1954 Internal Revenue Code. The basic philosophy behind the investment credit was that the good of the economy would be promoted by encouraging investment in productive property, and the federal government could aid this encouragement by giving a special tax break—a reduction in taxes—to those people who put additional productive property into use.

Simultaneously with working out the mechanism for encouraging the purchase of productive property, Congress was also addressing itself to what it considered loopholes or abuses relating to the depreciation of the same type of property. In section 1245 of the 1954 Internal Revenue Code as added by the 1962 Revenue Act, Congress sought to redress certain of these inequities, not by limiting depreciation, but rather by penalizing the gain realized upon the disposition of the property. Thus, at the same time the 1962 act encouraged the purchase of additional property, it also discouraged and penalized the disposition of the older property on hand.

The 1964 Revenue Act made some technical changes in the aforementioned provisions created by the 1962 act, and added a new and novel approach in determining the gain from the disposition of depreciable real estate by adding section 1250 to the 1954 Internal Revenue Code.

Prior to 1962, the tax analysis of a purchase, investment or reinvestment in depreciable property was a fairly uncomplicated affair and the businessman was governed practically entirely by purely business factors. However, now the businessman must consider the extent

---

* B.S., Marquette University, 1957; L.L.B., Marquette University, 1959; associated with the firm of Whyte, Hirschboeck, Minahan, Harding & Harland, Milwaukee, Wisconsin.
to which any disposition or acquisition of depreciable property could give him a credit against his taxes, could result in creating additional taxable income, or could convert capital gain to ordinary income.

THE INVESTMENT CREDIT

I. Introduction

To encourage investment, the investment credit allowed by section 38 of the 1954 Internal Revenue Code grants a taxpayer investing in certain enumerated property a credit against his tax. It is important to note that this is a credit and not a deduction, and hence reduces the tax itself dollar for dollar and not merely the taxable income. Thus, this credit is much more valuable than a mere deduction. Basically, the credit is equal to 7% of the investment in the designated property, but, for instance, in the case of a corporate taxpayer in the highest bracket, the credit is roughly the equivalent of an additional 14% deduction.

II. Amount of the Investment Credit

A credit against tax is allowed for taxable years ending after 1961 in an amount equal to a specified percentage of the qualified investment in property placed in service after that date. The percentage which qualifies for the credit depends upon the useful life of the asset as follows:

<table>
<thead>
<tr>
<th>Useful Life</th>
<th>Percent of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Between 4 and 6 years</td>
<td>2-1/3%</td>
</tr>
<tr>
<td>Between 6 and 8 years</td>
<td>4-2/3%</td>
</tr>
<tr>
<td>8 years or over</td>
<td>7%</td>
</tr>
</tbody>
</table>

The useful life is determined at the time the asset is placed in service by the taxpayer and is the same as that used for depreciation purposes. If the asset is not held for the length of time used in computing the credit, an adjustment may be necessary as explained below.

The credit reduces or is applied against the tax, and, therefore, the maximum amount which may be taken in any one year depends upon the amount of the tax due for that year. The credit is limited to the liability for tax up to $25,000 plus 25% of the liability for tax in excess of $25,000.

---

1 Revenue Act of 1964, § 203(c), INT. REV. CODE OF 1954, § 48(a) (1) (c), extended the investment credit to elevators and escalators constructed, reconstructed, erected, or acquired after June 30, 1963.

Where property is acquired prior to December 31, 1961, and is delivered to and in the possession and control of the taxpayer prior to that date, the property does not qualify as new § 38 property even though it is first utilized and put in use after 1961. Spec. Rul. 637, CCH 1963 STAND. FED. TAX REP. 56512 (June 19, 1963).

2 Technically, INT. REV. CODE OF 1954, § 46(a) (1), provides that the credit is 7% of the qualified investment in all cases. The amount of the credit is reduced for property with short useful lives by providing in INT. REV. CODE OF 1954, § 46(c) (2), that the investment qualifying for the credit is only 33-1/3% of the qualifying investment if the useful life is four to six years, and 66-2/3% if the useful life is six to eight years.

3 INT. REV. CODE OF 1954, § 46(a) (2).
Example: Assume the liability for tax for the year was $40,000 and the qualified investment was $500,000. The indicated investment credit would therefore be $35,000 (assuming all of the assets had a useful life of at least eight years). The allowable credit is $28,750 ($25,000 plus 25% of $15,000, the excess of the tax over $25,000). The unused $6,250 may be carried forward and back as explained below.

The first year the credit arises is the year the property is initially placed in use in the taxpayer's trade or business or used for the production of income. Thus, if property is purchased near the end of a fiscal year, but is not actually placed in use that year, the credit does not arise until the year in which the property is placed in service. Likewise, if a taxpayer purchases property on a deferred payment basis, the credit arises when the property is placed in service even though payment for the property has not been made.

It is possible that the credit arising in a year may not be completely used in that year. It may be that the credit exceeds the tax; this would be the case where a credit arises in a year the taxpayer sustains a loss. Another situation that could give rise to an unused credit is demonstrated by the above example; that is, where the use of the credit is limited by one-quarter of the tax in excess of $25,000. The law provides that an unused credit may be carried back to the three preceding taxable years, and carried forward to the five succeeding taxable years. The order in which this is accomplished is that the credit is applied to the earliest year and then to the succeeding years in order until it is extinguished. The mechanics are as follows: the sum of the credit for a year is equal to the credit arising in that year plus the amount of the carryover and the carryback to such year; to the extent that the taxpayer cannot use all of the credit available (including the carryover

4 INT. REV. CODE OF 1954, § 48(a) (1).
5 For the first year ending after December 31, 1961, the law does not require the proration of the credit arising in such year even if it began before that date. For instance, if a taxpayer is on a June 30 fiscal year and purchases § 38 property between January and June of 1962, and places it in service during that fiscal year, the credit may be applied against the entire tax liability for the year ending June 30, 1962; its application is not limited to half of the tax liability even though a portion of the income was earned before January 1, 1962. INT. REV. CODE OF 1954, §§ 48(b) (2), (c) (1). However, in determining the amount of a carryback to a 1961-1962 fiscal year, in effect the amount of the carryback is limited. Actually, for purposes of the carryback only, the amount of the tax against which the credit may be applied must be prorated according to the number of days in calendar 1962 that fall in the 1961-1962 fiscal year. INT. REV. CODE OF 1954, § 46(b) (4). For instance, if a taxpayer has an unused investment credit arising in the year ending June 30, 1963, in determining the extent to which it may be applied against an assumed June 30, 1962 tax liability of $25,000, the amount of the tax against which the credit may be applied is reduced to $12,500, since only half of the June 30, 1962 fiscal year fell in the 1962 calendar year.
6 INT. REV. CODE OF 1954, § 46(b). For special rule applying to fiscal years ending in 1962, see note 5 supra.
and carryback), the excess constitutes a carryover or carryback. An example will help demonstrate this.

Example: For calendar year 1962, a taxpayer has a $24,000 tax liability before an allowable investment credit of $10,000. For 1963, he has an unused credit of $5,000 which he can carry back to 1962. For 1964, he has an unused credit of $15,000. His carryback of the 1964 unused credit to 1962 is limited to $9,000—the amount of the 1962 tax liability minus the credit arising in that year and the credit arising in 1963. The remaining unused credit for 1964 may be carried over to taxable years 1965-1969.

An unused investment credit which arises from a net operating loss carryback under section 172 may not be carried back; it may be carried forward only.

Example: A taxpayer has a $32,000 net operating loss in 1966 which is carried back to 1963 and wipes out the liability for tax in 1963. As a result, the taxpayer has an unused investment credit of $9,000 for 1963, which arose from investment in that year and was originally applied against the tax for that year. This unused credit cannot be carried back to 1962, but it can be carried forward to 1964 and later years.

The investment credit may be applied only against the ordinary income tax, including the tax on capital gains. It may not be applied against the two corporate penalty taxes on income: (a) the personal holding company tax imposed by section 541 and (b) the accumulated earnings tax imposed by section 531.

The tax against which a credit is applied is first reduced by (a) the foreign tax credit, (b) the credit allowed individuals for partially tax exempt interest, and (c) the retirement income credit of individuals.

In the case of a joint return, the investment credit may be applied against the first $25,000 of the tax, plus one-quarter of the excess over $25,000 of the tax on the joint return. If a husband and wife, however, file separate returns, on either return the credit of that taxpayer is limited to the first $12,500 of tax, plus one-quarter of the excess. The

---

7 INT. REV. CODE OF 1954, § 181, was created by the Revenue Act of 1962, and it provided that an unused credit would constitute a deduction if it could not be used as a carryback and carryover. This provision was repealed by the Revenue Act of 1964, § 203(a)(3)(B), since the Revenue Act of 1964 also removed the requirement that the basis of the property be reduced by the amount of the credit. This repeal is effective in the case of § 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Revenue Act of 1964, § 203(a)(4).

8 INT. REV. CODE OF 1954, § 46(b)(3).

9 INT. REV. CODE OF 1954, § 46(a)(3).

10 Ibid. In addition the tax is reduced by the dividend received credit of individuals allowed by § 34. The Revenue Act of 1964, § 201(b), reduced the amount of this credit from 4% to 2% for 1964 and completely eliminated it for 1965 and subsequent years.
$25,000 basic amount is divided between them. There is an exception to this rule where the spouse of the taxpayer has no credit available for the taxable year which ends within or with the taxpayer's taxable year (either arising in that year or by reason of a carryover or a carryback), in which case the taxpayer is allowed the complete $25,000 basic amount; that is, he may apply his credit against the first $25,000 of tax and one-quarter of the excess.\footnote{11}

In the case of an affiliated group of corporations,\footnote{12} the $25,000 basic limitation is apportioned among the members of the group in accordance with the regulations.\footnote{13} Each member of the group may apply its credit against one-quarter of its tax in excess of the portion of the $25,000 basic amount available to it.

It is important to understand that the foregoing provision applies to an affiliated group even if a consolidated return is not filed and even if the members do not have the same fiscal year. The simple fact of the relationship through stock ownership is enough to require the apportionment of the $25,000 basic amount.

Example: Corporation A owns all of the stock of Corporation B, but they do not file a consolidated return, and in fact don't have the same fiscal year. Corporation A has a tax liability of $25,000 and a credit for the year of $25,000. For the corresponding year, Corporation B likewise has a $25,000 tax liability and $25,000 of credit available. If the $25,000 basic amount is apportioned equally to each of the companies (as allowed by the temporary regulation), each of the companies would have to pay a tax of $9,375, and would have a credit carryback or carryforward equal to this amount. \textit{Reason:} The basic amount for each company is only $12,500, so the credit may offset tax to the extent of only one-quarter of the tax in excess of $12,500. In this case the tax in excess of the basic amount is $12,500 for each corporation, and the one-quarter of such tax against which the credit can be offset is $3,125. The remainder of the tax must be paid.

Under subchapter S of the 1954 Code, certain corporations may elect to have their income taxed directly to their shareholders, and

\footnote{11}{\textit{Int. Rev. Code of} 1954, § 46(a) (4).}
\footnote{12}{An affiliated group is a parent corporation and all of its 80% subsidiaries, including a subsidiary's subsidiary, etc.; that is, it is a chain of corporations connected by at least 80% stock ownership. In addition, for purposes of determining the investment credit available, corporations exempt from taxation under § 501, insurance companies subject to taxation under § 802 or § 821, foreign corporations, corporations entitled to the benefits of § 931 by reason of receiving a large percentage of their income from sources within possessions of the United States, corporations organized under the China Trade Act of 1922, regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1, and unincorporated business enterprises subject to tax as corporations under § 1361 are included in the affiliated group. \textit{Int. Rev. Code of} 1954, §§ 46(a) (5), 1504(a) (b).}
\footnote{13}{\textit{Int. Rev. Code of} 1954, § (46) (a) (5). \textit{Treas. Reg.} § 1.46-1(f) (2) (1964) provides that the $25,000 basic amount may be apportioned in any manner the common parent may select, provided that the common parent and each such member of the group, less than 100% of the stock of which is owned in the aggregate by other members of the group, consent.
therefore, in effect, act as conduits for federal income tax purposes. For such corporations, the investment credit is useless, since they have no tax to pay; therefore, the investment credit also is passed on to the shareholders by being apportioned pro rata among the persons who are shareholders on the last day of the taxable year.\textsuperscript{14}

For many purposes under the federal income tax, trusts and estates are considered as mere conduits, at least to the extent they actually distribute income. Accordingly, the qualified investment of an estate or a trust for any taxable year must be apportioned between the estate or trust and beneficiaries according to the amount of income allocable to each. Likewise, the $25,000 basic amount available to a trust or estate must be reduced according to the manner in which income is apportioned between the trust or estate and the beneficiaries thereof.\textsuperscript{15}

Example: The taxpayer is a beneficiary of a trust and is taxable on half of its income, the trust being taxable on the other half as undistributed income. The trust has a tax of $15,000, but only $13,125 may be offset by any available credit. The basic amount for the trust is $12,500 (one-half of the ordinary basic amount of $25,000) and the credit may be applied against only one-quarter of the tax in excess of the $12,500 ($15,000 minus $12,500 equals $2,500; one-quarter of $2,500 equals $625; $12,500 plus $625 equals $13,125).

III. Investment in Property Qualifying for the Credit

The investment credit is based on the investment in certain designated property known as "section 38 property."\textsuperscript{16} To qualify for the credit, the property must be subject to the allowance for depreciation; that is, it must be used in the taxpayer's trade or business or held for the production of income. As stated above, the property must have a useful life of at least four years. With these qualifications, "section 38 property" may be divided into classifications as follows:

(a) \textit{Tangible Personal Property.}

All tangible personal property is "section 38 property." Patents, trademarks, goodwill, and similar property are not tangible, but rather are designated as intangible, and therefore the investment in property of this type does not qualify.\textsuperscript{17}

(b) \textit{Other Tangible Property.}

The Code\textsuperscript{18} contains a rather complicated definition of tangible property, other than personal property, which will qualify

\textsuperscript{14} \textit{Int. Rev. Code of 1954}, § 48(e).


\textsuperscript{17} The Senate Finance Committee Report on the Revenue Act of 1962 says that local law definitions of tangible personal property will not control and, therefore, the taxpayer will not become involved in arguments with the Internal Revenue Service as to whether or not the item is a trade fixture. Examples of tangible personal property given by the Committee report are printing presses, refrigerators, grocery counters, display racks and shelves. See also \textit{Treas. Reg. § 1.48-1(c) (1962).}

\textsuperscript{18} \textit{Int. Rev. Code of 1954}, § 48(a) (1) (B).
SALE OF DEPRECIABLE PROPERTY

tangible property, not including a building and its structural components, if such property is used as an integral part of a manufacturing, production or extraction process, or as an integral part of a system for furnishing transportation, communications, electrical energy, gas, water or sewerage disposal services, or is a research or storage facility used in connection with any of these activities. The areas of broadest application will be property used in connection with manufacture or transportation. (As can be seen, many of the items in this class relate to public utilities, and the law provides special rules for public utilities which, due to their limited application, will not be discussed in this article).

It can be expected that the above definitions will be clarified only by factual determinations by the Internal Revenue Service and the courts. At this time, it would seem that the possible points of controversy in this area could be grouped into two broad categories: whether the property is a structural component of a building, and whether the property is an “integral part” of the manufacturing, transportation or other processes.

c) Elevators and Escalators.

The 1964 Revenue Act extended the investment credit to elevators and escalators, notwithstanding the fact that such

---

19 INT. REV. CODE OF 1954, § 46(c) (3).
20 The Senate Finance Committee Report on the Revenue Act of 1962 lists examples of § 38 property, not personal property, but used as an integral part of manufacturing or transportation, as follows: blast furnaces, oil and gas pipe lines, railroad tracks and signals. Examples of property that is not personal property and that does not qualify as § 38 property because it is not used as an "integral part" of the designed activities, are pavements and parking areas. See also Treas. Reg. § 148-1(d) (4) (1962).
21 Revenue Act of 1964, § 203(c), created INT. REV. CODE OF 1954, § 48(a) (1) (C).
22 The Report of the Committee on Ways and Means, House of Representatives, dated September 13, 1963, refers to escalators and elevators as follows: "The House committee report indicated that the term 'structural components' of a building included such parts of a building as central air conditioning and heating systems, plumbing, and electrical wiring and lighting fixtures relating to the operation and maintenance of the building. The proposed regulations issued by the Treasury Department with respect to the term 'structural components' provide an extensive list of the type of items considered to be structural components and therefore not eligible for the investment credit. Among these items are escalators and elevators. While these regulations are an accurate interpretation of the intention of Congress last year in this respect, nevertheless your committee believes that it is appropriate to reconsider the treatment of escalators and elevators for purposes of the investment credit. Escalators and elevators are closely akin to assets 'accessory to the operation' of a business which presently are eligible for the investment credit. These assets include machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc. Your committee further believes that new elevator and escalator equipment represents an important aspect of modernization of plant and facilities."

"For the reasons cited above, your committee has concluded that new elevators and escalators installed after June 30, 1963, and modernization of existing elevators after that date should be eligible for the investment credit."
equipment would normally be a structural component of a building. This provision applies to elevators and escalators, the reconstruction or erection of which is completed, but not necessarily started, after June 30, 1963, or which were acquired after that date and the original use of which commenced with the taxpayer after such date.

To qualify as "section 38 property," the property must not only be the type of property listed in paragraphs (a), (b), or (c) above, but also must be used predominantly inside the United States. This does not apply to aircraft, vessels and motor vehicles operated to and from the United States. "Section 38 property" does not include property used predominantly to furnish lodging or in connection with the furnishing of lodging (except property of a motel or hotel furnishing lodging to transients and property used in connection with facilities made available to non-lodgers, such as a coffee shop open to the general public). Probably the best example of tangible personal property not qualifying for the credit because used in connection with lodging is personal property used in a rooming house or furnished apartments.

The investment in new "section 38 property" is equal to the basis of the property on which the depreciation is computed. Generally, this would be its cost, but there can be one variation: a carryover basis arising from the operation of section 1031. If a person trades-in a used machine, the basis of the new machine is the carryover basis of the old machine plus the cash (boot) paid if any.

**Example:** Taxpayer has a used machine with a depreciated basis of $10,000, but with a value of $12,000. He trades the machine and $8,000 cash for a machine with a price tag of $20,000. Since he recognizes no income on the trade-in, the basis of the new machine is $18,000 ($10,000 basis plus $8,000 cash) and the investment for purposes of the credit is $18,000.

This, of course, also means that elevators and escalators will be treated as coming under the recapture provision enacted last year. This in general provides that depreciation deductions taken with respect to such equipment in the future are to give rise to ordinary income to the extent of any gain recognized on the sale of such property."

23 INT. REV. CODE OF 1954, § 48(a) (2) (A).
24 INT. REV. CODE OF 1954, § 48(a) (2) (B).
25 INT. REV. CODE OF 1954, § 48(a) (3). See also INT. REV. CODE OF 1954, §§ 48(a) (4), (5), (6), which relate to certain types of property which are not "§ 38 property"—property used by certain tax-exempt organizations, property used by government units, and livestock.
26 INT. REV. CODE OF 1954, § 1031 (a), provides that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind held for such purpose.
27 INT. REV. CODE OF 1954, §§ 1031 (d), 1012, provide that the basis of the new property where no gain or loss is recognized is the carry-over basis of the property traded in plus the cash boot, if any, paid or minus the cash, if any, received by the taxpayer.
Different rules are applied in determining the investment credit when the property acquired is used rather than new property. Two important thoughts should be kept in mind when determining the investment credit from used "section 38 property":

(a) Only $50,000 of such property per year may be considered, and

(b) the investment is figured on the cash cost.

If a taxpayer purchases more than $50,000 of used property, he must select the used property on which the credit will be taken. The Internal Revenue Service will prescribe in the regulations the manner in which the selection should be made, and it can be expected that once the selection is made it is binding except insofar as the regulations allow it to be changed. Selecting the proper property can be important because the amount of the credit depends on the useful life of the property. Therefore, to obtain the maximum amount of credit the taxpayer should select property with a useful life of eight years or over.

As stated, the investment in used property cannot necessarily be computed in the same manner as the investment in new property. If the taxpayer makes a tax free trade-in of one used machine for another used machine used in his trade or business, the investment is based only on the additional cash paid, if any.

Example: The facts are the same as in the preceding example, except the taxpayer acquires a used machine rather than a new one. The investment credit is based only on the $8,000 of cash paid. It is only this $8,000 which is considered in determining the maximum $50,000 investment in used "section 38 property" per year.

As stated above, there is a $50,000 maximum limitation per year for investment in used "section 38 property." There is no provision

29 Int. Rev. Code of 1954, §§ 46(c)(1)(B), 48(c)(3)(B). Technically, the investment credit is not computed on so much of the basis of used property which is carried over under § 1031. Therefore, the credit would be computed on the basis (not just cash cost) where § 1031 does not apply.
31 Special rules apply where a subchapter S corporation or an estate or trust purchases used "§ 38 property." These entities, for certain purposes under the Code, are merely conduits and, therefore, might not have any tax against which a credit might be applied. Therefore, under Int. Rev. Code of 1954, § 48(e), the qualified investment of a subchapter S corporation is passed on pro-rata to the shareholders; however, in the case of used "§ 38 property," only a total of $50,000 can be passed on, regardless of the total investment in used "§ 38 property" attributable to the subchapter S corporation in any one year. The portion passed on may be added to a stockholder's own private investment in used property, but his total investment in used property (personal and subchapter S) may not exceed $50,000. For example, assume a taxpayer owns 50% of the stock in a subchapter S corporation which invests $60,000 in used property during the year. Only $50,000 of this investment may qualify for the credit. The shareholder will be considered
for a carryover or a carryback of any excess investment (even though there could be a carryover or a carryback of an investment credit). This means that if a taxpayer buys $60,000 worth of used machinery in 1964, but purchases no used machinery in 1963 or 1965, he cannot carry forward or backward the excess $10,000 investment in used "section 38 property." This $10,000 is forever lost for purposes of computing the investment credit. It should be remembered that it is the year in which the property is placed in service which determines the investment credit, and not the year of purchase or of payment. Thus, a taxpayer cannot avoid the $50,000 limitation by deferring payment to a later year if he commences the use of all the property in one taxable year.

There is one other additional limitation in computing the investment in used "section 38 property." Used "section 38 property" does not include property used by the same person who used the property before the taxpayer bought it. Thus, if a taxpayer who has been using his own property sells it and leases it back, the property cannot qualify for the credit in the hands of the buyer-lessee. Similarly, if a taxpayer who has been using rental property buys it and continues to use it, the property does not thereby become used "section 38 property."

If a taxpayer acquires "section 38 property," whether new or used, an additional limitation applies if the property is to replace property (a) stolen or (b) destroyed or damaged by fire, storm, shipwreck, or other casualty. The cost of used "section 38 property" or the basis of the new "section 38 property" must be reduced by the smaller of (a) the amounts received as compensation (for example, insurance proceeds) or (b) the adjusted basis of the property so destroyed, damaged or stolen.

**Example:** The taxpayer places in service on January 1, 1964, a new "section 38" asset having a basis of $6,000 and an assumed useful life of fifteen years. The asset is destroyed by fire in January 1972, and the taxpayer receives $3,000 insurance. The adjusted basis for the destroyed property is $3,516. The taxpayer buys new replacement property for $6,000. The basis of the new property for purposes of determining the credit must

---

33 Int. Rev. Code of 1954, § 46(c) (1) (B).
34 Int. Rev. Code of 1954, § 46(c) (4). This section shall be read in conjunction with § 1033 (non-recognition of gain on involuntary conversions).
be reduced by the $3,000 of insurance, since it is less than the adjusted basis of the destroyed property.

The above illustrates the general rule, but for every rule there is an exception. Where the decrease in the amount of the investment under the early disposition rule discussed below is greater than the adjustment to basis or cost required under the general rule, no adjustment to basis need be made.

**Example:** Assume the same facts as in the above example, except that the property is destroyed in January of 1966. In this case there would be no adjustment to the basis of the replacement, since the $6,000 decrease in qualified investment due to early disposition is greater than the amount of insurance received. Also, as explained below, the tax for 1965 will be increased by the $420 of credit previously allowed.

Under the Code, for purposes of the investment credit, a person leasing property can be treated the same as a purchaser.\(^3\) Under conditions prescribed by the regulations,\(^3\) a lessor of “section 38 property” may waive his right to the credit and allow the lessee to use the credit. This special treatment applies only to property which would be *new “section 38 property”* if acquired outright by the lessee. The useful life of the property in the hands of the lessee would be the same as in the hands of the lessor and is not limited to the term of the lease;\(^3\) however, the termination of the lease is considered a disposition of the property. The lessee's basis for purposes of the credit is the fair market value of the property itself.\(^3\)

As stated above, the amount of the investment credit depends upon the useful life of the property. If the property is disposed of or ceases to be “section 38 property” before the expiration of the period used in computing the original investment credit, an adjustment may be necessary.\(^3\) Thus, if the full 7% was taken on the assumption that property would be “section 38 property” for eight years, but the property

---

\(^3\) INT. REV. CODE OF 1954, § 48(d).


\(^3\) Prior to the Revenue Act of 1964, a lessee to whom an investment credit was passed through the lessor had to reduce the rent deduction by the credit allowed, such adjustment to be made pro-rata over the expected useful life of the asset. The Revenue Act of 1964, § 203(a) (3) (A), repealed this provision for property placed in service on or after January 1, 1964, for years ending after 1963. For property placed in service before that date, the change is effective for years beginning on or after January 1, 1964. The regulations will specify the manner in which the amount that the rental deduction was reduced for the credit will be distributed over the remaining useful life of the property. Such adjustment shall commence with the first tax year beginning after December 31, 1963. Revenue Act of 1964, § 203(a) (2) (B).

\(^3\) There are two exceptions to the rule: first, where the lessor and the lessee are both members of the same affiliated group and, second, where the lessor is not the manufacturer and the property was transferred to a lessee prior to February 26, 1964. In these cases, the credit is computed on the lessor's basis. INT. REV. CODE OF 1954, § 48(d) ; Revenue Act of 1964, § 203(b).

\(^3\) INT. REV. CODE OF 1954, § 47(a) (1).
is disposed of after four years, the original credit should have been only one-third of that claimed and an adjustment is required.

If "section 38 property" is kept longer than originally anticipated, no adjustment is permitted. Thus, if only two-thirds of the 7% investment credit was taken when the property was acquired and ascribed a useful life of six years, no additional credit is allowed when the property is kept for eight years or longer.

The adjustment in the credit can arise from sources other than disposition; that is, the rule applies whenever the property ceases to be "section 38 property." This could happen if the property is no longer used in a trade or business, or if it becomes permanently located outside of the United States. Undoubtedly many problems will arise in the case of automobiles which may be converted to personal use, assuming they were given a useful life of at least four years when purchased. The problems become magnified if the business use of the auto changes from year to year; that is, the taxpayer uses the auto 50% for business in the year it is acquired and thus claims the investment credit on half of the cost. In the next year he may use the car 40% in the business and the third year the use may be 60% for business.

It is important to note that there can be a loss of credit and therefore an increase in tax for many transfers which were heretofore considered tax-free. For instance, it is conceivable that the transfer of "section 38 property" to a partnership or to a controlled corporation could result in the loss of the credit. The law has not changed the rule that no income is derived from transfers such as this, but the same tests are not applied to determine if the credit is lost. The law specifies that a mere change in the form of conducting a trade or business will not cause a loss of the credit if the taxpayer retains a substantial interest in the trade or business.40 "Change in form" and "substantial interest" are not defined. It does seem clear that an entire trade or business must be transferred and the taxpayer's proportionate interest cannot be changed. If a taxpayer transferred half of his trade or business to a new corporation, or if a taxpayer and another combined their businesses in a new corporation, the receipt of the stock by the taxpayer would be tax free, but it is conceivable that the transfer of the property would result in a loss of the credit. The important thing to remember is that the simple fact that the transfer may be tax free does not necessarily mean that the credit will remain intact.

When the credit is lost due to early disposition, the effect is that the tax for the year of disposition is increased by the amount of the credit previously used. (Note that it is the tax, not merely the income, which is increased.) The adjustment is made in the year of disposition,

40 INT. REV. CODE OF 1954, § 47(b).
not the year the credit was claimed; therefore, no interest for underpayment of tax is charged for the period the taxpayer enjoyed the credit.

There could be a situation where the investment credit never actually reduced the tax.

Example: In 1962 a taxpayer has no income, but invests $10,000 in "section 38 property" with a useful life of eight years. Since there is no income, the $700 credit could not be used in 1962; the credit could not be carried back to a period earlier than 1962. If the taxpayer disposes of the property in 1963, there has been a disposition resulting in the loss of the credit, but the credit had never been used.

To give effect to the fact that the credit was never used, the adjustment is made in the carryover or carryback. Thus, in the example, the carryover to 1963 would be reduced $700 and therefore eliminated.

Example: Assume the same facts as in the above example, except that the property was disposed of in 1964 and that $300 of the credit was used in 1963. In such a case, the tax for 1964 would be increased $300 to reflect the extent of which the credit was used. Moreover, the carry forward of $400 to 1964 would be eliminated.

Destruction of or damage to or theft of "section 38 property" is an early disposition, but will not be treated as such where (a) the property is replaced by "section 38 property," and (b) the adjustment to basis or cost of the replacement property (as set forth above) is at least as much as the decrease in qualified investment which would result if such occurrence were treated as an early disposition.

Prior to the Revenue Act of 1964, the basis of property had to be reduced by the amount of the investment credit allowed with respect to such property. Under the Revenue Act of 1964, the basis of property placed in service prior to January 1, 1964, is completely restored.

GAIN FROM DISPOSITION OF CERTAIN DEPRECIABLE PROPERTY

I. Introduction

In 1962, Congress sought to prevent what it considered to be an abuse of the depreciation deduction. Prior to that time, a taxpayer had been able to gain at least a theoretical tax advantage by depreciating property below its market value, taking the depreciation deduction against ordinary income, and then selling the property at a profit and paying only the capital gains tax. In 1962, section 1245 was created, which (with certain related provisions) in effect provided that the
income from the disposition of certain depreciable property (not including buildings or their structural components) would be ordinary income to the extent of the depreciation claimed since the beginning of 1962. Moreover, in an effort to plug so-called loopholes, the new law extended taxation to certain transactions which were theretofore tax-free. Thus, the new law not only accomplished its avowed purpose of converting capital gain to ordinary income, but it also imposed a tax where heretofore no income had been recognized. Congress once again, in 1964, legislated in the area of depreciation, making it more complicated and confused; it created, in section 1250, an entire new set of rules to apply to real estate not covered by the Revenue Act of 1962. The Revenue Act of 1964, like its predecessor, extends the tax collector's grasp to transactions which had previously been treated as tax-free.

II. Property Subject to the New Depreciation Rules

In general, the property subject to the rules of section 1245 imposing ordinary income upon the entire gain recognized on its disposition (up to the depreciation claimed since January 1, 1962) is the same property as that which qualifies for the investment credit. However, there is one additional classification of property included in section 1245; that is, intangible personal property. The property affected by the rules on depreciable property laid down by section 1245 must be used in the trade or business or for the production of income and may be summarized as follows:46 (a) personal property, except livestock, (b) other property, not including buildings or their structural components, which is tangible and is used as an integral part of manufacturing, production, extraction, or furnishing transportation, communications, electrical energy, gas, water, or sewerage disposal services, or constitutes research or storage facilities used in connection with any of the foregoing activities, and (c) an elevator or escalator.47

The inclusion of all personal property, and not merely tangible personal property, means that these depreciation rules apply to such items as patents, copyrights, trademarks, certain franchise agreements and covenants not to compete. (Goodwill would not be included, since it is not depreciable.)

As in the case of "section 38 property," section 1245 property must be used in the trade or business or for the production of income, and must be subject to the allowance for depreciation. However, it is not required that section 1245 property have a useful life of at least four

46 INT. REV. CODE OF 1954, § 1245(a) (3).
47 The provisions of INT. REV. CODE OF 1954, § 1245, were extended to elevators and escalators by the Revenue Act of 1964, § 203(d), which created INT. REV. CODE OF 1954, § 1245(a) (3) (c).
years, while the property cannot qualify for the investment credit unless it has a useful life of at least this length. The only qualification on the rule that the property must be subject to the allowance for depreciation is where the property ceases to be used in the trade or business but ownership remains unchanged, or where property is transferred to another with the carryover basis as explained hereafter.

Property subject to the new and different rules of section 1250 is "any real property (other than section 1245 property . . .) which is or has been property of a character subject to the allowance for depreciation provided in section 167." Thus, section 1250 property includes intangible real property such as a leasehold of land, a building and its structural components, and all other tangible real property except property used as an integral part of manufacturing, production, extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewerage services or research or storage facilities in connection with these activities.

III. The Concepts of "Recomputed Basis" and "Additional Depreciation"

An important concept in determining the income on the disposition of section 1245 property is the recomputed basis of the property. As stated, the purpose of the original section 1245 was to tax as ordinary income the gain from the disposition of section 1245 property to the extent of the depreciation claimed since the beginning of 1962. Therefore, the recomputed basis is the adjusted basis plus the depreciation claimed since January 1, 1962, except that in the case of elevators and escalators only the depreciation since July 1, 1963, is added to the adjusted basis.

Section 1250 created a new concept known as "Additional Depreciation," and is not concerned with "recomputed depreciation" as such. Section 1250 was aimed primarily at real estate speculators who buy property, claim some form of accelerated depreciation, and then sell

---

48 INT. REV. CODE OF 1954, § 1245(a)(3), defines § 1245 property in terms of property "which is or has been property of a character subject to the allowance for depreciation . . ." [Emphasis added.]
49 INT. REV. CODE OF 1954, § 1245(b).
50 INT. REV. CODE OF 1954, § 1250(c).
51 The cost of a leasehold itself can be subject to amortization, and thus it is not completely accurate to say that § 1250 property does not include the land itself, since a leasehold interest in the land could be subject to amortization, and thus the leasehold of the land would be § 1250 property.
52 There is one exception: elevators and escalators do not constitute § 1250 property since they were made subject to the provisions of § 1245 by the Revenue Act of 1964, § 203(d).
53 In other words, real property which is § 1245 property. Examples would be railroad tracks, blast furnaces and bridges.
54 INT. REV. CODE OF 1954, § 1245(a)(2).
55 INT. REV. CODE OF 1954, § 167(d), specially allowed the double declining balance method and the sum of the years-digits method. The 150% declining balance method was acceptable under the INT. REV. CODE OF 1939 in most instances.
the property, all in a relatively short period of time. This device was aimed at converting ordinary income into capital gain by applying the deduction for the so-called “excess depreciation” against ordinary income each year at the taxpayer's highest bracket, and then selling the property and paying capital gain tax on the amount the property had been depreciated below market value. Unlike section 1245, section 1250 does not convert all gain attributable to depreciation (since the enactment of section 1250) into ordinary income, but rather only the depreciation taken in excess of straight line depreciation. Thus, “Additional Depreciation” means the depreciation adjustments attributable to the period after December 31, 1963, which would exceed the depreciation computed on a straight line basis, except that if the property was held for only a year or less,56 “Additional Depreciation” includes all depreciation since December 31, 1963.57

Under the new law, as under traditional concepts of income realization, the gain recognized for tax purposes upon the disposition of either section 1245 or section 1250 property is the excess of the amount realized over the adjusted basis (generally, cost less depreciation). However, the new provisions convert at least a portion of that gain from capital gain status to that of ordinary income. Moreover, sections 1245 and 1250 apply entirely different sets of rules in determining what portion is ordinary income.

Under section 1245, the portion of the gain that constitutes ordinary income is the recomputed basis or the amount received or the fair market value of the property in the case of a disposition other than a sale, exchange, or involuntary conversion, whichever is less, minus the adjusted basis. To state it another way, all of the gain realized, up to the amount of depreciation added back to the adjusted basis to de-

56 The special provision requiring all depreciation for property held for less than a year to be taxed as ordinary income (to the extent of gain) cannot necessarily be considered a repudiation of Cohn v. United States, 259 F. 2d 371 (1958) and Rev. Rul. 62-92, 1962-1 CUM. BULL. 29, on the argument that Congress is impliedly recognizing a right to take depreciation for the year of sale. The year provision of INT. REV. CODE OF 1954, § 1250(b) (1), does not mean the taxable year and, therefore, it could be argued Congress was aiming at the depreciation for the portion of the holding period preceding the fiscal year of sale. Thus, if property was acquired on June 30, 1964, by a calendar year taxpayer and sold on May 31, 1965, for more than the original cost, the Cohn rule would allow long term capital gain treatment for the depreciation attributable to calendar 1964, whereas under § 1250(b) (1) the entire difference between cost and adjusted basis at time of sale would be ordinary income.

57 INT. REV. CODE OF 1954, § 1250(b). In determining the straight line depreciation for a lessee, the useful life includes the period of any of the lessee's renewal options, but not exceeding two-thirds of the original term and not exceeding the useful life of the underlying asset. Thus, a lessee computing depreciation on the straight line method with a useful life equal to the original terms of the lease could have Additional Depreciation, since, for purposes of § 1250, the useful life would have to be considered with reference to renewal options.
termine the recomputed basis, is ordinary income. Any excess gain will constitute capital gain as in the past. The following examples will clarify these rules.

**Example:** A piece of section 1245 property (other than an elevator or an escalator) had an adjusted basis of $10,000 on January 1, 1962. An additional $1,000 depreciation is claimed in each of 1962 and 1963. The property is sold for $9,000 on January 2, 1964. The ordinary income on this sale is $1,000. The adjusted basis is $8,000 and the recomputed basis is $10,000 (the adjusted basis plus depreciation claimed since 1962). The ordinary income is equal to the lesser of the recomputed basis ($10,000) or the amount realized ($9,000) minus the adjusted basis ($8,000).

**Example:** The facts are the same as above, except that the property is sold for $11,000. In this case, ordinary income is $2,000 and capital gain is $1,000. Ordinary income is equal to the lesser of the recomputed basis ($10,000) or the amount realized ($11,000), minus the adjusted basis ($8,000). The excess of the amount realized over the recomputed basis is capital gain, which is the treatment that it would have received prior to the Revenue Act of 1962.

In the case of section 1250 property, the law does not aim to convert all gain resulting from depreciation to ordinary income, but only that properly attributable to depreciation in excess of straight line depreciation. Moreover, the amount of this gain which will be converted to ordinary income depends upon the length of time the property was held. The maximum amount of ordinary income which can result

---

58 Recomputed basis is the adjusted basis plus depreciation claimed since January 1, 1962, except in the case of elevators and escalators, in which case the starting date is July 1, 1963.
59 Int. Rev. Code of 1954, § 1250(f). Section 1250(f) contains special rules to cover the situations where additional improvements are made to § 1250 property or the property is put into use at different times. Without such rules, a substantial two-year old improvement to an item of § 1250 property held over ten years would not be subject to § 1250. An improvement is any addition to a capital account after the initial acquisition or after completion of the property. It doesn't have to involve a physical addition. If a taxpayer sells his old residence and purchases a new one, and if the gain was not recognized due to Int. Rev. Code of 1954, § 1034, any addition to basis due to an increased cash investment would be considered an improvement subject to these special rules. An improvement is subject to this special rule only if it and all other improvements made during a three year period ending as of the end of any year exceeds all three of the following:

1. 25% of the adjusted basis of the property computed as of the beginning of such three year period.
2. 10% of the adjusted basis computed without the deduction for depreciation and amortization required by Int. Rev. Code of 1954, §§ 1016(a)(2), (3), as of the beginning of the three year period.
3. $5,000.00.

Notwithstanding the above rule, no improvement is subject to the special rule (or includible with other improvements in determining if the above three year rule applies) if all of the improvements for the taxable year don't exceed the greater of $2,000 or 1% of adjusted basis of the property as of the beginning of the year determined without the deductions required by §§ 1016(a)(2), (3).

In addition to the above rules for separate improvements, the property is
from the disposition of section 1250 property is the lesser of the Additional Depreciation (as explained above) or the gain realized.\textsuperscript{60} To determine the portion of this maximum amount which is converted into ordinary income, the following rules are applied:

If property was held one year or less, the entire maximum amount is taxed as ordinary income, and as stated above, even straight line depreciation is included in Additional Depreciation.

If the property was held less than twenty-one full months but more than one year, the entire maximum amount is taxed as ordinary income, but here, straight line depreciation is not included in Additional Depreciation.

If the property was held ten years or less, but at least twenty-one full months, the percentage of the maximum amount converted to ordinary income varies from 1\% to 99\%, in inverse ratio to the number of months held.

If the property was held more than ten years, no portion of the maximum amount is converted to ordinary income.

The foregoing rules on section 1250 property can be illustrated by the following examples:

\textit{Example:} The taxpayer buys a building on May 2, 1964, and sells it on January 2, 1966. For the years 1964 and 1965, he deducts $20,000 depreciation, but depreciation computed for this period on the straight line method would have been $12,000. Because the property was held for twenty months, the gain, not exceeding $8,000, would be taxed as ordinary income. (Note that post-1963 depreciation includes depreciation for \textit{periods} after 1963 and not just depreciation taken in \textit{taxable years} beginning after 1963.)

\textit{Example:} The facts are the same as the foregoing example, except that the property is sold January 2, 1967, and the depreciation claimed by that time was $28,000, whereas the depreciation that would have been allowable on a straight line method would have been $18,000. The Additional Depreciation is equal to $10,000, but the maximum amount which would be converted to ordinary income would be 88\% ($8,800 if the gain exceeded $10,000).

The special rules laid down by section 1245 apply to disposition in taxable years beginning after December 31, 1962 (except for elevators and escalators where the rules apply to dispositions after December 31, 1963).\textsuperscript{61}

\textsuperscript{60} \textit{Int. Rev. Code of 1954, § 1250(a) (1) (B).} The gain is determined as the excess of amount realized in the case of a sale, exchange or involuntary conversion or the fair market value in the case of any other disposition, over the adjusted basis of such property.

\textsuperscript{61} As stated above, recomputed depreciation is computed from January 1, 1962, although only dispositions on or after January 1, 1963, are subject to the section. Some tax authorities claim that the year's period shows Congress
The rules of section 1250 apply to dispositions occurring after December 31, 1963, the date from which Additional Depreciation is computed.

The general purpose behind sections 1245 and 1250 is not to change the rules as to when a transaction results in income, but rather the sections are designed to change only the character of the income received. Therefore, since a gift does not give rise to income, a gift of section 1245 or section 1250 property has no significance income-taxwise. Just as the adjusted basis of the donor carries over to the donee, so likewise there is a carryover of the recomputed basis in the case of section 1245 property,\(^6\) and of the Additional Depreciation in the case of section 1250 property.\(^6\) The result is that the donee receives the property with the potential section 1245 or section 1250 income attached to it. It was stated above that section 1245 or section 1250 property is property used in the trade or business or for the production of income. One exception to this rule would be where a donee receives the property, as stated in this paragraph, but retains it for his personal use only. In the case of section 1250 property, just as the Additional Depreciation carries over, so too the holding period is transferred, and therefore, for purposes of determining the percentage of the maximum amount that can be converted to ordinary income, the taxpayer gets the benefit of the length of time his donor held the property.\(^6\)

As in the case of a non-charitable donee, no income is realized by the gift of section 1245 or section 1250 property to a charity. The charity, of course, would be tax-exempt, so would not realize income from its sale of section 1245 or section 1250 property. To plug what it must have considered a loophole, Congress has compensated for this omission of taxation by limiting the charitable deduction. The donor's charitable 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.\(^6\) The net result is approximately the same as if the donor agreed with the Internal Revenue Service's rule stated in Rev. Rul. 62-92, \(^62\) which was based on the Cohn case, supra note 56. This theory is based on the idea that in the case of a disposition during 1963, no depreciation would be allowed if a gain would result thereby, but this ignores the situation of a fiscal year taxpayer. For instance, a taxpayer on a June 30 fiscal year could dispose of property at a significant gain in December of 1963, and even under Rev. Rul. 62-92, he could claim depreciation for the entire year ending June 30, 1963.

\(^6\) INT. REV. CODE OF 1954, §§ 1245 (a) (2), 1245 (b) (1).
\(^62\) INT. REV. CODE OF 1954, §§ 1250 (b) (3), 1250 (d) (1).
\(^63\) INT. REV. CODE OF 1954, § 1250 (e) (2).
\(^64\) INT. REV. CODE OF 1954, § 170 (e). This limitation can be of significant importance for taxable years beginning after December 31, 1963. The Revenue Act of 1964, § 209 (c) (1), created INT. REV. CODE OF 1954, § 170 (b) (5), which allows individuals to carry forward for five years certain charitable contributions, and the Revenue Act of 1964, § 209 (d) (1), amended INT. REV. CODE OF 1954, § 170 (b) (2), to allow corporations a five year carry forward. Prior to the Revenue Act of 1964, if an individual's charitable contributions in any one year exceeded the maximum amount deductible for that year, the excess
had sold the property and given the proceeds to charity (except to the extent of any capital gain due to the fact that the value exceeded the recomputed basis or the percentage of the maximum amount recognized as ordinary income, as the case may be, or except to the extent the taxpayer would not have been able to use the charitable deduction due to the 20% and 30% limitations of section 170).

Example: A taxpayer has a 1245 asset used in his trade or business with a basis of $1,000, a recomputed basis of $2,000, and a fair market value of $1,500. If he sells the asset and gives the proceeds to charity, he has $500 of ordinary income and an offsetting $1,500 charitable deduction, so his net charitable deduction is $1,000. If he gives the asset itself to charity, the charitable deduction is still only $1,000, and there is no ordinary income.

(These new rules apply only to section 1245 and section 1250 property and therefore would not affect a gift of securities to charity.)

About the only way to avoid the ordinary income potential on section 1245 or section 1250 property is to die owning it. No income results from a transfer at death,66 and the recipient acquires a stepped-up basis so the recomputed basis or Additional Depreciation drops out of the picture.

The Code specifies certain tax-free transactions which remain tax-free even if section 1245 or section 1250 property is involved.67 However, to the extent that any income would arise from these transactions under other provisions of the tax law, that income would be converted to ordinary income to the extent specified as in the case of any taxable sale. To the extent that the transactions are tax-free, the recomputed basis or the Additional Depreciation carries over to the recipient.68 The principal tax-free exchanges involved here are as follows: (1) distributions to a parent corporation upon the complete liquidation of a subsidiary69 (unless the parent acquired the subsidiary within the last two years);70 (2) incorporation, that is, transfer to a controlled corporation for its stock or securities;71 (3) transfers in tax free reorganizations of corporations;72 (4) contributions to a partnership in exchange

66 INT. REV. CODE OF 1954, §§ 1245(b) (2), 1250(d) (2).
67 INT. REV. CODE OF 1954, §§ 1245(b) (3), 1250(d) (3).
68 INT. REV. CODE OF 1954, §§ 1245(a) (2), 1250(b) (3). Under INT. REV. CODE OF 1954, § 1250(e) (2), the holding period also carries over on the tax-free transfer of § 1250 property.
69 INT. REV. CODE OF 1954, § 332.
70 In such a case, under INT. REV. CODE OF 1954, § 334(b) (2), there is no carryover of basis, and §§ 1245(b) (3), 1250(d) (3), apply only where there is a carryover basis under § 332 and certain other sections enumerated therein.
71 INT. REV. CODE OF 1954, § 351.
72 INT. REV. CODE OF 1954, § 361. Sections 1245(b) (3), 1250(d) (3), also apply to basis carried over under INT. REV. CODE OF 1954, §§ 371(a) (reorganization in certain receivership and bankruptcy proceedings), 374(a) (certain railroad reorganizations).
for a partnership interest; and (5) distributions by a partnership in complete or partial liquidation (subject to special rules on recognition of gain).

The above rules relating to tax-free exchanges do not apply to distributions to tax-exempt organizations (other than tax-exempt cooperatives), since a later disposition of the property by such organizations would not result in any ordinary income.

Even though, as indicated, there are numerous transactions in which section 1245 or section 1250 property can be transferred without precipitating additional tax under these sections, there are certain transfers which can result in ordinary income being imposed where previously no income at all was recognized. The general areas, as discussed below, are as follows: like kind exchanges, involuntary conversions, distributions as a dividend, distributions in partial or complete liquidation, and sale by a liquidating corporation.

To the extent that any gain would be recognized from an exchange of property for similar property due to the receipt of boot (that is money or property not similar to that exchanged), or upon an involuntary conversion (due to the failure to invest in similar property), gain will be considered ordinary income to the extent specified above in the case of an ordinary sale. Moreover, to the extent that property which is not section 1245 or section 1250 property, as the case may be, is received, gain will be recognized as ordinary income even though heretofore no gain would have been recognized. For example, if property is involuntarily converted, no gain is recognized if the taxpayer invests the insurance proceeds in similar property or acquires control of a corporation owning such property; but the stock in a controlled corporation would not be either section 1245 or section 1250 property, so the ordinary income potential would be lost unless gain was recognized upon the involuntary conversion.

Prior to the Revenue Act of 1962, a corporation received no income when it paid a dividend, unless it paid the dividend in LIFO inventory or in property which was subject to a liability in excess of the corporation’s basis. However, the Revenue Act of 1962 added another situation in which a corporation may realize income upon the payment of a dividend: the distribution of section 1245 property with a value in excess of adjusted basis.

---

73 INT. REV. CODE OF 1954, § 721.
74 INT. REV. CODE OF 1954, § 731.
75 INT. REV. CODE OF 1954, §§ 1245(b) (3), 1250(d) (3).
76 INT. REV. CODE OF 1954, § 1031(b).
77 INT. REV. CODE OF 1954, § 1033(a).
78 INT. REV. CODE OF 1954, §§ 1245(b) (4) (B), 1250(d) (4).
79 INT. REV. CODE OF 1954, § 1033(a) (3) (A).
80 This point is not specifically detailed in the Code, but § 1245(a) (1) states that gain from the disposition of § 1245 property will be recognized.
A similar rule was applied to section 1250 property by the Revenue Act of 1964. For purposes of determining the gain, the corporation is deemed to have received the fair market value of the property distributed. The purpose behind these provisions is to prevent the ordinary income potential, thus avoiding taxation entirely, since the stockholder who receives the property can acquire a stepped-up basis.

A corporation can realize ordinary income if it distributes section 1245 or section 1250 property with a value in excess of adjusted basis in partial or complete liquidation. The rule applies whether the stockholder receiving the property is an individual or another corporation, and thus the rule applies to the liquidation of a wholly-owned subsidiary.

The tax is imposed on the transferor and not the transferee, and the fact that the recipient may realize no income, and in fact may suffer a loss by reason of liquidation, is unimportant. This rule can have unexpected results and caution is indicated.

One familiar method for a corporation to purchase a business from another corporation is to buy all of the stock and then to liquidate the acquired company. In this way, the purchaser acquires a basis for the assets equal to his cost basis of the stock, and the liquidation has always been considered tax-free. Thus, if Corporation $A$ pays $400,000 for all the stock of Corporation $B$ and immediately liquidates it, Corporation $A$ realized no income, and the basis for the property in its hands is $400,000, but since the Revenue Act of 1962, Corporation $B$ may incur income upon the liquidation. The result is that Corporation $A$ does not receive $400,000 worth of property, since there may be a tax liability to be discharged. Therefore, the purchaser may have an incentive in recognizing some good will if it paid a premium for the stock. At least, it is clear that the particular facts in each case should be carefully examined, and these provisions should be kept in mind in negotiating the purchase price.

Before the Revenue Act of 1962, a corporation could avoid income

withstanding any other provision of the Code and none of the enumerated exceptions apply to a dividend distribution. Section 1245(a)(1)(B)(ii) states that if the property is disposed of other than by a sale, exchange, or involuntary conversion, the income is computed with reference to the fair market value of the property transferred.

As in the case of § 1245, § 1250 doesn't specifically cover this point, but § 1250(a)(1) states that the rule of the section applies notwithstanding any other provision of the Code, and this type of distribution is not one of the enumerated exceptions. Likewise, § 1250(a)(1)(B) states that the income is computed with reference to the fair market value of the property disposed of, if there is no sale, exchange, or involuntary conversion.

There is no specific provision in §§ 1245, 1250, for distribution in liquidation (except for the liquidation of a subsidiary held for over two years, as discussed above).

Except where the subsidiary was held for over two years, and thus Int. Rev. Code of 1954, § 334(b)(2), does not apply.

on the sale of its assets if it adopted a plan of liquidation, sold all of the assets, and liquidated within a twelve month period. This rule is no longer true to the extent that the corporation sells section 1245 property with a value in excess of the adjusted basis, or sells section 1250 property held less than ten years where some Additional Depreciation would be present. Ordinary income will be recognized to the extent stated above in the case of any other sale, but no capital gain will be recognized. Thus, if a corporation in the process of a twelve month liquidation sells section 1245 property with a basis of $10,000, a recomputed basis of $12,000, and receives $15,000, it realizes $2,000 of ordinary income, but there is no capital gain recognized on the remaining $3,000. This same rule applies if the corporation sells section 1245 or section 1250 property on the installment basis and distributes the notes before it has reported all the gain.

If a taxpayer sells a large amount of section 1245 and/or section 1250 property in one taxable year, perhaps in connection with the sale of an entire business, he might have to pick up as ordinary income all of the depreciation deductions claimed since 1961 on section 1245 property and the Additional Depreciation on section 1250 property (assuming the value of the property was this substantial). In the ordinary case, the depreciation claimed since 1961 or 1963, as the case may be, would have applied against income which otherwise would have been taxed perhaps at rates less than the rate applicable in the year of sale. The effect of lumping all the income in one year, the year of

86  INT. REV. CODE OF 1954, § 337.
87  See note 80 supra. There is no exception in § 1245 for the operation of § 337.
88  See note 81 supra. There is no exception in § 1250 for the operation of § 337.
89  If a taxpayer's principal results from the disposition of § 1245 or § 1250 property due to some form of accelerated write-off, he might find it to his advantage to adopt a slower method of depreciation. INT. REV. CODE or 1954, § 167(e) (1), allows a taxpayer at any time, assuming there is no agreement under § 167(d) to the contrary, and without permission from the Commissioner of Internal Revenue, to change from a declining balance method (either 150% or 200%) to a straight line method. The Revenue Act of 1962, § 13(b), added to the INT. REV. CODE of 1954, § 167(e) (2), which allows a taxpayer, without permission from the Commissioner of Internal Revenue, to change from any declining balance or sum of the years-digits method to the straight line method, but this election had to be exercised by the last day (including extensions) for filing the tax return for the first taxable year beginning after December 31, 1962; apparently the election did not have to be made in the return itself. No comparable provision was contained in the Revenue Act of 1964 for § 1250 property. Of course, a taxpayer can always change from one depreciation method to another, provided he has the prior consent of the Commissioner of Internal Revenue. Both §§ 1245, 1250, provide that the computation therefore shall be made on the basis of the depreciation allowed, and not merely allowable, if the taxpayer can establish that the maximum allowable was not actually taken. However, the mere process of a taxpayer not claiming the full depreciation to which he was entitled under his customary depreciation method would probably be subject to challenge as an unauthorized change in accounting method under INT. REV. CODE of 1954, § 446(e), or else it could be said that the taxpayer's method of accounting did not clearly reflect income, as required by INT. REV. CODE of 1954, § 446(b).
sale, conceivably could push the taxpayer into a much higher bracket. Of course, if a taxpayer makes a substantial profit on the sale of his business, chances are that the profit was attributable primarily to good will. Therefore, he can avoid the ordinary income problem to the extent that the purchase price could be allocated to assets other than section 1245 property. However, it could be expected that the purchaser would rather allocate the purchase price to section 1245 property or section 1250 property, since other property, such as good will, may not be depreciable. Likewise, the purchaser would have an incentive to allocate more to section 1245 property with an assumed relatively short useful life, rather than to section 1250 property, with a longer life; but the seller would probably prefer a section 1250 allocation, rather than a section 1245 allocation, since only depreciation in excess of straight line depreciation is subject to section 1250 (if the property has been held for over a year) and since, due to a long holding period, only a portion of the ordinary income might be recognized under section 1250.

This points up another allocation problem. Prior to section 1250, a seller didn't care how a purchase price of real estate was allocated between land (non-depreciable) and improvements (depreciable). However, now a seller would like to be able to claim that improvements had little relative value and attribute most of the purchase price to the land. However, the purchaser would want to avoid an allocation to non-depreciable property.

IV. Conclusion

It is impossible to make a summary analysis of the mechanics of the new provisions of the Internal Revenue Code concerning the purchase or sale of depreciable property; however, it can be safely stated that these provisions will effect every businessman in the country—and many not engaged in business. Since there are numerous aspects of this area which involve entirely new concepts in the field of income taxation, and since many of the old, traditional concepts and methods have been drastically changed, it can be concluded that caution is dictated and each proposed transaction should be examined to determine the effect of the Revenue Acts of 1962 and 1964.

---

90 The Revenue Act of 1964, § 232, made substantial amendments to part 1 of subchapter Q of chapter 1 (§§ 1301-05) and, depending upon a taxpayer's particular situation, the new, more liberal income averaging rules might alleviate, at least in part, the hardship from such lumping of income.