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In *American Dredging Co.*, the fact that the complaint did not specify a federal statute should not have prevented the federal court from acquiring jurisdiction.[32] With a federal question implicit in the complaint, the fact that the district court would have been unable to grant injunctive relief and would have dismissed the action should not have had any bearing on its jurisdiction to retain the case. *Lincoln Mills* suggests that a uniform policy in the labor law field regarding injunctive relief is desirable. If Congress wishes to change this policy it has the unquestioned authority to do so. Until it acts, state courts should accept the prohibitions of the Norris-LaGuardia Act and deny injunctions, or the cases should be readily removable to the federal district courts.

CHARLES G. JOHNSON

TAX DEPRECIATION DEDUCTIONS IN YEAR OF SALE

One of the most disputed areas of taxation involves the allowance of a depreciation deduction in the year a depreciable asset is sold at a price exceeding its adjusted basis. Under the 1954 Code,[1] depreciation deductions may be taken faster than the actual physical depreciation.[2] By selling the asset when total depreciation deductions exceed actual physical depreciation, the taxpayer obtains a substantial tax savings. The depreciation allowance is taken as a deduction from ordinary income,[3] while the increase in gain upon the sale is taxed as capital gain.[4] Thus, ordinary income is converted into capital gain to the extent of the excessive depreciation deductions. The Commissioner of Internal Revenue attempted to minimize this conversion of ordinary income into capital gain by disallowing any depreciation deduction in the year of sale. He also sought a statute expressly declaring all gain from the sale to be ordinary income.

Recently Congress enacted sections 1245[5] and 1250[6] of the Internal Revenue Code. Section 1245, to the extent of the depreciation deductions, prevents any gain received upon the sale of personal prop-

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[32]Dynamic Mfrs., Inc. v. Local 614, Teamsters Union, 103 F. Supp. 651 (E.D. Mich. 1952).

[1]Int. Rev. Code of 1954.

[2]See Int. Rev. Code of 1954, §§ 167(a)(2), 167(b)(3), 179. These code sections respectively provide for the use of the declining balance method of depreciation, the sum of the digits method, and the small business depreciation allowance.

[3]Int. Rev. Code of 1954, §§ 161, 167(a).

[4]Int. Rev. Code of 1954 § 1231.

[5]Section 13 of the Revenue Act of 1962.

[6]Section 231 of the Revenue Act of 1964.

erty from being treated as capital gain. Under section 1250, a percentage of the gain due to excessive depreciation of realty is taxed as ordinary income.

Both statutes, however, are limited in their scope of application. Neither statute affects tax situations prior to 1962;[7] both statutes contain a number of exceptions; section 1250 is not concerned with gain resulting from market appreciation of the asset; and section 1250 is not applicable after a ten-year holding period.[8] Because of these limitations, which still allow substantial conversion of ordinary income into capital gain, the Commissioner will continue to disallow depreciation deductions in the year of sale, subject to future case developments.[9]

Macabe Co.[10] is the first Tax Court case allowing a depreciation deduction in the year of sale when the sale price exceeds the asset's adjusted basis.[11] The Macabe Corporation sold a building at a price in excess of its depreciated basis and deducted a depreciation allowance for the period during the year of sale during which it owned the building. The Commissioner, however, disallowed the deduction and assessed a deficiency.[12]

The Commissioner contended:

1. The building had not depreciated, but actually had appreciated in value, as shown by the sales proceeds;

2. The salvage value[13] should be equated to the known sales price;

[7]Section 1245 applies only to deductions taken after December 31, 1961; and § 1250 applies only to deductions taken after December 31, 1963.

[8]Under § 1250, only the "applicable percentage" is taxable. "Applicable percentage" is 100 per cent minus one percentage point for each full month the property is held after the date on which the property has been held for twenty full months. On this basis, zero per cent would be taxable after ten years. See § 1250 (a)(2).

[9]For additional study of §§ 1245, 1250, see H.R. Rep. No. 749, 88th Cong., 1st Sess. 103 (1963); 16 Major Tax Planning, Recapture of Depreciation under IRC §1245, 583 (1964); Kahn, Recapture of Depreciation, 42 Taxes 918 (1964); Schapiro, Recapture of Depreciation and § 1245 of the Internal Revenue Code, 72 Yale L.J. 1483 (1963); Comment, 11 U.C.L.A.L. Rev. 593 (1964).

[10]42 T.C. 1105 (1964). The United States has appealed this case to the Court of Appeals for the Ninth Circuit. For cases decided after the Macabe case see infra, note 60.

[11]Adjusted basis is the cost of property reduced by depreciation deductions which have been previously claimed. Int. Rev. Code of 1954, § 1016.

[12]See Int. Rev. Code of 1954, § 6211.

[13]"Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer." Treas. Reg. § 1.167(a)-1(c)(1) (1956), as amended (1964).

3. The amount regarded as the salvage value (sale price) plus prior deductions for depreciation exceeded the original cost of the building;[14]

4. The taxpayer had fully recovered the adjusted basis which remained in the building at the beginning of the year of sale.

The Tax Court found the estimated useful life[15] was correct, and that the value of the building had substantially increased from the time salvage value and useful life had been estimated.[16]

Deciding in favor of the Macabe Co., the Tax Court stated that the Commissioner had failed to distinguish between gain resulting from excessive depreciation deductions[17] and gain resulting from value appreciation due to market conditions, and that in equating salvage value with sales proceeds, the Commissioner had not complied with the Regulations.[18] The court held that the increase in the building's value was due solely to market conditions, and no element of excessive depreciation had been proved. The court concluded that Macabe had not recovered his adjusted basis in the asset and was entitled, therefore, to deduct the depreciation occurring prior to the transfer, during the year of sale.

Four judges dissented[19] on the ground that this case was not distinguishable from earlier cases[20] which disallowed identical depreciation deductions. The question of whether the Commissioner could prevent the conversion of ordinary income into capital gain by disallowing depreciation deductions in the year of sale was first decided by

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[14]The "reasonable allowance" of the Int. Rev. Code of 1954, § 167 is that amount which should be set aside each year, so that the aggregate of the amounts set aside, plus salvage value, will equal the cost of the asset. Treas. Reg. § 1.167(a) 1(a), (1956), as amended (1960). Any depreciation which would cause the total amount to exceed the cost basis of the asset is not allowable. Treas. Reg. § 1.167(b)—0 (1956).

[15]"[T]he estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income." Treas. Reg. § 1.167(a)-(b), (1956), as amended (1964).

[16]Such estimates are necessary in order to arrive at a "reasonable and consistently applied method of computing depreciation" as required by Treas. Reg. § 1.167(b)-0 (1956). Also see Massey Motors, Inc. v. United States, 364 U.S. 92 (1960); Burnet v. Niagara Brewing Co., 282 U.S. 648 (1931).

[17]Excessive depreciation means all depreciation deductions that exceed the actual physical depreciation as determined by the straight-line depreciation rate.

[18]See generally Treas. Reg. § 1.167(a)-(i).

[19]42 T.C. 1105, 1114 (1964). There are sixteen judges on the Tax Court. A fifth judge dissented but did not concur in the dissent of the other four.

[20]Fribourg Nav. Co. v. Commissioner, 335 F.2d 15 (2d Cir. 1964); United States v. Motorlease Corp., 334 F.2d 617 (2d Cir. 1964). For subsequent history of these two cases, infra note 38, 44 respectively.

the Court of Appeals for the Sixth Circuit in *Cohn v. United States*.[21] This case involved assets which were depreciated over a reasonably estimated useful life. Salvage value, however, was not estimated by the taxpayer.

In affirming the judgment of the district court and disallowing the depreciation deduction in the year of sale when the sale price exceeded the asset's adjusted basis, the court of appeals said:

> "But the Government is not contending that salvage value... should be adjusted at all on account of 'mere fluctuation in market value.' In so far as this case is concerned the issue is whether salvage value can be adjusted *at or near the end of the useful life* of the asset when it is shown by the actual sale of the asset that there is a substantial difference between what was estimated and what it actually is."[22]

The *Cohn* decision is limited to a factual situation in which there is an unreasonable estimate of salvage value and the asset is near the end of its useful life.[23] If the salvage value is unreasonable, it is susceptible to redetermination[24] and could logically be equated to the sales price because the asset is near the end of its estimated useful life.[25] It appears that this case does not establish a rule of law which would disallow all depreciation deductions in the year of sale whenever the sales price exceeds the asset's adjusted basis.[26]

In 1962, Revenue Ruling 62-92[27] was issued as a result of the *Cohn* decision. The Ruling concluded:

> "Therefore, the deduction for depreciation of an asset used in the trade or business or in the production of income shall be adjusted in the year of disposition so that the deduction, otherwise properly allowable for such year under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the property at the beginning of such year exceeds the amount realized from sale or exchange."[28]

By denying all depreciation deductions in the year of sale when the sales price is equal to or greater than the asset's adjusted basis,[29]

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[21]259 F.2d 371 (6th Cir. 1958).

[22]Id. at 378. (Emphasis added.)

[23]S & A Co. v. United States, 218 F. Supp. 677, 684 (D. Minn. 1963); 9 J. Taxation 141 (1963); Comment, 11 U.C.L.A.L. Rev. 593, 610 (1964).

[24]See Int. Rev. Code of 1954, §§ 167(a), 167(f).

[25]S & A Co. v. United States, 218 F. Supp. 677, 684 (D. Minn. 1963). For subsequent history of this case, see infra note 47.

[26]Merritt, 20 J. Taxation 156, 159 (1964).

[27]Rev. Rul. 92, 1962—1 Cum. Bull. 29.

[28]Id. at 31.

[29]Supra notes 26, 27.

Revenue Ruling 62-92 disregards the fact that gain may be due solely to fortuitous market appreciation.[30] Consequently, the Ruling permits the Commissioner to tax such gain at ordinary rates. The fact that useful life and salvage value were originally estimated correctly would not make any difference since the Ruling automatically equates salvage value to sales price.[31]

While the *Cohn* decision is limited to a factual situation in which an unreasonable estimate of salvage value is used, and the asset's estimated useful life is near its end, the Ruling is applicable regardless of a reasonable estimation of salvage value and irrespective of the asset's remaining useful life. Revenue Ruling 62-92, therefore, has a much broader effect on the disallowance of depreciation deductions in the year of sale than does the *Cohn* decision.[32]

The Federal Regulations affect the problem of depreciation deductions in the year of the sale. Regulation 1.167(a)-1(c) provides that a reasonably estimated salvage value shall not be redetermined unless there is a significant change in useful life. Thus, the Regulations prohibit any change in a reasonable estimate of the salvage value of an asset unless useful life is redetermined.[33] Since the Regulations are issued by the Commissioner, it is contradictory for him to redetermine the salvage value (i.e., equate salvage value to sales price) when there is no dispute as to the taxpayer's estimate of useful life. Of course, any unreasonable estimate of salvage value is subject to change whether or not useful life is redetermined.[34] This was true in *Cohn,* but it does not apply in *Macabe,* since reasonable estimates of salvage value were used.

After the *Cohn* decision, the Tax Court consistently disallowed all depreciation deductions in the year of sale when the asset was sold for more than its adjusted basis.[35]

The first important decision following *Cohn* was *Edward v. Lane,*[36] which involved the completed contract method[37] of reporting income. The Commissioner sought to equate salvage value to sales price. The

[30]Comment, 11 U.C.L.A.L. Rev. 593, 613-14 (1964).

[31]Supra, note 26; Rabin, 17 J. Taxation 376, 379 (1962).

[32]Supra note 26.

[33]Treas. Reg., § 1.167(a)-1(c) (1956), as amended (1964).

[34]See Int. Rev. Code of 1954, § 167(a); see also Cohn v. United States, 259 F.2d 371 (5th Cir. 1958).

[35]Ferrari, 20 J. Taxation 308-09 n.11 (1964).

[36]37 T.C. 188 (1961).

[37]Under the completed contract method of income returns, all income and deductions that arise under a particular contract are deferred until the completion of the contract. Treas. Reg. § 1.451-3(b)2 (1957).

Tax Court held that since depreciation deductions were not taken until the contract ended, it was unnecessary for the taxpayer to make an original estimate of salvage value; and thus it was only reasonable to use the sales price as the salvage value. As in *Cohn,* it appears that the ruling in *Lane* is limited to its facts: useful life was at its end and salvage value had not been estimated prior to the sale.

The first case involving a depreciation deduction in the year of sale, in which the facts are distinguishable from *Cohn,* was *Fribourg Nav. Co.*[38] Unlike *Cohn,* both the estimates of useful life and salvage value were reasonable. In *Fribourg,* the value of the asset had substantially increased because of fortuitous market conditions,[39] so that the asset sold for more than its original cost. The Commissioner disallowed any depreciation deduction in the year of sale. In affirming the decision of the Tax Court, the Court of Appeals for the Second Circuit[40] held that the taxpayer had fully recovered his basis in the asset when he sold the asset for more than its original basis, since under *Cohn* and Revenue Ruling 62-92, the salvage value must be equated to the sales price. Thus, the court in *Fribourg* upheld Revenue Ruling 62-92 and did not make any distinction between gain due to excessive depreciation deductions and gain due to fortuitous market conditions.

Since the *Cohn* decision, however, the district courts have been consistent in finding for the taxpayer.[41] *Kimball Gas Prod. Co. v. United States*[42] involved the declining balance depreciation method[43] under which it is unnecessary to estimate salvage value. The taxpayer sold its assets for a price in excess of their adjusted basis. The Commissioner disallowed any depreciation deduction in the year of sale, since the sales price was the actual salvage value. The district court disagreed and held that since this was the sale of a going concern, the sales price necessarily included the additional value inherent in the sale of a going concern. The court concluded that it was incorrect to equate the salvage value to the sales price, because the gain from the sale was not due solely to salvage value.

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[38]39 P-H Tax Ct. Mem. 1698 (1962), aff'd, 335 F.2d 15 (2d Cir. 1963), cert. granted 379 U.S. 998 (1965).

[39]The increase in value of the asset, a ship, was due to the Suez crisis, which subsequently ended as suddenly as it had begun, and the value of the ship dropped until it was again substantially in line with the estimated figures.

[40]Supra note 38.

[41]Supra note 35.

[42]CCH 63-2 U.S. Tax Cas. ¶ 9507 (W.D. Tex. Dec. 3, 1962).

[43]The declining balance method of depreciation is explained fully in Treas. Reg. 1.167(b)-2 (1956), as amended (1964).

In 1963,a district court in *Motorlease Corp. v. United States*[44] held the Commissioner could not automatically disallow depreciation deductions simply because the sales price exceeded the asset's adjusted basis. The court held that, since the estimates of useful life and salvage value were reasonable, and a straight-line depreciation method[45] was used, it was impossible to take excessive depreciation. The court concluded the gain was due to favorable market conditions, and that such gain was taxable as capital gain. This case was subsequently reversed in the Court of Appeals for the Second Circuit.[46]

Again in 1963, a district court ruled against the Commissioner in *S & A Co. v. United States*,[47] wherein reasonable estimates of useful life and salvage value had been used. The assets, however, were sold before the end of the estimated useful life at a price in excess of their adjusted basis. After equating salvage value to sales price, the Commissioner disallowed the depreciation deduction. The court held that either Revenue Ruling 62-92 only applied to a factual situation similar to the *Cohn* case or that the Ruling was plainly incorrect. The court stated that "the sale price received for an asset prior to the expiration of its useful physical life is no more than a reflection of the market value of the asset at a particular point in time."[48] Since the estimated salvage depends on depreciation through the complete estimated useful life, the sales price could not reasonably be equated to salvage value before the end of the assets' useful life. Although the Commissioner did not dispute the estimated useful life, the court pointed out that a clear necessity for a redetermination of useful life life must be shown in order to change the estimated salvage value.[49] Since the sale date was considerably before the end of the estimated useful life, salvage value would be greater than originally estimated. This would possibly prevent the sale price from exceeding the remaining readjusted basis. *S & A Co.* has recently been affirmed by the Court of Appeals for the Eighth Circuit.

The diverse approaches of the Tax Court and district courts to the problem of depreciation deduction in the year of sale result

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[44]215 F. Supp. 356 (D. Conn. 1963), rev'd 334 F.2d 617 (2d Cir. 1964), petition for cert. filed, CCH 1965 Stand. Fed. Tax Rep. 70,906 (Nov. 13, 1964) (No. 685).

[45]The straight-line method of depreciation is explained fully in Treas. Reg. § 1.167(b)-1 (1956), as amended (1960).

[46]Supra note 44.

[47]218 F. Supp. 677 (D. Minn. 1963, aff'd, 338 F.2d 629 (8th Cir. 1964), petition for cert. filed, CCH 1965 Stand. F. Tax Rep. 70,907 (Jan. 27, 1965) (No. 862).

[48]Id. at 682.

[49]Id. at 682; see Treas. Reg. § 1.167(a)-1(c) (1956), as amended (1964).

[50]Supra note 47.

from different concepts regarding the purpose of a depreciation deduction.[51]

On the one hand, the Tax Court, prior to the *Macabe* case, appears to have adopted the theory that the purpose of a depreciation deduction is to compensate a taxpayer for an actual decrease in the value of the asset.[52] Under this theory, salvage value should be equated to sales price since the actual sales proceeds would determine the gain or loss in the asset's value. Irrespective of the reasonableness of estimated useful life and salvage value, gain from both market appreciation and excessive depreciation would affect the allowance of a depreciation deduction.

On the other hand, the district courts base their concept of a depreciation deduction on the theory that a taxpayer should be allowed to recover the cost of the asset from ordinary income.[53] Thus, market appreciation will not affect the allowance of a depreciation deduction, because it would in no way affect the original cost of the asset. The reasonableness of the estimated useful life and salvage value is controlling since excessive depreciation does not exist where estimates of useful life and salvage are reasonable.

The district courts' concept of a depreciation deduction seems to be more in accord with traditional concepts which allow depreciation deductions to recover the cost of an asset.[54]

In the principal case, *Macabe Co.*, the Tax Court held that a rule of law asserting that no depreciation deductions are allowable in the year of sale failed to distinguish between gain resulting from excessive depreciation and gain resulting from an appreciation in market value.[55]

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[51]Comment, 11 U.C.L.A.L. Rev. 593, 613 (1964).

[52]Evidentially this was the theory held by the Tax Court until Macabe, since no distinction was made between gain due to excessive depreciation and gain due to market appreciation. Ibid.

[53]Ibid.

[54]The American Institute of Certified Accountants states: "'The cost of productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility.... It [depreciation accounting] is a process of allocation, not of valuation.'" Comment, 11 U.S.L.A.L. Rev. 593, 612 at n.165 (1964). See United States v. Ludey, 274 U.S. 295 (1927).

[55]Market appreciation of the assets value will obviously increase the gain received upon the sale of the object. Depreciation, however, through exhaustion will only increase the gain at sale when it is excessive (i.e., when an asset is depreciated faster than actual depreciation). The increased gain comes from the difference between the sales price and the lower adjusted basis.

Gain from excessive depreciation is a result of the concept of depreciation through exhaustion which permits the recovery of investment cost in a depreciable asset by allowing a deduction against ordinary income.[56] This depreciation of investment cost occurs through use and time, irrespective of market conditions which may increase or decrease the asset's value.[57] The *Macabe* case points out that Section 167 of the Internal Revenue Code, which allows deductions for depreciation due to exhaustion, distinguishes gain resulting from depreciation by exhaustion from gain due to appreciation in market value. The Section states: "When an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, and 1231, and other applicable provisions of the law."

The court in *Macabe* distinguished the Fribourg decision, in which a depreciation deduction was disallowed although market appreciation was apparent, on the ground that "there is no indication... that the taxpayer carried its borden of proof as to the amount of gain due to market appreciation as contrasted with gain due to the claiming of excess depreciation."[58] Since *Macabe* held that a depreciation deduction is disallowable only when gain is due to excessive depreciation, proof of a certain amount of gain due to market appreciation, or excessive depreciation, will be the controlling factor.[59]

It is submitted that the *Cohn* principle has been unreasonably extended by the courts in two respects. Firstly, numerous cases, which have relied on *Cohn*, have involved entirely different facts. Secondly, the decision has been extended by being interpreted as a rule of law that a depreciation deduction is automaticaly disallowed in the year of the sale when the sales price exceeds the asset's adjusted basis. As a result of these extensions, market appreciation, realized upon the disposition of the asset, is treated as reducing the adjusted basis of the asset, thus preventing the Code's intended depreciation deduction against ordinary income.

The *Macabe* decision, which places the burden of proof of market appreciation on the taxpayer, appears to solve the Commissioner's problem of excessive depreciation with the resulting conversion of or-

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[56]Macabe Co., 42 T.C. 1105, 1107 (1964); See Detroit Edison Co. v. Commission, 319 U.S. 98, 101 (1943); United States v. Ludey, 274 U.S. 295, 301 (1927).

[57]Treas. Reg. § 1.167(a)-1(a).

[58]Macabe Co., 42 T.C. 1105, 1108 (1964).

[59]See Nichols, 43 T.C. 14 (1964).