Denver Law Review

Volume 40 | Issue 6 Article 1

April 2021

Some Comments on Cohn, and Revenue Ruling 62-92: Depreciation Recapture

Lawrence Lee

Recommended Citation
Lawrence Lee, Some Comments on Cohn, and Revenue Ruling 62-92: Depreciation Recapture, 40 Denv. L. Ctr. J. 301 (1963).

SOME COMMENTS ON COHN,‡ AND REVENUE RULING 62-92: DEPRECIATION RECAPTURE

BY LAWRENCE LEE*

I. INTRODUCTION

The District Court decisions in *Motorlease Corp. v. United States*,[1] and *S & A Company v. United States*,[2] suggest that the *Cohn* case may in the future be severely limited in its application, but for the conservative attorney the application of *Cohn* is still a factor to be considered in buying and selling assets.

Consider, for example, the usual factual pattern involving the purchase and sale of corporate assets. When one corporation desires to acquire the assets of another going concern by purchase (to obtain a stepped-up basis) the transaction may take either of two forms: (1) Seller's corporation sells the assets to the purchaser pursuant to a plan of liquidation under section 337.[3] The corporation is then liquidated, the proceeds being distributed to seller subject to tax at capital gains rates (section 331); (2) Seller sells his stock to the corporate purchaser (subject to tax at capital gains rates) which in turn liquidates (section 332), its newly acquired subsidiary electing to treat the purchase price as the basis of the assets pursuant to section 334 (b) (2). No gain is recognized to the corporation under section 336. However, hidden in either of these relatively simple fact patterns is the possible application of the depreciation recapture rule formulated by *Cohn* and Revenue Ruling 62-92.

Before continuing it should be noted that the issue, to the extent of depreciation claimed after 1961, may have been rendered moot with respect to personal property by the passage of section 1245 in 1962.[4] It can be argued that the enactment of a specific section to deal with the problem should supersede the Internal Revenue Service's administrative interpretation.[5] *Cohn*, at least at this writing, does apply to depreciable real property. However, H.R.

‡ Cohn v. United States, 259 F.2d 371 (6th Cir. 1958).

Briefly stated, the court held that a taxpayer could claim no deduction for depreciation in the taxable year in which the property was sold where the selling price was greater than the depreciated base at the start of the year.

* Associate in the Denver firm of Ireland, Stapleton, Pryor & Holmes.

1 215 F. Supp. 356 (D. Conn. 1963).

2 218 F. Supp. 677 (D. Minn. 1963).

3 All section references are to the Internal Revenue Code of 1954, unless otherwise specified.

4 For a discussion of section 1245, see Rustigan, *The Taxation of Depreciable Property*, 40 Taxes 937 (1962).

5 *See* S & A Company v. United States, *supra* note 2. A *Cohn* adjustment disallows the depreciation claimed in the year of sale. Section 1245 treats the difference between either recomputed basis (adjusted basis plus all depreciation claimed or allowable after 1961) or the sales price (or fair market value) and the adjusted basis of the property at the time of disposition, as ordinary income. The recomputed basis includes allowed and allowable depreciation. See section 1245 (a) (2). If *Cohn* is still applicable after the enactment of section 1245 and proposed section 1250, which adjustment is applied first? A different result might be achieved using either the recomputed basis formula or sales price formula, if the *Cohn* adjustment is first or second in order of application. This is especially true because of the inclusion of "allowable" depreciation in the recomputed basis formula.

8363[6] contains in Bill section 220 a new Code section 1250 which operates to recapture all or a percentage of depreciation on certain dispositions of the real property. This provision is an outgrowth of the "real estate tax shelter" proposal contained in President Kennedy's 1963 Tax Message. Certainly to the extent that section 1250 does not effect complete recapture as to real estate, the Service will argue for the application of the *Cohn* doctrine. Of course, taxpayers may also argue that section 1250 supersedes *Cohn.*

II. THE COHN CASE

Cohn v. United States[7] involved these facts: Cohn had established flying schools during 1941 and 1942 under contracts with the Army Air Force. The arrangement was expected to last only until the end of 1944, and the useful life of the property used in the business was calculated on that basis, with no allowance for salvage value. The movable equipment was sold in 1944 at a substantial gain. The Court of Appeals sustained the disallowance of depreciation claimed in the year the assets were sold because the sales price exceeded the basis of the assets at the beginning of the year of sale. The Internal Revenue Service interprets the rationale of the court to be as follows: In the year of sale the value of the assets is established and such value is salvage value for depreciation purposes. Since in *Cohn* the readjusted salvage value exceeded the adjusted basis of the property at the beginning of the year, the asset was in effect fully depreciated and no deduction was allowable in that year.

Last year the Service issued Rev. Rul. 62-92,[8] applying with full vigor Regulation § 1.167(a)-1. Sections (b) and (c) which, if considered *pari passu,* state that salvage value may be redetermined ". . . by reason of conditions known to exist at the end of the taxable year. . . ." Regulation § 1.167(a)-1(c) provides simply that ". . . if there is a redetermination of useful life under the rules of paragraph (b) of this section salvage value may be redetermined based upon facts known at the time of such redetermination of useful life." Regulation § 1.167(a)-1(b) provides that useful life may be modified if conditions at the end of the taxable year so warrant. Taxpayers had for years assumed subsection (c) was merely complementary to subsection (b), *i.e.,* salvage value would be redetermined only in conjunction with useful life.[9] The Internal Revenue Service obviously believes that subsection (c) has independent application. The ruling itself states:

> Accordingly, it is the position of the Service that the *Cohn* case applies equally to the 1939 Code and the 1954 Code and that it is not only reasonable but proper to take the ultimate

---

6 H.R. 8363, as Ordered Reported to the House on September 10, 1963. The proposed section 1250 is intended to be the counterpart of section 1245. See H. Rept. No. 749, 88th Cong., 1st Sess. p. A148. Briefly stated, upon disposition of "section 1250 property," the section will recapture the "applicable percentage" of the lower of (A) the "additional depreciation" or (B) the excess of the amount realized (or fair market value) over the adjusted basis of the property. The "applicable percentage" is 100% minus one percentage point for each full month the property involved was held after the date on which the property had been held 20 full months. Thus, if the property is held at least 10 years, the applicable percentage is zero and no gain is treated as ordinary income. The term "additional depreciation" is the spread between allowed or allowable depreciation over the depreciation which would have been allowed under the straight-line method.

7 259 F.2d 371 (6th Cir. 1958).

8 1962-2 Cum. Bull. 29.

9 See S & A Company v. United States, *supra* note 2.

facts into consideration in determining the depreciation deduction for the year of disposition of the asset. 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.

III. RECENT CASES

The theory of the *Cohn* case has since been an issue in seven reported decisions.[10] In *Edward v. Lane*,[11] the taxpayer, having elected to report income arising from a long-term construction contract on the completed contract basis, reported in 1953 the payments received during the years of performance (1951-1953), and, correspondingly, deducted all the costs and expenses incurred during the performance period, which included depreciation on equipment and physical plant in an amount representing the entire cost of the depreciable property. In short, the taxpayer did not assign any salvage value to the equipment. However, when the original contract was near completion, taxpayer, through his corporation, was the successful bidder for additional work in the area. Thereafter, beginning in 1953, the depreciable equipment was sold to the corporation for approximately one-half of its original cost. In turn the Commissioner fixed the salvage value at the sale price and disallowed depreciation for 1953.

One of the arguments made by the taxpayer was that the anticipated salvage value, here zero, if reasonably founded when estimated, controls and it makes no difference that it finally develops that the equipment in fact has a salvage value. The Tax Court rejected this argument on two grounds. First, it noted that depreciation, including salvage value, may be readjusted if conditions so warrant at the close of each year. Second, the court cited *Cohn* as authority for the proposition that salvage value can be adjusted at or near the end of the useful life of the asset when it is shown by an actual sale of the asset that there is a substantial difference between what was estimated as salvage and what it actually develops to be. The court also found that the sales price of the equipment actually represented an accurate yardstick for measuring salvage value. However, the Court did state:

> The foregoing authorities (*Cohn* and *Wier Long Leaf Lumber Co.*, 9 T.C. 990) involved taxpayers who were actually faced with the necessity of estimating a salvage value of depreciable assets at the time of acquiring the same. In the instant case, however, the petitioner faced no such necessity. He elected to compute his profit, as we have said, on the completed contract basis. Depreciation, under that method, is an amount equal to cost of the assets, less the salvage value thereof. And depreciation is not taken, under said method, pro rata over the years during which the contract is performed; but, rather, it is taken as one lump sum, in the year when the contract is completed. Therefore, salvage value of depreciable assets need not be fixed at the commencement of the contract; it must be found, and deducted from cost, when the contract is completed. It is thus seen to be totally immaterial and irrelevant, what petitioner's

10 S & A Company v. United States, *supra* note 2; Motorlease Corp. v. United States, *supra* note 1; Wasmer v. United States, 62-2 U.S.T.C. para. 9134, 10 A.F.T.R.2d 6162; Contra Costa Trucking Co.. 22 T.C.M. 1018 (1963); Fribourg Navigation Co., 21 T.C.M. 1533 (1962), on appeal to Second Circuit; Randolph D. Rouse, 39 T.C. 7 (1962); Edward V. Lane, 37 T.C. 188 (1961). *See also*, Kimball Gas Prod. Co. v. United States, 63-2 U.S.T.C. para. 9507, 12 A.F.T.R.2d 5105, on appeal to Fifth Circuit, which, while not citing the *Cohn* case, did involve a *Cohn* adjustment in a liquidation situation; and 763 C.C.H. para. 8520.

11 37 T.C. 188 (1961).

anticipation of salvage values were when these assets were acquired.[12]

Randolph D. Rouse[13] involved a taxpayer in the business of buying, owning and renting residential houses in the years in issue, who depreciated the houses on a straight-line using a 25-year life without consideration of salvage value. The taxpayer had sold some of the houses at prices in excess of their undepreciated cost as of the first of the year of sale. Thus, it was apparent because of the sale, which the court stated constituted a condition known to exist at the end of the period for which the return was made, that the "salvage value" for each house sold was in excess of its undepreciated cost for the year of sale. Accordingly, citing *Cohn* as authority, the court sustained the disallowance of depreciation on the houses sold for the year of sale.

In *Wasmer v. United States,*[14] the plaintiffs entered into a contract of sale on July 11, 1957 to sell *all* of the assets of every kind connected with radio and television stations for a lump sum approximating $2 million. The assets had been depreciated on the straight-line and declining balance methods. It is not clear from the opinion whether salvage was estimated for the assets depreciated on the straight-line method. Because of FCC complications, title did not pass and the sale was not closed until January 20, 1958. The Commissioner took the position that the *Cohn* case applied since it appeared that the price fixed in the contract as allocated to the depreciable assets exceeded the book value of those assets on January 1, 1957. Accordingly, he disallowed depreciation for 1957. The court found as a fact that the actual value of the depreciable assets was less than the book value and that the purchase price, therefore, did not exceed the salvage value. However, with respect to the *Cohn* case, the Court stated:

> The *Cohn* case is claimed by defendant as authorizing a disallowance of depreciation in 1957 since the contract fixed actual value. In that case there was a sale of the specific items of depreciable property. There was no lump sum sale of depreciable and non-depreciable assets. Here the sale of the radio and television equipment, as well as all intangibles, was consummated in 1958 on the contract signed in 1957, the last full year of use. *If the items of depreciable property and no other had been sold at a specified price Cohn would apply. It is applied to the extent that actual value is salvage value. Book value is to be disregarded if less than actual value.*[15]

Fribourg Navigation Co.[16] involved a sale of a cargo vessel costing $469,000 for $695,500 under a plan of liquidation pursuant to section 337. The vessel was depreciated according to a letter ruling from the Service, the Service having agreed to a straight-line method on a three-year life and a salvage value amounting to $54,000. Thus, unlike the previously discussed cases, the taxpayer in the instant case did use a salvage value, which was in effect

12 *Id.* at 197.
13 39 T.C. 7 (1962).
14 10 A.F.T.R.2d 6162 (1962).
15 *Id.* at 6163 (Emphasis supplied).
16 21 T.C.M. 1533 (1962), on appeal to Second Circuit.

fixed by the Service. The Commissioner's action in disallowing a depreciation deduction for the year of sale was sustained by the Tax Court on the authority of *Randolph D. Rouse.*[17]

In *Motorlease Corp. v. United States,*[18] the taxpayer was in the car rental business. Apparently mindful of *Massey Motors, Inc. v. United States,*[19] the taxpayer, using a straight-line method, did in fact use a "reasonable" salvage value. Nevertheless, for the years in issue the taxpayer sold automobiles at prices in excess of their depreciated basis at the time of sale. In each such instance, the Commissioner substituted the selling price for the taxpayer's basis, thereby wiping out any gain but disallowing depreciation for the year of sale. The substance of the District Court's lengthy opinion in sustaining the taxpayer was simply that *Cohn* has no application to a situation in which the taxpayer claims depreciation on the basis of a reasonable estimate for salvage value. The Court distinguished *Cohn, Lane* and *Rouse* on the grounds that in those cases the taxpayer did not utilize any salvage value. The Court, however, did not have the benefit of Judge Harron's opinion in *Fribourg Navigation Co.,*[20] which in fact involved a situation wherein the taxpayer not only used salvage value but a salvage value fixed by the Service, since that decision did not come down until two days before the District Court's opinion.

In *S & A Company v. United States,*[21] S & A on April 1, 1956 sold its land and depreciable assets, with a total cost of $2,082,256.22 and accumulated depreciation of $943,042.76, in a taxable sale for $3,099,123.15 electing to report the gain on the installment method. On its return for the fiscal year ended August 31, 1956, S & A claimed depreciation in the amount of $125,481.77 for the period September 11, 1955 to April 1, 1956. The Commissioner disallowed the deduction on the basis of the *Cohn* theory. The District Court, in a well reasoned opinion, reviewed the history of section 167 and the regulations thereunder and reached these conclusions: (1) that the regulations authorize adjustment of salvage value only when useful life is adjusted, and useful life may only be adjusted when there is a clear and convincing basis to do so; (2) that *Massey Motors*[22] authorized adjustment of useful life only when it is shown

17 *Supra* note 14.
18 *Supra* note 1.
19 364 U.S. 92 (1959).
20 *Supra* note 16.
21 *Supra* note 2.
22 *Supra* note 19.

that the taxpayer did not intend to use the assets for their full useful life, and (3) that *Cohn* and *Wier Long Leaf Lumber Co.*[23] decided only that the original estimate of useful life may be reconsidered in the year that the useful life of the assets terminates in normal course, and do not represent authority to readjust useful life because of a casual sale of the assets before termination of their expected life. With respect to Rev. Rul. 62-92, the court commented:

> The body of the Ruling discusses the *Cohn* case and proceeds to assert that the Regulations saying there shall be no change in salvage value because of fluctuations in market value "does not preclude adjustment of salvage value where there is a clear and convincing basis therefor even though no adjustment of useful life is required." It is apparent that this Ruling is broader than the decision in *Cohn*. Were it to be followed, it certainly would encompass the facts of the case at bar. And yet, the Ruling defines *Cohn* as a case in which "it was held that it is proper * * * in computing the deduction for depreciation of an asset, to adjust salvage value *at or near the end of the useful life of an asset* where there is a difference between what was estimated and what salvage value as shown by actual sale proves to be." (Italics added) Thus, I must conclude that either the Ruling is limited to the fact situation of disposal of assets at or near the end of useful life, or that the Ruling is erroneous as a matter of law. The result of such a decision being identical on the facts here, it becomes unnecessary to make the choice.[24]

Finally, *Contra Costa Trucking.*,[25] in which the Commissioner disallowed depreciation in the year of sale, involved an effort by the taxpayer to bring itself within the dictum of *Wasmer v. United States*[26] by arguing that *Cohn* does not apply to the sale of a going concern (depreciable and nondepreciable assets). The Tax Court sustained the Commissioner on factual grounds, *viz.*, that the sale in fact concerned only the depreciable property in issue, and, even if a sale of a going concern, because the taxpayer failed to prove that the allocated purchase price did not exceed the opening basis.

On balance the Service has been largely successful in applying the *Cohn* case, although decisions such as *S & A Company v. United States*[27] may represent a new trend in the cases. However, in view of the Service's success in the Tax Court,[28] the revenue agents will undoubtedly be instructed to continue to apply the *Cohn* theory to pre-section 1245 (and proposed section 1250) years, or in areas to which the statutory recapture rules do not apply.

IV. TAXPAYER'S POSITION

The taxpayer's arguments can be summarized along these lines: It was the design of Congress in enacting section 167 to permit a taxpayer to recover, tax-free, the total cost to it of assets used in

23 9 T.C. 990 (1947), *reversed on different issue*, 173 F.2d 549 (5th Cir. 1949).
24 *Supra* note 2 at 685.
25 22 T.C.M. 1018 (1963).
26 *Supra* note 14.
27 *Supra* note 2.
28 Fribourg Navigation Co., *supra* note 16 is now on appeal to the Second Circuit. The case is a strong one factually for the taxpayer and the Commissioner may have made a serious error in not conceding.

its trade or business. Annual allowances for depreciation are deductible to reflect this decrease in value. Thus, the allowance is that amount which should be set aside for the taxable year so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property.[29]

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.[30]

A determination of salvage value is based on the taxpayer's consistent practice and experience. If a taxpayer disposes of an asset in a casual sale before its physical exhaustion, it should, nevertheless, be entitled to depreciate that asset on the basis of the estimated useful life and salvage value dictated by its customary experience or practice, and not on a useful life equal to the time the asset was actually held.[31] *Massey Motors v. United States*[32] holds nothing more than that salvage value may equal "resale value" if the asset may reasonably be expected to be disposed of prior to the end of its physical life.

It is the announced policy of the Internal Revenue Service not to disturb depreciation deductions computed on an estimated useful life and salvage value, unless "there is a clear and convincing basis for change."[33] Salvage value may not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels.[34]

Finally, to the extent the Service is equating the sales price to final salvage value vis-a-vis the original estimate, it is using hindsight, which is prohibited.[35]

This is substantially the argument put forth successfully by the taxpayer in *S & S Company v. United States*,[36] but rejected by the Tax Court. The Service's formula in the Tax Court seems to be simply that it has authority to adjust salvage whenever conditions so warrant,[37] that *Massey Motors v. United States*[38] requires a *realistic* estimate of salvage value, and that a sale price in excess of basis demonstrates a realistic value which is a "clear and convincing" basis for change. As Rev. Rul. 62-92 states:

> The provision in section 1.167 (a) -1 (c) of the regulations to the effect that salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels applies to assets still on hand. The provision does not preclude adjustment of salvage value where there is a clear and convincing basis

---

29 Treas. Reg. § 1.167(a)-1(a) (1956), *as amended*, T.D. 6507, 1960-2 Cum. Bull. 91.
30 Treas. Reg. § 1.167(a)-1(c) (1956), *as amended*, T.D. 6507, 1960-2 Cum. Bull. 91.
31 Treas. Reg. § 1.167(a)-1(b)-(c) (1956), *as amended*, T.D. 6507, 1960-2 Cum. Bull. 91.
32 *Supra* note 19.
33 Treas. Reg. § 1.167(a)-1(b)-(c) (1956); Rev. Rul. 90, 1953-1 Cum. Bull. 43; Rev. Rul. 91, 1953-1 Cum. Bull. 44.
34 Treas. Reg. § 1.167(a)-1(c) (1956), *as amended*, T.D. 6507, 1960-2 Cum. Bull. 91.
35 Commissioner v. Cleveland Adolph M. R. Corp., 160 F.2d 1012 (6th Cir. 1947), *reversing* 6 T.C. 730 (1946); Commissioner v. Mutual Fertilizer Co., 159 F.2d 470 (5th Cir. 1947), *reversing* 5 T.C. 112 (1945); Universal Mills, 7 T.C.M. 886 (1948). *See also* Washburn Wire Co. v. Commissioner, 67 F.2d 658 (1st Cir. 1933), *reversing* 26 B.T.A. 464, 1146 (1932); Geuder, Paeschke & Fref Co., 41 F.2d 308 (7th Cir. 1930), *reversing* 11 B.T.A. 1248 (1928).
36 *Supra* note 2.
37 Wier Long Leaf Lumber Co., *supra* note 23.
38 *Supra* note 19.

therefor even though no adjustment of useful life is required. The purpose of the provision is to eliminate needless and endless controversies over depreciation allowances which at best are merely informed estimates of the cost of using the property in the taxpayer's business. That purpose has been served when the asset is disposed of and when a final transaction has occurred over which there can be no dispute or difference of opinion or judgment.

V. Pre-Year of Disposition Adjustment

The harshness of the Service's administrative position could be deflected in large part by carefully planning the date of the sale, and, perhaps, if the Service stopped there, nothing more could be said.[39] However, alarming reports from the Boston, San Francisco, Detroit, and Pittsburgh offices indicate that the Service is endeavoring to extend its position even further in two respects. If *Wasmer v. United States*[40] is any indication, it has already done so successfully in one area. *Wasmer*, while lost on the value issue, did indicate that salvage could be adjusted for the pre-sale year if the price of the depreciable assets was fixed by contract in that year, and the price so fixed exceeded not only the opening basis of the assets for the year in which the sale takes place but also the opening basis for the year in which the sales price is fixed by contract. The ruling, Rev. Rul. 62-92, extended only to the year of sale so that the Service's position, to a degree, came without warning.

Furthermore, the Service is also taking a position that it is not essential that the value of the assets be fixed by a sale, but that any method by which the value can be ascertained is a suitable basis for a *Cohn* adjustment. While the ruling concerned a sale, the language used was "sale or exchange," although it did intimate that only a sale could establish a value "over which there can be no dispute or difference of opinion or judgment." Thus, the Service apparently takes the position that it may adjust salvage value not only in the year of disposition (whether by sale or otherwise), but also for each prior open year in which the value of the depreciable assets is fixed

39 Using the first simple example set forth in the introduction, if when the corporation sells the assets the price as allocated to the assets exceeds the adjusted basis of those assets at the beginning of the taxable year of sale, then any depreciation claimed by the corporation in that year will be disallowed (at least to the extent the depreciation deduction equals the spread between adjusted basis and sales price). The solution is to sell the assets as soon as possible after the first of the year, or to delay to the next year if the transaction is shaping up near the close of the year.

40 *Supra* note 14.

by some identifiable event and that value exceeds the adjusted basis of the assets.[41] So far, this interpretation has only manifested itself in the area of liquidations. *Fribourg Navigation Co.*[42] involved a liquidation pursuant to section 337. Such an adjustment, of course, can be rationalized by the fact that a sale is involved. However, several cases have arisen in which the Service is taking the position that because an allocation, pursuant to section 334(b) (2), of the purchase price of the stock as fixed in a contract of purchase would attribute a value to the assets in excess of their adjusted basis either at the beginning of the taxable year in which the liquidation takes place or in the year in which the stock is purchased, the test of Rev. Rul. 62-92 is satisfied.[43]

VI. LIQUIDATIONS PURSUANT TO SECTIONS 332 and 334(b) (2)

The remainder of this paper is devoted to suggesting some of the arguments that can be made to answer the Commission's contention.[44]

A. Year of Liquidation

Initially it should be noted that while the purchase of 80% of the stock of a company and its subsequent liquidation within a two-year period provides a method for determining basis of the assets in the hands of the purchaser under section 334(b) (2), the acquired corporation is not regarded as *selling* the assets so as to recognize gain or loss.[45] The shareholders of the acquired corporation are regarded as selling stock, not assets. There is not, therefore, a sale of assets by the transferor corporation. Under Rev. Rul. 62-92

---

41 Apparently the Service, on this basis, could argue that *Cohn* applies to the exceptions provided in section 1245(b) and proposed section 1250.

42 *Supra* note 16.

43 Consider the effect of this approach on the second example given in the introduction, with these additional facts: The contract to purchase the stock for $110,000 is signed on December 1, 1960. The aggregate basis of the depreciable assets as of January 1, 1960, is $90,000 and depreciation for the year (January 1 to December 31) is $10,000, resulting in an end-of-year adjusted basis of $80,000. The parent liquidates the subsidiary on July 1, 1961, the subsidiary claiming depreciation for six months of $5,000 for the short year January 1 to July 1, 1961. The parent *i.e.*, the purchasing corporation may find that as a result of a *Cohn* adjustment, it has purchased $15,000 of ordinary income. The Service will argue that the contract fixed a price for the assets on December 1, 1960, which on an allocated basis is in excess of their opening basis, and, accordingly, salvage should be readjusted upward to eliminate the depreciation for 1960. Further, as to 1961, the readjusted basis is $90,000 which nevertheless is still less than the $110,000 paid for the stock (allocated to assets). Accordingly, the $5,000 depreciation claimed for the short year will be disallowed. If the *Cohn* theory is not applicable, no adjustment of depreciation is warranted under section 1245 since the disposition took place before December 31, 1962. But if the liquidation was post January 1, 1963, then section 1245 would cut across sections 332 and 336 (because of the applicability of section 334(b) (2) and treat as ordinary income all depreciation deducted after December 31, 1961 (i.e., the lesser of either recomputed basis or sales price over the adjusted basis of the property at disposition). Presumably, however, if the parent assumes the liability for any deficiency in tax resulting from either a *Cohn* or section 1245 adjustment, its basis (in the stock and therefore in the distributed assets) will be increased by that amount. Treas. Reg. § 1.334-1(c) (4)(v); Sen. Rept. No. 1881 87th Cong., 2d Sess. p. 285 (August 16, 1962).

44 The arguments presented are strictly legal arguments. It is, of course, open to the taxpayer to argue that factually the price is not ascertained before the close of the year because of the existence of some sort of condition precedent to closing the deal. For example, suppose the contract is signed by the Seller and Purchaser on December 1, 1963, providing that Seller will sell all of his stock in exchange for cash and stock of the purchasing corporation provided, however, that the stock of the purchasing corporation on the closing date is quoted at $40.00 on the stock exchange. The closing date is set for January 15, 1964. Rev. Rul. 69-92 did contain this proviso:

> Revenue Rulings 90 and 91, as clarified by Revenue Procedure 57-18, are, of course, applicable for taxable years prior to the year of disposition where there is a clear and convincing basis existing at the end of such prior taxable year for an adjustment in the depreciation deduction. See also section 1.167(b)-0(a) of the regulations.

The argument could be made that because of the condition precedent, the deal could fall through before the actual closing date if the price on the exchange was below $40.00 and, accordingly, the contract was not a "clear and convincing basis for a change" in the depreciation claimed.

45 Dallas Downtown Dev. Co. v. Commissioner, 12 T.C. 114 (1949), acq. 1950-1 Cum. Bull. 2; Steubenville Bridge Co. v. Commissioner, 11 T.C. 789 (1948), acq., 1950-1 Cum. Bull. 5.

the depreciation adjustment is limited with respect to the amount realized from a "sale or exchange." *Cohn* involved a sale. Subsequent Tax Court decisions are based on sales of the assets.[46]

In the liquidation that follows the acquisition of stock there is no determination under section 1001(b) of the "amount realized" by the transferor, *i.e.*, the determination called for in Rev. Rul. 62-92. Even if a corporation could be considered to realize anything on the receipt of its shares for cancellation, the need for this determination is dispensed with by section 336, which precludes recognition of gain on a distribution of property in partial or complete liquidation. Accordingly, there is no occasion to determine whether opinions will agree or differ as to values to be assigned to assets distributed in liquidation.

In fact, the purchase price of the stock does not necessarily even purport to provide an undisputed measure of the aggregate fair market value of the several assets of the corporation less its liabilities. It would be a coincidence if the purchase price of all of the stock of a corporation was equal to the aggregate of the values of the depreciable and non-depreciable assets of the corporation, separately computed, either at the date of liquidation or at the date of stock purchase. Accordingly, the common agreement as to the value of individual depreciable assets, which is the basis from which Rev. Rul. 62-92 purports to apply, does not exist.

In the case of a transaction in which the "amount realized" is determined, and to which Rev. Rul. 62-92 by its terms applies, the taxable event is a sale of a *specific* depreciable asset which permits an uncontested determination of the consideration received therefor, and hence of the salvage value. In the case of a transaction to which section 334(b)(2) applies, the only event in the year of liquidation to which Rev. Rul. 62-92 could apply is the distribution of assets in exchange for stock. But if this event alone is sufficient to invoke the rule of Rev. Rul. 62-92, the Internal Revenue Service cannot logically stop at section 332 liquidations to which section 334(b)(2) applies. The significant event, a transfer of assets in exchange for stock in which no gain is recognized to the transferor, occurs as well in section 332 liquidations to which section 334(b)(1) applies, in reorganization exchanges under section 368(a)(1)(C) and section 361(a), in taxable liquidations under section 331 and tax-free liquidations under section 333, in partial liquidations under section 346, and in redemptions under section 302. It is no answer to say that in the first two cases a transferor's basis is carried over, since Rul. 62-92, unlike section 1245, disallows depreciation *prior* to the transaction by which the asset is disposed of, and hence redetermines its basis at the date of disposition. It may be seriously questioned whether the Service is prepared to take the position that Rev. Rul. 62-92 is applicable in each of the transactions above enumerated.

B. Year in which Stock is Purchased

The execution of such an executory contract for the purchase of stock or, indeed, its consummation within the taxable year by the

46 See e.g., Fribourg Navigation Co., *supra* note 16; Randolph D. Rouse, *supra* note 13; Edward V. Lane, *supra* note 11.

purchase of the stock, itself provides no transaction determining the salvage value of taxpayer's depreciable assets "over which there can be no dispute or difference of opinion or judgment." No determination of separate asset value or redetermination of basis of assets is required by this event, even if the purchased company thereby becomes a member of an affiliated group filing consolidated returns. Again, if the purchase price of the stock represented the aggregate of the separate fair market values of the assets, depreciable and non-depreciable, it would be the sheerest coincidence.

The only event which occurs in the year in which the contract is executed or the purchase is consummated is the establishment of an aggregate value for the stock. The aggregate fair market value of a company's stock may also be established for tax purposes when the sole stockholder dies or makes a gift of all of the stock. Is Rev. Rul. 62-92 therefore to be applied to the corporation in each such case?

In the case of a listed stock the fair market value of all its shares may be determined from market quotations, with suitable adjustments for blockage prescribed by the Internal Revenue Service. Is Rev. Rul. 62-92 to be applied to such companies day by day?

The Service presumably is invoking Rev. Rul. 62-92 on the theory that the purchasers of the transferor's stock amounts "in effect" to the purchase of its assets, including its depreciable assets. In the case of the garden variety of purchase contemplated by Rev. Rul. 62-92 there is no problem in determining the amount for which the property has been purchased. In the case of a liquidation under section 334(b) (2), however, the problems become extremely complex.

Under section 334(b) (2) the liquidation can occur as long as two years after the purchase of the stock. The adjustments necessary to determine, upon liquidation, how much the individual items of property were purchased for, *i.e.*, their basis, are quite complex. First, the basis of the stock itself must be adjusted for transactions occurring during the period between the purchase of the stock and liquidation. [47] The basis of the stock so adjusted must then be allocated on the basis of relative fair market values of the properties *on the date they are received* in the liquidation.[48]

The discussion above relates to the problems which can arise in the application of Rev. Rul. 62-92 due to variations in the values of the depreciable properties and other properties between the purchase of the stock and the liquidation. Further problems are raised by reason of the prospect of changes in the assets themselves by reason of dispositions during this period. That such dispositions are to be anticipated is evidenced by the examples given in Regulation § 1.334-1 (c) (5). The problem would be even more acute if, in the examples given, the depreciable property had been disposed of in a tax-free exchange for other depreciable property pursuant to the provisions of section 1031 (a).

The fact is that at the time a contract for the purchase of stock is executed, and even when the stock is purchased, the parent can have no assurance as to what individual assets it will be considered to have "in effect purchased" for purposes of section 334 (b) (2). If the Service proposes an adjustment under Rev. Rul. 62-92 for a taxable year prior to the liquidation it may be found that the depreciable property adjusted will have been sold, exchanged, distributed or destroyed before a liquidation occurs. No portion of the basis established by the purchase price of the stock may therefore in fact be applied to the depreciable property subjected to depreciation disallowance on the basis of such purchase price.

A corporate purchaser is under no obligation at the time it purchases 80% control of a subsidiary to make a commitment or election to liquidate the company within the two-year period provided in section 334 (b) (2). It is not infrequently the case that a decision whether to liquidate or not is deferred for the full 24 months in order to ascertain whether it is more advantageous taxwise and business-wise to liquidate immediately before expiration of the two-year period, immediately afterwards, or to maintain the corporation in existence.

If the Internal Revenue Service proposes to apply Rev. Rul. 62-92 to disallow depreciation in the taxable year in which a contract for the purchase of 80% of the stock of a subsidiary is executed or cunsummated but in which a liquidation has not occurred, it must be prepared to apply this rule in the case of *every* such purchase, whether a liquidation within two years has been proposed or disaffirmed, because the parent retains a free election.

VII. Conclusion

Finally, it should be noted that some taxpayers have suggested that if *Cohn* is logically extended, the taxpayer should be entitled to greater depreciation in the year of sale if the asset is in fact sold for less than its remaining undepreciated basis. This question is largely settled by section 1231 which permits the taxpayer an ordinary loss (to be offset by section 1231 gains) if the asset is sold at a loss. However, this is not to say the argument should not be pressed in areas to which section 1231 is not applicable.

---

47 Treas. Reg. § 1.334-1(c)(4) (1955), *as amended*, T.D. 6298, 1958-1 Cum. Bull. 432.
48 Treas. Reg. § 1.334-1(c)(4)(viii) (1955), *as amended*, T.D. 6298, 1958-1 Cum. Bull. 432.