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if he can effectuate such discrimination himself. It appears that such position would put a premium on self-help. Thus, perhaps it may be concluded that the "persuasive reasons" why the Court did not consider the constitutional questions in the instant case stemmed from the fact that it did not approve of the discrimination here involved, but yet was reluctant to condemn it as unconstitutional because of the complications inherent in such a decision.

*Hillary J. Crain*

### INCOME TAXATION — DEPRECIATION OF AN ASSET NOT USED FOR ITS FULL ECONOMIC LIFE

The United States Supreme Court in three cases decided during the last term has defined the concepts of "useful life" and "salvage value" as applied to depreciable property that is sold prior to exhaustion of its full economic life. A hypothetical case will serve to illustrate the situation presented in two of these cases.<sup>1</sup> During the taxable years in question, 1950 and 1951, taxpayer sold cars which he had previously purchased for use in his business. The cars had an original cost of \$1,600 each, and taxpayer depreciated them by the straight line method, taking a useful life of four years and a salvage value of zero.<sup>2</sup> After using the cars for less than two years, he sold them for \$1,400 each. During this period \$500 per car was deducted as depreciation, leaving a net profit of \$300 per car.<sup>3</sup> A total of 290 cars were sold in the two years, at a profit of \$87,000, which was treated as a capital gain. The Commissioner of Internal Revenue contended that for depreciation purposes, useful life was the period over which the taxpayer actually used the cars in his trade or business, and salvage value was their actual resale value. Therefore, the taxpayer could have deducted only

1. The figures in the hypothetical case approximate those as set out in *Evans v. Commissioner*, 264 F.2d 502 (9th Cir. 1959).

2. This is the most common method of depreciation. The annual allowance is computed by this formula:

$$\frac{\text{original cost} - \text{salvage value (if any)}}{\text{useful life}}$$

$$\text{In the hypothetical case: } \frac{\$1600 - 0}{4 \text{ years}} = \$400 \text{ per year per car}$$

See Treas. Reg. § 1.167(b)-1 (1956).

3. Net profit = Resale Price - Adjusted Basis [Cost - Depreciation Taken].  
In the hypothetical case Net Profit = \$1400 - (\$1600 - \$500) = \$300.

the difference between his cost and the actual resale value, or \$200 per car, as depreciation, resulting in a net profit of zero. Taxpayer argued that even if these interpretations were correct, they should not be retroactively applied to the taxable years in question. The Courts of Appeals for the Fifth and Ninth Circuits had divided on the correct interpretation of these terms<sup>4</sup> and on certiorari to the United States Supreme Court, *held*, for the Commissioner.<sup>5</sup> The depreciation on the property in question "is to be calculated over the estimated useful life of the asset while actually employed by the taxpayer, applying a depreciation base of the cost of the property to the taxpayer less its resale value at the estimated time of disposal."<sup>6</sup> *Massey Motors Inc. v. United States, Commissioner v. Evans*, 80 Sup. Ct. 1411 (U.S. 1960).

In the third case, involving taxable years 1954, 1955, and 1956, the taxpayer was in the business of renting cars and trucks, depreciation being calculated by the declining balance method.<sup>7</sup> The automobiles were depreciated on the basis of a four-year useful life, their estimated full economic life, although they were normally sold after approximately two years.<sup>8</sup> The Commissioner argued that these automobiles could not be depreciated by the declining balance method because of the failure to meet the statutory requirement of a three-year useful life in taxpayer's business. Taxpayer, however, actually used his trucks for more than three years, and they were admittedly qualified for declining balance depreciation. Yet, they had been depreciated below a reasonable salvage value, and as a consequence on resale taxpayer derived substantial capital gains. The Com-

4. In *United States v. Massey Motors, Inc.*, 264 F.2d 552 (5th Cir. 1959) the court held for the Commissioner. But in *Evans v. Commissioner*, 264 F.2d 502 (9th Cir. 1959), based on similar facts, the court held for the taxpayer.

5. Four Justices dissented on the ground that these interpretations should not be applied to the taxable years of 1950 and 1951.

6. *Massey Motors Inc. v. United States*, 80 Sup. Ct. 1411, 1413 (1960).

7. INT. REV. CODE of 1954, § 167(b)(2).

8. An example of how the Hertz taxpayer was computing depreciation by declining balance. Note that depreciation is taken at twice the rate allowable under the straight line method. This car was held for fourteen months and then sold.

Cost .....		\$ 2048.00
Depreciation (50% of declining balance)		
1st year .....	\$ 1024.00	
2d year (held 2 months).....	85.33	1109.33
Basis at time of sale.....		938.67
Selling price .....		1600.00
Long term capital gain.....		661.33

*Hertz Corp. v. United States*, 165 F. Supp. 261, 269, n. 6 (D. Del. 1958).

missioner contended that under no method of depreciation could an asset be depreciated below a reasonable salvage value. The district court held for the taxpayer,<sup>9</sup> but the Court of Appeals for the Third Circuit reversed.<sup>10</sup> The Supreme Court, *held* affirmed for the Commissioner. The automobiles in question do not have the three-year useful life in the taxpayer's business required for depreciation by the declining balance method. The trucks in question may not be depreciated below a reasonable salvage value. *Hertz Corp. v. United States*, 80 Sup. Ct. 1420 (U.S. 1960).

From the inception of the federal income tax in 1913 there has been an allowance for depreciation of assets used in a trade or business. As expressed by Mr. Justice Brandeis, the theory behind this allowance is that as an asset is used, a gradual sale is made of it.<sup>11</sup> The taxpayer is compensated for the cost of the asset and at the end of the useful life the depreciation taken, plus the salvage value, should equal the cost. If they do not, a fortiori, the taxpayer has either made a gain or suffered a loss on the overall transaction. Prior to 1942, these gains or losses were taken as, or deducted from, ordinary income in the year of sale. In that year, however, Congress provided that profits from these transactions could be taken as capital gains, and the same result obtains under Section 1231 of the 1954 Code of Internal Revenue.<sup>12</sup> During the war businesses were reluctant to sell their capital assets because of the tax consequences involved as a result of the inflated market. This section was probably intended to stimulate these sales, but at the same time it provided the possibility of a tax saving which Congress may not have contemplated.<sup>13</sup> Taxpayers could take the maximum allowable depreciation on their assets, based on their full economic life, deducting this from ordinary income. Since the profit derived from resale could be taken as a capital gain instead of ordinary income, a tax saving would result to the extent that the ordinary income rates exceeded the capital gains rates as applied to such profit. This advantage was not available to most businesses, which use their assets until the resale value is negligible; but for those which dispose of their depreciable assets

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9. *Hertz Corp. v. United States*, 165 F. Supp. 261 (D. Del. 1958).

10. *Hertz Corp. v. United States*, 268 F.2d 604 (3d Cir. 1959).

11. *United States v. Ludey*, 274 U.S. 295, 301 (1927).

12. INT. REV. CODE of 1954, § 1231, former Int. Rev. Code of 1939, § 117(j).

13. For an extended discussion of this section and its legislative history, see Dakin, *The Capital Gains Treasure Chest: Rational Extension or Expedient Distortion*, 14 LOUISIANA LAW REVIEW 505 (1954).

while the resale value was substantial, the tax saving was often very great.<sup>14</sup>

The Commissioner has maintained that assets in such a situation are held for the dual purpose of use and sale.<sup>15</sup> If held for sale, they would be in the nature of inventory; and sales occurring in the ordinary course of business are not subject to capital gain treatment. For the most part, this has been an unsuccessful argument,<sup>16</sup> even where the purchasing corporation was in the business of selling used cars, and was controlled by the selling corporation.<sup>17</sup> It was not until it became apparent that the courts would not adhere to this contention that the Commissioner assumed his present position as to the meaning of useful life and salvage value.<sup>18</sup> Treasury Regulation 111, which was applicable to the instant *Massey* and *Evans* cases, prescribed that the amounts written off as depreciation, "plus the salvage value, will, at the end of the useful life of the property, equal the cost or other basis."<sup>19</sup> The terms "useful life" and "salvage value" were not defined. It is significant that the requirements of the regulation would be met if useful life were the full economic life of the asset, and the salvage value were zero. On the other hand, the requirements would also be met if useful life were the period over which the taxpayer used the asset in his business, and the salvage value were the actual resale value. Few administrative and court decisions have been rendered in this area, and none actually involved the basic issue that was presented in the instant cases.<sup>20</sup> Generally the cases appear to support the proposition that useful life is the full

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14. *Massey Motors Inc. v. United States*, 80 Sup. Ct. 1411, 1414 (1960).

15. The Commissioner argued this point in the instant cases in the lower courts, but abandoned it in the Supreme Court.

16. See, e.g., *Philber Equipment Corp. v. Commissioner*, 237 F.2d 129 (3d Cir. 1956); *Smith v. Commissioner*, 232 F. 2d 142 (5th Cir. 1956); *United States v. Bennett*, 186 F.2d 407 (5th Cir. 1951); *Latimer Looney Chevy Co. v. Commissioner*, 19 T.C. 120 (1952).

17. *Philber Equipment Corp. v. Commissioner*, 237 F.2d 129 (1956). The Tax Court has not followed the *Philber* case. *Hillard v. Commissioner*, 31 T.C. 961 (1959).

18. The first cases in which the Commissioner assumed this position were *Koelling v. United States*, 171 F. Supp. 214 (D. Neb. 1957); *Pilot Freight Carriers, Inc. v. Commissioner*, 15 T.C. Memo. 1027 (1956).

19. *Treas. Reg. 111, § 29.23(1)* (1942).

20. Although the terms useful life and salvage value were discussed in the cases cited by the Court, they are not presented in the same context as in the instant cases. In order for a decision to have been in point, it must have (1) involved taxable years subsequent to 1942 and (2) involved a taxpayer who normally disposed of the assets prior to exhaustion of their full economic value. Almost every decision that was cited was distinguished by either the majority or the dissenting opinion on one of these grounds.

economic life of the asset,<sup>21</sup> but that salvage value is the actual resale value.<sup>22</sup> Regardless of the confusion which may have existed, regulations promulgated in 1956 and the decisions in the instant cases make it clear that the Commissioner has prevailed. The present law thus defines useful life as the estimated life of the asset in the taxpayer's business,<sup>23</sup> and salvage value as the estimated resale value at the estimated time of disposal.<sup>24</sup>

In the 1954 Code Congress provided for an accelerated computation of depreciation known as the declining balance method.<sup>25</sup> Depreciation is computed by applying a constant rate to the unrecovered cost of the property, and theoretically this unrecovered cost would always be the salvage value.<sup>26</sup> Pursuant to his authority as prescribed by the Code,<sup>27</sup> the Commissioner promulgated a regulation which provided "in no event shall an asset be depreciated below a reasonable salvage value."<sup>28</sup> On its face, this regulation could conceivably conflict with the theoretical salvage value as prescribed by the Code, and if so, it would be invalid.<sup>29</sup> However, the Court found that the legislative history of the statute favored the contention that the regulation did not conflict with the statute, and was therefore applicable to depreciation by declining balances.<sup>30</sup> As a result of the instant *Hertz* case the taxpayer must always consider the estimated resale value of his assets before computing depreciation, regardless of the method used. This will prevent the asset from being depreciated below a reasonable salvage value.

21. See cases cited in *Massey Motors Inc. v. United States*, 80 Sup. Ct. 1411, 1417, n. 5 (1960).

22. *Id.* at 1416, n. 2.

23. Treas. Reg. § 1.167(a)-1-(b) (1956).

24. *Id.* at (c).

25. INT. REV. CODE OF 1954, § 167(b)(2).

26. In the following example the depreciable asset had a cost of \$1000 and a 4-year useful life. The asset may be depreciated at a rate twice that allowable under the straight line method (see note 2 *supra*) or, in this example, 50% per year. The depreciation over the 4-year span would be:

(1) \$1,000	(2) \$500	(3) \$250	(4) \$125
x 50%	x 50%	x 50%	x 50%
<hr/>	<hr/>	<hr/>	<hr/>
\$500	\$250	\$125	\$62.50

The undepreciated balance at any time was, according to the taxpayer, the "built in" salvage value.

27. INT. REV. CODE OF 1954, § 167(b).

28. Treas. Reg. § 1.167(a)-1(a) (1956).

29. *United States v. Two Hundred Barrels of Whiskey*, 95 U.S. 571, 576 (1877).

30. Authority for contending that the regulation was in conflict with the statute was a rather inconclusive passage of legislative history. The Court found other legislative history to be more persuasive. *Hertz Corp. v. United States*, 80 Sup. Ct. 1420, 1423 (1960).

In the instant cases the Court was in agreement as to the meaning of the present law, but divided on the issue of retroactive application, a practice which is not favored in tax cases.<sup>31</sup> The four dissenting Justices felt that the statute and regulations were ambiguous, and that the taxpayers were entitled to rely on previous administrative practice. Formerly, the Commissioner's stand as to the meaning of useful life and salvage value was "flatly opposed" to his position in the instant cases, and consequently he could not change his position without notice.<sup>32</sup> Three of the dissenting Justices joined the majority in the *Hertz* case, which was governed by the 1954 Code. Their distinction was based on the proposition that the taxpayer was not entitled to rely on administrative practice of an earlier date than the applicable statute.<sup>33</sup>

The majority was convincing on the matter that the practices employed by these taxpayers were not intended by Congress.<sup>34</sup> However, the rationale with respect to the retroactive issue is questionable since the crux of the Court's finding seems to be that salvage value had always been considered as resale value.<sup>35</sup> Assuming the correctness of this proposition, the crucial issue remains, "resale value when?" The applicable regulation stated that depreciation taken, plus salvage value, should equal the cost of the asset at the end of *the useful life*.<sup>36</sup> Therefore, even if salvage value is resale value, this means little until useful life is defined. The majority conceded that the Commissioner had acquiesced in inconsistent holdings as to the meaning of useful life,<sup>37</sup> and more often than not it had been previously held to be the full economic life of the asset. Resale value at the end of the full economic life of an asset would, of course, be only the scrap value. The pertinent issue would then appear to be the definition of useful life, rather than salvage value. It is submitted that the dominant consideration in the case, as far as the majority was concerned, was that the purpose of depreciation

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31. 26 C.F.R. § 601.201 (1955).

32. *Massey Motors Inc. v. United States*, 80 Sup. Ct. 1424, 1427 (1960).

33. *Helvering v. Reynolds*, 313 U.S. 428 (1941). Mr. Justice Douglas refused to concur in this distinction and would have held for the taxpayer in all three cases.

34. For an argument that Congress may have intended this type of tax saving, see Yellon, *Depreciation, Obsolescence, and Salvage: Useful Life*, PROCEEDINGS OF THE NEW YORK UNIVERSITY EIGHTEENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 181, 193-200 (1959).

35. *Massey Motors Inc. v. United States*, 80 Sup. Ct. 1411, 1416 (1960).

36. *Treas. Reg. 111, § 29.23(1)* (1942).

37. *Massey Motors Inc. v. United States*, 80 Sup. Ct. 1411, 1416 (1960).

is to compensate the taxpayer for the cost of his asset, but for no more. As expressed by Mr. Justice Clark, "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss."<sup>38</sup> In light of this consideration the taxpayer could have prevailed only by showing that he was clearly entitled to the tax saving.

These decisions indicate that the Commissioner has succeeded in his attempt to have the law applied as it was probably intended. The depreciation of an asset which is normally held for its full economic life will not be affected, but only those which are sold while they have a substantial resale value. If any relief is to be forthcoming for the businesses which have lost these tax advantages, it apparently must come through congressional action.

*Peyton Moore*

MINERAL RIGHTS — EFFECT OF FORCED UNITIZATION WITH  
PRODUCING ACREAGE SUBSEQUENT TO PRIMARY TERM  
UNDER LEASE CONTAINING COMMENCE DRILLING  
AND CONTINUOUS DRILLING CLAUSES

Plaintiff, a Texas resident, sued, in an action removed to federal district court, to have his mineral lease on certain Louisiana lands declared superior to defendant's lease. Defendant's lease, executed on a standard printed form,<sup>1</sup> contained the customary sixty-day continuous drilling clause<sup>2</sup> and the customary thirty-day commence drilling clause.<sup>3</sup> Defendant was engaged in drilling operations at the expiration of the primary term but

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38. *Ibid.*

1. Bath Louisiana Special 14-BR 1, M. L. Bath Co., Shreveport, La.

2. *Ibid.*: "5. If prior to discovery of oil, gas, sulphur or other mineral on said land, lessee should drill a dry hole or holes, thereon, or if after discovery of oil, gas, sulphur or other mineral, the production thereof should cease from any cause, this lease shall not terminate if the lessee commences operations for additional drilling or reworking within sixty days thereafter or (if it be within the primary term) commences additional drilling operations or commences or resumes the payment or tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole or cessation of production. . . ."

3. *Ibid.* "5. . . . If at the expiration of the primary term, oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other mineral, so long thereafter as oil, gas or other mineral is produced from said land. . . ."