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Taxation—Federal Income—Statutory Interpretation—Useful Life-Salvage Value.—Hertz Corporation v. United States.

Allan B. Solomon

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Whether a lien fulfills the requirements of specificity stated above is a matter of federal law.⁹ A state court's characterization of a lien as specific and choate, while entitled to consideration, is not binding on the federal courts.¹⁰ On the other hand, if the state court decides that the lien is inchoate, as was done in the instant case, this classification is practically conclusive.¹¹

The doctrine of the inchoate lien has been the subject of severe criticism.¹² One critic has pointed out that the concept of the inchoate lien as created by the Supreme Court has subsequently been enlarged to include practically every lien to be found in American law.¹³ The most valid criticism seems to be that it does not apply to federal tax liens. The federal tax lien is not regarded as an inchoate general lien, but a specific and perfected lien which without the aid of any subsequent court action attaches to the property of the tax debtor.¹⁴

The problem of the inchoate lien probably would not have arisen had the Supreme Court adhered to a holding that the priority of liens be based upon a "first in time, first in right theory" which they seemed to follow in an earlier case.¹⁵ However, since the Court did not subsequently follow the rule it has become, in this regard, purely academic.¹⁶ It is felt that Congress could ameliorate the situation presented in the instant case by providing that when an attachment lien is followed by judgment, the judgment should relate back to the date of the attachment and thereby the priority of the lien be preserved. There seems to be no indication, however, of any Congressional action in this respect within the immediate future.¹⁷

THEODORE C. REGNANTE

Taxation—Federal Income—Statutory Interpretation—Useful Life—Salvage Value.—*Hertz Corporation v. United States*.¹—The corporate taxpayer was engaged in the business of renting automobiles and trucks, the former of which had a useful life to it of less than three years but a physical life of four. In preparing the federal income tax returns for the years 1954, 1955, and 1956, the taxpayer claimed depreciation on the automobiles on the basis of the four year physical life using the declining balance method at a rate of fifty per cent per year on the undepreciated

⁹ *United States v. Gilbert Associates*, 345 U.S. 361 (1953).

¹⁰ *United States v. Waddell, Holland & Flinn, Inc.*, 323 U.S. 353 (1945).

¹¹ *Illinois ex rel. Gordon v. Campbell*, supra note 5, at 371.

¹² MacLachlan, *Improving the Laws of Federal Liens and Priority*, 1 B. C. Ind. & Com. L. Rev. 73 (1959).

¹³ Kennedy, *The Pernicious Career of the Inchoate and General Liens*, 63 Yale L.J. 905 (1954).

¹⁴ Note, 22 Geo. Wash. L. Rev. 583, 588 (1954).

¹⁵ *United States v. City of New Britain*, 347 U.S. 81 (1954).

¹⁶ Comment, 54 Mich. L. Rev. 829 (1956).

¹⁷ MacLachlan, supra note 12, at 82.

¹ 268 F.2d 604 (3d Cir. 1959).

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balance without a salvage value limitation. Taxpayer paid estimated taxes each year and applied for a refund based on the difference between the estimated taxes paid and those finally computed. Since the Commissioner failed to take action on the claims within six months, the taxpayer brought suit for the refund in the United States District Court for the District of Delaware.² On judgment for the taxpayer,³ the government appealed. The Court of Appeals for the Third Circuit reversed holding that "useful life" as defined in § 167(c) of the IRC of 1954 means the useful life of the asset to the taxpayer. Therefore, taxpayer had to use the less than three year life in the computation of its depreciation on the automobiles. Because of the shortening of the life, the taxpayer was precluded from using the declining balance method of depreciation.⁴ Since the trucks had a useful life to the taxpayer of more than three years the declining balance method was appropriate. However, in using this method, the court decided that depreciation could not be claimed below a reasonable salvage value.

The various Courts of Appeals have split on the interpretation of the useful life concept. In *Evans v. Commissioner of Internal Revenue*⁵ the Ninth Circuit decided that the concept meant the physical life of the asset without regard to taxpayer's actual holding period. In reaching this decision the court rejected the Commissioner's interpretation of similar language in the 1954 Code.⁶ The Fifth Circuit in *United States v. Massey Motors, Inc.*⁷ accepted the Commissioner's interpretation holding that useful life to the taxpayer is the accepted meaning of "useful life." However, the court may have been influenced by the fact that the depreciated assets were sold at a price greater than the original cost within the same taxable year in which they were purchased by the taxpayer.⁸ The *Hertz*⁹ decision adopted the reasoning of the Fifth Circuit.

The Third Circuit in *Hertz*¹⁰ is the first of the circuits to decide a case testing the validity of the Commissioner's Regulations which forbid depreciation below a reasonable salvage value when the declining balance method is elected by the taxpayer.¹¹ The court in making its determination of legislative intent with respect to this issue confined itself to a particular Congressional hearing. It seemingly ignored reports by the Senate Finance Committee showing that Congress may have intended that salvage value

² 1954 IRC § 7422 and § 6532.

³ 165 F. Supp. 261 (D. Del. 1958).

⁴ 1954 IRC § 167(c).

⁵ 264 F.2d 502 (9th Cir. 1959).

⁶ Income Tax Regulations (1954 Code) § 1.167(a)(1)(b) provides in part that ". . . the estimated useful life of an asset . . . is the period over which the asset may reasonably be expected to be useful to the taxpayers on his trade or business. . . ."

⁷ 264 F.2d 552 (5th Cir. 1959).

⁸ Cf. *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1959) where the court held that depreciation could be disallowed in the year of sale where the asset was sold at a profit.

⁹ See supra note 1.

¹⁰ See supra note 1.

¹¹ Income Tax Regulations (1954 Code) § 1.167(b)(2)(a).

be built into the declining balance method and need not be considered by the taxpayer.¹²

The Hertz Corporation has applied for and been granted certiorari in the United States Supreme Court.¹³ It is submitted that the Third Circuit's interpretation of useful life could have been better substantiated by consideration of the fundamental concept of depreciation. The depreciation deduction should effect the distribution of the cost of a tangible capital asset over its estimated useful life in a systematic and rational manner. The deduction should seek to set off the cost of an asset against the income produced by it during its life. Actual physical life of an asset, if different from the holding period of the taxpayer, should be irrelevant.

The ability of the taxpayer to depreciate the asset below a reasonable salvage value is of great importance as a capital gain tax would be paid on any gain arising from the sale of the asset while depreciation is charged against ordinary income. The Supreme Court's problem in this issue will be to weigh the importance of the capital gain to the taxpayer on the sale of the depreciated property against the need for additional tax revenue. Whatever the final decision, it is probable that Congress has not spoken its last word on the subject.

ALLAN B. SOLOMON

United States Arbitration Act—Stay of Proceedings—Declaration of National Law—Fraud as an Arbitrable Issue.—*Robert Lawrence Co., Inc. v. Devonshire Fabrics, Inc.*¹—A Massachusetts buyer brought an action for damages in the United States District Court for the Southern District of New York, jurisdiction being grounded on diversity of citizenship, for alleged fraud in the inducement of a purchase agreement requiring interstate shipment of goods. The disputed contract, made in New York with a New York seller, contained an arbitration clause covering "any complaint, controversy, or question which may arise." The defendant seller moved to stay the legal proceedings pending arbitration, relying on § 3 of the United States Arbitration Act.² The District Court denied the motion,

¹² Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 201 (1954) which in essence says that salvage value is not applicable because at the expiration of the useful life there remains an undepreciated balance which represents salvage value; Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 203 (1954) which in substance states that the limitation of a three year life was placed on the declining method so that the asset could not be completely depreciated in the year of purchase.

¹³ 361 U.S. 811 (1959).

¹ 271 F.2d 402 (2d Cir. 1959), cert. granted 28 U.S.L. Week 3259 (1960).

² 9 U.S.C. §§ 1-14 (1958). The legislation was first enacted in 1925; 43 Stat. 883 (1925), 9 U.S.C. §§ 1-15 (1946). It was enacted into positive law by Act, July 30, 1947, c. 392, 61 Stat. 670, without changing any of its provisions and designated officially as Title 9 U.S.C.

The heart of the Act is contained in §§ 2, 3, 4. § 2 makes "valid, irrevocable, and enforceable" written provisions for arbitration in contracts involving interstate commerce and maritime transactions; § 3 provides for a stay of action in federal courts