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Essay

Unifying Depreciation Recapture

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To achieve fairness and accuracy, an income tax system must accomplish two objectives: allow depreciation deductions for the erosion in the value of assets used to produce income, and correct errors that may result from excessive depreciation allowances. The Internal Revenue Code currently fares well in accomplishing the first objective but conspicuously fails to achieve the second.

One of the two main depreciation corrective mechanisms is embodied in Internal Revenue Code § 1250. This section requires that upon the disposition of depreciable real estate used in a trade or business, a portion of the gain that reflects the taxpayer's prior depreciation deductions must be treated as ordinary income or, in tax parlance, "recaptured." Recapturing gain as ordinary income is consistent with the treatment of depreciation itself, which allows ordinary deductions over the period during which the asset was used to produce income.

The problem is that § 1250 is seriously flawed. When it was initially enacted, it corrected some excessive depreciation allowances; however, under current law, it rarely applies at all. Taxpayers are thus able to achieve significant tax arbitrage windfalls: by taking generous depreciation deductions, they can shelter income subject to high ordinary tax rates while recognizing subsequent gains produced by those deductions at preferential capital gains rates.

The reform that this analysis calls for is remarkably simple: Congress should repeal § 1250 and uniformly apply the more accurate recapture rules of § 1245—which currently applies only to assets other than real estate—to all depreciable assets. Uniform depreciation recapture rules would produce a more coherent tax regime, fostering fairness, efficiency, and accuracy.

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Unifying Depreciation Recapture

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I. INTRODUCTION

From its inception, one of the central features of our income tax system has been an allowance for depreciation deductions for property used in a trade or business or for the production of income.[1] Such allowances are necessary to reflect income accurately: as assets are used to produce income, they generally diminish in value over time. Taxpayers should be able to account for these declines with depreciation deductions against profits.[2]

But depreciation deductions are inevitably speculative in the sense that until a taxpayer sells or otherwise disposes of an asset, there can be no certainty about the precise amount its value has eroded over time. Upon disposition, precision can be achieved: the amount realized can be compared to the taxpayer's initial investment in the asset. The difference is the actual erosion in the asset's value, and this number can be compared with the total of depreciation deductions allowed.

If the depreciation allowed is understated, a loss will result.[3] In

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[1] Since 1909, a depreciation deduction has been associated with the federal income tax system. *See* Payne-Aldrich Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 113 (providing that net income includes a reasonable allowance for depreciation of property deductions). For an excellent historic overview of depreciation deductions, see Henry J. Lischer, Jr., *Depreciation Policy: Whither Thou Goest*, 32 SW. L.J. 545, 546–71 (1978).

[2] *See* United States v. Ludey, 274 U.S. 295, 300 (1927) ("The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used."); *see also* MARVIN A. CHIRELSTEIN & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION 187 (12th ed. 2012) (noting that a conceptual approach to depreciation would be to allow a deduction for the amount by which the asset declined in value by the end of the year); Yoram Margalioth, *Not a Panacea for Economic Growth: The Case of Accelerated Depreciation*, 26 VA. TAX REV. 493, 503 (2007) ("Economic analysis views investment in depreciable assets, such as machines, like any other investment. . . . The annual depreciation is the difference between the present value of expected cash flow from the asset at the start of each year and the present value of the expected cash flow at the end of each year."); Anthony P. Polito, *Fiddlers on the Tax: Depreciation of Antique Instruments Invites Reexamination of Broader Tax Policy*, 13 AM. J. TAX POL'Y 87, 93 (1996) ("The historic concept of the depreciation regime was justifiable as increasing the degree to which taxable income clearly reflects economic income.").

[3] The Internal Revenue Code requires recognition of gain, and allows recognition of loss, upon the "sale or other disposition" of assets. I.R.C. § 1001 (2012). The prescribed computation consists of

general, such losses are deductible against ordinary income, as they should be, because they represent costs of generating profits that the tax accounting rules had not previously recognized.[4] Conversely, if the depreciation deduction allowed is overstated, a gain will result. Such gains have typically been treated favorably under the Internal Revenue Code ("the Code"),[5] principally through lower tax rates applicable to such gains. This combination of ordinary deductions and subsequent capital gains creates an extraordinary—and unjustified—benefit to taxpayers.

Approximately half a century ago, when Congress introduced § 1250 into the Code, it purported to tackle this problem. In order to foster equity in the income tax,[6] Congress declared the following: upon the sale or exchange of depreciable real property (primarily buildings used in a trade or business), all or a portion of the gain attributable to prior depreciation deductions—which gave rise to ordinary income tax deductions—would be treated as ordinary income rather than as capital gains and, accordingly, would not warrant preferential capital gains tax rate treatment.[7] Unfortunately, this rule initially applied to only a portion of the gain, not to all of it,[8] and currently has virtually no application at all.

To illustrate by example, in one of the rare situations in which § 1250 still applies, suppose that on January 1, 2015, a taxpayer in the highest marginal income tax bracket (currently, 39.6%) purchases a $1,000,000 residential rental real estate building and subsequently sells this real estate

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subtracting the taxpayer's adjusted basis from the amount realized. *Id.* § 1001(a). In most cases, the adjusted basis is the original cost of the asset minus depreciation deductions allowable over the course of its use. Thus, if upon disposition the adjusted basis is larger than the amount realized, it will mean that the depreciation deductions allowable over time understated the erosion in value in the asset. Subtracting that adjusted basis from the amount realized will produce a negative number, which is the measure of the loss the taxpayer sustained over the period of the asset's use.

[4] I.R.C. § 1231 applies to assets held for more than one year that are used in a trade or business, and allows net gains from the disposition of such assets in any tax year to be treated as long-term capital gains, but allows net losses from the disposition of such assets to be treated as losses that are fully deductible against ordinary business income. I.R.C. § 1231(a)(1)–(2) (2012).

[5] 26 U.S.C. §§ 1–8023 (2012). Unless otherwise indicated, all provisions mentioned in this Essay refer to the Internal Revenue Code.

[6] *See* Hoffman F. Fuller, *The Recapture of Depreciation*, 39 TUL. L. REV. 15, 20–21, 33–34 (1964) (explaining how §§ 1245 and 1250 were enacted "to reform . . . the relationship between depreciation deductions and the tax effects to the property owner resulting from subsequent disposition of the depreciated property"); Selwyn A. Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285, 285–92 (1965) (noting that §§ 1245 and 1250 were enacted to close an income tax loophole by recapturing depreciation); Edwin L. Kahn, *Recapture of Depreciation*, 42 TAXES 918, 922 (1964) (commenting that §§ 1245 and 1250 have addressed the problem of overgenerous property depreciation deductions).

[7] I.R.C. § 1250(a)(1)(A) (2012).

[8] When first enacted, § 1250 applied only to the difference between straight-line and accelerated depreciation, and even this amount was reduced by one percent for each month over twenty months that the property was held, so that after ten years or 120 months, no income was recaptured. *See* I.R.C. § 1250(a)(2) (1964).

on December 31, 2015 for $1,000,000. On his tax return, the taxpayer would be allowed $36,363 of depreciation deductions;[9] furthermore, the taxpayer would also have to report $36,363 of gain (i.e., $1,000,000 amount realized less $963,637 adjusted tax basis). In the parlance of the Code, because title to the property was held for one year or less, the character of this gain would be *§ 1250 recapture income* taxable as ordinary income.[10] The symmetrical nature of the deduction and income characterization makes sense: the depreciation deduction would yield $14,400 in tax savings ($36,363 x .396). Such tax savings, however, would be offset dollar for dollar by the subsequent recognition event, yielding an additional $14,400 of taxes ($36,363 x .396).

This sensible result is also an exceedingly unusual result. This is because § 1250 works in this fashion only in the rare case in which the real estate asset is bought and sold within a one-year time period. In the far more common situation in which title to real property is held for more than one year, § 1250 usually fails to recapture *any* of the excess depreciation deductions allowed at ordinary rates.

A second example illustrates the more common case: suppose that a taxpayer purchases a $1,000,000 residential rental estate building on January 1, 2015, but this time the taxpayer holds the property for two years before selling it for $1,000,000 on December 31, 2016. In both 2015 and 2016, the taxpayer would be entitled to take $36,363 of depreciation deductions,[11] yielding total tax savings of $28,800 (($36,363 x 2) x .396). On his 2016 tax return, the taxpayer would have to report a resulting $72,726 gain ($1,000,000 amount realized less $927,274 adjusted tax basis). Because title to the property was held more than one year, the character of this gain would be "*[u]nrecaptured section 1250 gain*,"[12] one of several types of capital gains income for which special (and lower) tax rates are imposed.[13] In this particular example, the capital gains tax rate is 25%.[14] This income characterization thus produces a tax burden of only $18,181.50 ($72,726 x .25).[15]

An ideal recapture provision would tax the resulting gain at a rate that would produce the same amount of tax as the excess depreciation deductions had saved. This example demonstrates the shortcomings of

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[9] I.R.C. § 168(b)(3)(B), (c), (d)(2)(B) (2012). For simplicity, this example ignores the mid-month convention mandated by I.R.C. § 168(d)(2)(B).

[10] *Id.* § 1250(b)(1).

[11] This second example again ignores the application of the mid-month convention.

[12] I.R.C. § 1(h)(6) (2012) (emphasis added).

[13] *Id.*

[14] *Id.* § 1(h)(1)(E). In some cases, depending largely on the aggregate amount of the taxpayer's income, an additional 3.8% tax on net investment income under I.R.C. § 1411 may apply.

[15] Had the resultant gain instead been treated as ordinary income, the taxpayer would have experienced a $28,800 tax burden ($72,726 x .396). See I.R.C. § 1 for the Code's tax schedule.

§ 1250: the taxpayer saved $28,800 through the depreciation deductions that are now known to have been unnecessary in view of the fact that the asset lost no value at all; and yet when those deductions are recaptured, only $18,181.50 is collected. Indeed, over time, the taxpayer's tax-arbitrage profits grow more robust (although the percentage of tax savings remains constant).[16] Thus, § 1250 falls well short of its supposed goal of correcting inappropriate tax savings associated with excessive depreciation deductions.[17]

This analysis explores § 1250, explains its many flaws, and proposes its repeal. It proceeds as follows: Part II provides a short historical background of what led Congress to enact § 1250 and how, over time, it has evolved. Part III details the ways in which § 1250 violates several important tax principles, draws arbitrary property distinctions, and favors high-income taxpayers at the expense of low-income taxpayers. In light of § 1250's evident shortcomings, Part IV explains why including real estate within the ambit of § 1245—the Code's recapture bulwark that generally applies to non-real estate depreciable property[18]—is preferable to retaining § 1250. Finally, Part V offers our conclusions.

II. SECTION 1250: ITS ORIGINS AND EVOLUTION

To understand § 1250 and its flaws requires some knowledge of its history. We divide this history into the following three successive chronological segments: (A) judicial response to the character inequity problem; (B) legislative solution to the character inequity problem; and (C) evolution of § 1250 from its enactment to its current status.

A. *Judicial Response to the Character Inequity Problem*

Until 1962, the Code contained no provisions regarding depreciation recapture. This allowed egregious inequity as taxpayers readily transformed depreciation allowances that gave rise to ordinary income tax deductions into capital gains. During these years, this alchemy involving character transformation was not difficult to accomplish.

For most of the years during the pre-recapture period, taxpayers claiming depreciation deductions had to estimate how long they would use a business asset (the "useful life" of the asset) and for what value they

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[16] Indeed, had the building been fully depreciated, per § 1250(a)(1)(B), it would have produced $396,000 of tax savings ($1,000,000 x .396) and subsequently sold for $1,000,000, and the tax due would have been $250,000 ($1,000,000 gain x .25). The $146,000 difference between these two amounts ($396,000 – $250,000) reflects a 37% savings, which constitutes a pure, after-tax windfall to the taxpayer.

[17] *See* sources cited *supra* note 6 (explaining the general function of § 1250 and the congressional intent behind it).

[18] I.R.C. § 1245(a)(3) (2012).

might be able to sell that asset at the conclusion of its use (the "salvage value" of the asset).[19] In an ideal tax system, depreciation deductions would be intended to measure an asset's true economic decline in value, and thereby foster accurate reporting of business income.[20] But even well-intentioned taxpayers could make mistakes about how long they would use assets and/or their salvage values. Additionally, economic forces (e.g., a sudden metal shortage or surge in availability) could cause assets' fair market values to either skyrocket or drop precipitously.[21]

These factors could and sometimes did produce significant variation between depreciation deductions claimed and the amounts that, retrospectively, would have reflected an asset's true economic decline in value. Consider, for example, a taxpayer who purchased a $1,000 piece of machinery, with an estimated five-year useful life and zero-dollar salvage value. Over the course of the ensuing five-year period, assume that the taxpayer took $200 of annual depreciation deductions. Over those five years,[22] as a result of taking these depreciation deductions, the taxpayer could shelter $1,000 of income, producing $400 of tax savings (assuming a 40% effective tax rate on ordinary income). At the end of Year 5, for one or more reasons—the machine's useful life proved longer than anticipated, its salvage value was higher than expected, and/or there was a machine shortage—the machinery sold for $1,000. This sale would produce a $1,000 gain (i.e., $1,000 amount realized with a zero-dollar adjusted tax basis), triggering a $200 corresponding tax burden (assuming a 20% preferential tax rate on capital gains). With respect to this asset purchase, the taxpayer was able to achieve $400 in tax savings at the price of only a $200 tax burden.

The resulting $200 subsidy that was accorded from the U.S. government to the taxpayer was obvious to anyone, including judges who heard cases involving depreciation disputes. Those judges could have simply noted the inequity and concluded that it was up to Congress to craft a remedy. However, some courts saw at least one opportunity to lessen—

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[19] *See* Massey Motors, Inc. v. United States, 364 U.S. 92, 97, 102–03 (1960) (explaining that, prior to Congress's instituting accelerated cost-recovery systems in 1954, taxpayers could depreciate property based upon how long they intended to use such property rather than over the property's useful life).

[20] *See, e.g.*, United States v. Ludey, 274 U.S. 295, 300–01 (1927) ("The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the [asset] in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost.").

[21] *See, e.g.*, Fribourg Navigation Co. v. Comm'r, 383 U.S. 272, 274 (1966) (discussing the change in a ship's fair market value after the 1956 Suez crisis and holding that, notwithstanding the change, the taxpayer was still allowed to take depreciation deductions).

[22] Because we are describing here a basic fact pattern that prevailed over a variety of tax years and tax rules, we are using abstract parameters that do not necessarily reflect accurately any particular set of depreciation provisions or tax rates.

albeit only slightly—this inequitable outcome, and seized upon it.

The basic amelioration strategy consisted simply of disallowing depreciation deductions in the year of the sale of an asset, to the extent that the sales price exceeded the asset's putative salvage value.[23] To illustrate, in the prior example, since the $1,000 sales price exceeded the putative zero-dollar salvage value by $1,000, the $200 depreciation deduction associated with the last year of asset ownership would be disallowed in its entirety. By disallowing the asset's depreciation deduction for its last year of service, courts were able to reduce the government's subsidy to the taxpayer, but only to the extent of the tax benefits obtained in the final year of the asset's use.

In addition to its limited scope, this judicial solution—eponymously referred to as the "Cohn Rule" after the case that inaugurated it—suffered from other shortcomings.[24] First, not all courts subscribed to even this limited response to the arbitrage problem.[25] In addition, in the absence of specific statutory grounding, this rule was never incorporated into the routine reporting by taxpayers who were not audited; thus, it was only applied in select cases.

By the early sixties, both the White House and Congress recognized that there was a serious problem inherent in an income system that permitted depreciation allowances, yet contained no associated corrective mechanisms when these allowances proved too generous.[26] While well intentioned, the judiciary's half-baked solution, grounded on tenuous

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[23] *See, e.g.*, Rouse v. Comm'r, 39 T.C. 70, 78 (1962), *acq.*, 1963-2 C.B. 5; Lane v. Comm'r, 37 T.C. 188, 194–95 (1961); Weir Long Leaf Lumber Co. v. Comm'r, 9 T.C. 990, 1003 (1947), *aff'd in part, rev'd in part*, 173 F.2d 549, 553 (5th Cir. 1949), *acq.*, 1948-1 C.B. 3.

[24] *See* Cohn v. United States, 259 F.2d 371, 377–78 (6th Cir. 1958) ("[W]here at the end of any taxable year there is a clear and convincing basis, in the light of facts reasonably known to exist at the time, for making a redetermination of the remaining useful life of the asset, such a redetermination may be made. If a redetermination is made, the depreciation is not modified for prior years, but the remaining depreciated cost is spread ratably over the new estimated remaining useful life and depreciation reductions taken accordingly for the current and succeeding years."); *see also Rouse*, 39 T.C. at 77–78 (refusing to disallow depreciation deductions incurred in earlier tax years); Rev. Rul. 62-92, 1962-1 C.B. 29, 31 ("[T]he 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." (emphasis added)).

[25] Those taxpayers who used an accelerated depreciation method (e.g., double-declining balance) and whose depreciation deductions were correspondingly smaller in later years, fared much better under the Cohn Rule than those taxpayers who elected to use a slower depreciation method (e.g., straight-line method) and thus had correspondingly larger depreciation deductions in later years.

[26] *See* Horvitz, *supra* note 6, at 289 ("Having seen the problems of applying the judicial and administrative approaches, President Kennedy, on April 20, 1961, recommended legislation to eliminate the possibility of converting a depreciation deduction into a capital gain.").

statutory and regulatory footing,[27] was not a long-term fix to the ubiquitous problem of excessive depreciation allowances. Meaningful reform, if it were to happen, would have to happen in the form of legislation.

B. *Legislative Solution to the Character Inequity Problem*

Congress took its cue and responded first in 1962[28] with the introduction of § 1245 (generally, applicable to personal property)[29] and then in 1964 with the introduction of § 1250 (generally, applicable to real property).[30]

The objective of these related sections was to curtail taxpayers' ability to convert ordinary deductions into capital gains.[31] More specifically, they operated to "recapture" prior depreciation deductions as ordinary income rather than allowing taxpayers to treat such income as capital gains. Sections 1245 and 1250, however, differed significantly in scope and application.

Section 1245 operates with admirable directness to convert excess depreciation deductions into ordinary income. Upon the disposition of personal property, the amount of "recapture income" treated as ordinary income is, in virtually all cases, equal to the lesser of two computations: the initial purchase price, less the adjusted basis of the asset; or the amount realized upon the sale or disposition, less the adjusted basis in the asset.[32] This amount will be precisely the amount of excess depreciation claimed over the taxpayer's use of the asset.

For example, if an asset had been purchased for $10,000, and sold at a time when depreciation deductions had reduced its basis to $6,000, a sale at a price of $7,500 would produce recapture under the second computational rule above: $7,500 – $6,000, or $1,500, which is the exact amount of the excess depreciation claimed. A sale at a price of $12,000

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[27] *See* Treas. Reg. § 1.167(c) (1956) (implying that unless the taxpayer redetermined an asset's useful life, its salvage value should remain constant).

[28] There was one, very limited, earlier effort. The legislative precursor to both §§ 1245 and 1250 is § 1238, which required ordinary income recapture pertaining to accelerated deductions for emergency facilities to be subsequently sold at a gain. It was originally enacted as I.R.C. § 117(g)(3) of the 1939 Code, added by the Revenue Act of 1950, Pub. L. No. 81-814, § 216, 64 Stat. 906, 939.

[29] Revenue Act of 1962, Pub. L. No. 87-834, § 13, 76 Stat. 960, 1032.

[30] Revenue Act of 1964, Pub. L. No. 88-272, § 231, 78 Stat. 19, 100.

[31] In campaigning for reform in the hearings on the Revenue Act of 1962 before the Senate Committee on Finance, Treasury Secretary Dillon observed that "the excess depreciation, having been charged against income taxable at ordinary rates, is recouped and taxed only as capital gains." *An Act to Amend the Revenue Act of 1954 to Provide a Credit for Investment in Certain Depreciable Property, to Eliminate Certain Defects and Inequities, and for Other Purposes: Hearing on H.R. 10650 Before the S. Comm. on Fin.*, 87th Cong. 88 (1962) [hereinafter *1962 Senate Hearings*] (statement of Hon. Douglas Dillon, Secretary of the Treasury).

[32] *See* I.R.C. § 1245(a)(1) (2012) (providing statutory guidelines for calculating the amount of recapture income that can be treated as ordinary income).

would produce recapture under the first computational rule: $10,000 – $6,000, or $4,000, which is, again, the exact amount of the excess depreciation claimed.

In contrast, § 1250 is a halfhearted measure—and a conceptual mess. It disregards the basic principle of depreciation recapture, which is to prevent conversion of ordinary income into capital gain. Instead, it treats as recapture income only those depreciation deductions that were in excess of what the straight-line depreciation method would have produced. The balance is treated as § 1231 gain, which is generally categorized as capital gain and subject to preferential tax rates.[33]

It appears that Congress adopted the halfhearted approach of § 1250 largely because it was persuaded to do so by the powerful real estate lobby. This lobbying group argued that real estate had distinctive characteristics that required unique tax treatment.[34] One such distinguishing characteristic is that real estate, unlike other assets used in a trade or business, generally appreciates in value;[35] and, as such, it is vulnerable to the so-called lock-in effect,[36] which reflects the tax disincentive to realize taxable gains.[37] Because taxpayers ultimately have complete control over the timing of realization events, the greater the potential tax exposure, the greater the disincentive to realize gains. Obviously, applying the rules of § 1245 to real estate gains would increase the amount of tax paid on realized gains and thus unambiguously exacerbate the lock-in effect. In congressional circles, this argument apparently carried great weight, as § 1250's legislative history echoes with this concern, signifying that the real estate

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[33] Recall that if § 1250 property is held for one year or less, the entire gain is treated as recapture income. *See id.* § 1250(b)(1).

[34] Charles S. Franklin, *Real Property Depreciation Recapture: An Ineffectual Reform of the Tax Laws*, 19 VAND. L. REV. 1336, 1355 (1966) ("The National Association of Homebuilders, 'the sole national spokesman of the homebuilding industry in the United States,' exerted substantial efforts at the 1962 and 1963 congressional hearings to defeat first, and successfully, the original Treasury proposal and then, unsuccessfully, the House version later enacted as [§] 1250." (footnotes omitted)).

[35] *See* S. REP. NO. 87-1881, at 95 (1962) (describing the reasoning behind Congress's decision not to apply § 1245 to buildings).

[36] *See 1962 Senate Hearings*, *supra* note 31, at 3554, 3556–58 (statement of Emil Gould, Chairman, Tax Studies Comm., Nat'l Ass'n of Homebuilders) (describing the tendency of real estate to appreciate in value and the corresponding danger of the lock-in effect).

[37] *See* Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 TAX NOTES 195, 200–01 (1990) (describing the lock-in effect as "the tax-induced reluctance to dispose of assets" caused by "the combined effects of a realization requirement and a relatively high tax on realized gains"); Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 256–58 (1957) (arguing that § 1250 discourages real estate investors from realizing capital gains due to its tax treatment of real property); Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344–46 (1993) ("The lock-in effect describes an investor's reluctance to incur a tax on realization of gains. . . . An investor who is not taxed until realization and who can avoid tax . . . tends not to change investments, even though he may believe that higher returns are available elsewhere.").

lobby was instrumental in shaping the watered-down legislative outcome.[38]

Because of their structural design differences, §§ 1245 and 1250 produce strikingly different tax outcomes. Consider the situation of a taxpayer who, in 1964, purchases and places into service a piece of machinery and a building, each for $100,000. To enable direct comparison, we assume that the machinery and the building each have a ten-year useful life, that taxpayer employed a 200% declining-balance depreciation method, and that neither the mid-year nor mid-month convention applies. The following table illustrates the taxpayer's depreciation deductions for each asset as well as each asset's adjusted tax basis at year's end:

Year	Actual Depreciation	Straight-Line Depreciation	Excess of Actual over Straight Line	Adjusted Tax Basis
1964	$20,000	$10,000	$10,000	$80,000
1965	16,000	10,000	6,000	64,000
1966	12,800	10,000	2,800	51,200
1967	10,240	10,000	240	40,960
1968	8,192	10,000	(1,808)	$32,768
Total	$67,232	$50,000	$17,232	

Suppose that at the end of 1968, the taxpayer sold both the machinery and the building for $100,000. The resulting gains would be as follows:

	Section 1245	Section 1250
Property	Machine	Building
Amount Realized	$100,000	$100,000
Less Adjusted Basis ($100,000 cost less $67,232 depreciation)	(32,768)	(32,768)
Gain Recognized	$67,232	$67,232

While the gains associated with the sale of both pieces of property are equivalent, the character of these gains is not. The following chart highlights these differences:

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38 *See* H.R. REP. NO. 88-749, at 102–03 (1963) ("Your committee generally has limited the depreciation recapture to the excess over straight line depreciation because it believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs over time. If a gain still occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property. The portion representing the rise in value is comparable to other forms of gains which quite generally are treated as capital gains. Moreover, your committee believes that when the property is held for an extended period of time, gains realized on the sale or other disposition of the property are more likely to be attributable to price rises generally than to an excess of depreciation deductions."). The Senate Committee adopted this view in substantially unchanged wording. See S. REP. NO. 88-830, at 133 (1964) for the adopted language.

	Section 1245	Section 1250
Property	Machine	Building
Total Gain Recognized	$67,232	$67,232
Recapture (Ordinary) Income	67,232	10,339[39]
Balance Taxed Under § 1231	-0-	$56,893

Assuming the tax rate on ordinary income is 40% and the capital gains tax rate is 20%,[40] the resulting tax consequences are quite different, as demonstrated by the chart below.

	Section 1245	Section 1250
Property	Machine	Building
Tax on Recapture Income	$26,892.80	$4,135.60
Tax on § 1231 Income	-0-	11,379.60
Total Tax	$26,892.80	$15,514.20

In percentage terms, the overall tax burden incurred on the sale of the machinery is 73%[41] higher than the tax burden on the sale of the building, even though the taxpayer is in exactly the same economic position with respect to each acquisition and sale.

Obviously, these differing tax burdens produce more favorable treatment of real estate investments than of investments in other assets. To that extent, it is equally clear that they diminish the potency of the lock-in effect as to those tax-favored assets. Congress was apparently persuaded that this was justified by the distinctive nature of real estate investments.[42] More specifically, the legislative history articulates that personal property generally tends to decline in value whereas real property generally tends to increase in value;[43] that being the case, Congress decided that as an appreciating asset, akin to other capital investments, associated gains should be accorded capital treatment, other than those gains associated with accelerated depreciation deductions.[44]

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[39] Note that the "applicable percentage" taxable as ordinary income is 60% after the holding-period reduction, *see supra* note 8 and accompanying text, namely, 100% less 40% (months held in excess of twenty).

[40] Because the example is theoretical, not based on actual Code provisions applicable to any particular year, we are using approximate tax rates that roughly re-create the rate structures applicable in many recent tax years.

[41] ($26,892.80 – ($4,135.60 + $11,379.60)) / ($4,135.60 + $11,379.60).

[42] *See* S. REP. NO. 88-830, at 132 (1964) ("Congress did not include real property in the recapture provision applicable to depreciable personal property because it recognized the problem in doing so where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period of time.").

[43] *Id.*

[44] *See id.* ("The bill . . . takes this . . . into account [by] . . . mak[ing] sure that the ordinary income treatment is applied upon the sale of the asset only to what may truly be called excess depreciation

C. *Evolution of § 1250 from Its Enactment to Its Current Status*

During the ensuing five decades from its enactment in 1964, Congress has made periodic reforms to the Code, some directly bearing upon § 1250 and others indirectly. These changes vary widely in their form and significance.

In 1969, Congress decided that many real estate investments had become de facto tax shelters. Accelerated depreciation, the use of leverage, and the ten-year phaseout of § 1250 recapture income (which allowed gains to be taxed at preferential capital tax rates)[45] were effective—perhaps overly so—in luring taxpayers to make tax-driven real estate investments.[46] To remedy this problem, Congress tweaked § 1250: in the case of nonresidential property, the ten-year phaseout period was eliminated (i.e., the accelerated portion of any depreciation deduction (in excess of straight-line depreciation) would be recaptured as ordinary income regardless of the duration of the owner's tenure in that property);[47] and in the case of residential property, the ten-year phaseout period was elongated to sixteen and two-thirds years, with the tapering-off period beginning one hundred months after the real property in question was placed in service.[48]

Over the next two decades, § 1250 became marginally more stringent. This is reflected in two separate pieces of legislation. First, as part of the Tax Reform Act of 1976, except for certain low-income housing, the recapture phaseout for § 1250 property was eliminated, so that all gains associated with the difference between accelerated and straight-line depreciation on residential real estate were made subject to recapture.[49] Second, as part of the Tax Equity and Fiscal Responsibility Act of 1982, Congress enacted § 291,[50] which reduced the capital gains treatment available for § 1250 property held by corporate taxpayers.[51] Specifically, § 291 provided that in addition to whatever ordinary income § 1250 would give rise to, corporate taxpayers would also have to recognize an additional

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deductions. It does this first by providing that in no event is there to be a recapture of depreciation as ordinary income where the property is sold at a gain except to the extent the depreciation deductions taken exceed the deduction which would have been allowable had the taxpayer limited his deductions to those available under the straight-line method of depreciation. Secondly, a provision has been added which in any event tapers off the proportion of any gain which will be treated as ordinary income so that it disappears gradually over a 10-year holding period for the real estate. As a result, under the bill, no ordinary income will be realized on the sale of real estate held more than 10 years.").

[45] *See supra* text accompanying note 32.

[46] *See* S. REP. NO. 91-552, at 212 (1969); H.R. REP. NO. 91-413, at 165 (1969).

[47] I.R.C. § 1250(a)(2)(B)(ii) (1970). This legislation was enacted as part of the Tax Reform Act of 1969, Pub. L. No. 91-172, § 521(b), 83 Stat. 487, 652–53.

[48] I.R.C. § 1250(a)(1)(C)(iv) (1970).

[49] Tax Reform Act of 1976, Pub. L. No. 94-455, § 202(a)–(b), 90 Stat. 1520, 1527–30.

[50] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 204(a), 96 Stat. 324, 423–26.

[51] I.R.C. § 291(a)(1) (1982).

fifteen percent of the recognized gain as ordinary income on the portion of the gain that § 1245 would have treated as ordinary income.[52]

Following these modest efforts to enhance the vigor of § 1250, however, in the Tax Reform Act of 1986, Congress significantly curtailed its revenue potency. Aside from equalizing the tax rates on ordinary income and capital gains (which proved to be short-lived),[53] Congress, as part of the Code's overhaul, introduced the Modified Accelerated Cost Recovery System (MACRS).[54] Under MACRS, all real property placed into service after 1986 had to employ the straight-line depreciation method.[55] As a result of this reform, § 1250 recapture income, which by definition depends on a mathematical difference between accelerated and straight-line depreciation deductions, was effectively programmed to be phased out of existence with two extraordinarily limited exceptions: real property disposed of within one year of its acquisition[56] and a narrow class of § 1250 property (e.g., certain fifteen-year land improvements and seven-year theme park structures).[57] As all real property placed into service before 1987 will now be fully depreciated (whether the taxpayer used an accelerated or straight-line method),[58] § 1250 recapture provisions have been essentially rendered a nullity (i.e., the use of accelerated depreciation is impermissible with respect to any real property acquired after 1986).[59]

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[52] *Id.* As part of the Tax Reform Act of 1984, Congress increased this percentage from 15% to 20%. Pub. L. No. 98-369, § 68(a), 98 Stat. 494, 588.

[53] Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(b)(2), 100 Stat. 2085, 2217 (codified at I.R.C. § 172(d)(2) (1988)). This legislative change made the recapture of prior depreciation deductions no more financially onerous than the recognition of capital gains (i.e., both kinds of income endured the same tax rates). However, the Omnibus Budget Reconciliation Act of 1990 reinstituted the rate differential between ordinary income and capital gains, once again making the latter more financially attractive than the former. Pub. L. No. 101-508, § 11101(c), 104 Stat. 1388, 1388-404 to -405 (codified at I.R.C. § 1 (1994)).

[54] Tax Reform Act of 1986 §§ 201(a), 203(a)(1)(a).

[55] I.R.C. §§ 168(b)(3), 1250(b)(1) (1988).

[56] *Id.* § 1250(b)(1). Note that due to the high transaction costs associated with the transfer of real estate (e.g., financing expenses, legal fees, and realty transfer taxes), real estate is rarely purchased and subsequently sold within a one-year time span.

[57] *Id.* § 168(e); *see also* Rev. Proc. 87-56, 1987-2 C.B. 674, *modified and clarified*, Rev. Proc. 88-22, 1988-1 C.B. 785.

[58] In 1986, prior to the MACRS straight-line depreciation mandate in 1987, a nineteen-year class life was the longest depreciation period available for real estate. *See* Simplification of General Imputed Interest Rules Act of 1985, Pub. L. 99-121, § 103(a), 99 Stat. 505, 509 (codified at I.R.C. § 168 (1988)); *see also* Daley v. Comm'r, 62 T.C.M. (CCH) 1197, 1201 (1991) ("The recovery period for real property placed in service after May 8, 1985, and before January 1, 1987, was 19 years.").

[59] The Treasury regulations instruct that when comparing accelerated depreciation results with straight-line results, the comparison must include results that would have been produced "if depreciation had actually been determined under the straight line method throughout the period the property was held." Treas. Reg. § 1.1250-2(b)(3)(i) (2015). The Treasury regulations add that "[s]uch useful life . . . shall be determined by taking into account for each taxable year the same facts and circumstances as would have been taken into account if the taxpayer had used such method throughout the period the property was held." *Id.* § 1.1250-2(b)(3)(ii).

The last small injection of life into § 1250 occurred approximately one decade later. In the Taxpayer Relief Act of 1997, in the context of a general reform of capital gains provisions, Congress decided that the "unrecaptured" § 1250 income (i.e., the portion of gain related to the prior straight-line depreciation deductions) should be subject to its own unique tax rate.[60] With respect to unrecaptured § 1250 gain, Congress chose a tax rate between the ordinary income tax rate and the capital gains tax rate, which then and now equals 25%.[61]

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This historic trajectory indicates that, compared to its § 1245 counterpart, § 1250 recapture was feeble at inception, gained a little strength (but not much) in subsequent tax reform efforts, and has been all but repealed by the passage of time since the Tax Reform Act of 1986 eliminated accelerated depreciation for real estate.

To illustrate, consider again the situation of a taxpayer who purchases and places into service a piece of machinery and a building, each for $100,000, but this time in 2015. For pedagogical reasons, assume that both the machinery and the building each have a ten-year useful life, neither the mid-year nor mid-month conventions apply, the taxpayer elects to use the straight-line depreciation method for the machinery,[62] and, in accordance with the Code, uses the straight-line method for the building.[63]

The following table illustrates the taxpayer's depreciation deductions for each asset as well as each asset's adjusted tax basis at year's end:

Year	Depreciation	Adjusted Tax Basis
2015	$10,000	$90,000
2016	10,000	80,000
2017	10,000	70,000
2018	10,000	60,000
2019	10,000	$50,000
Total	$50,000	

Suppose that at the end of 2019 the taxpayer sells both the machinery and the building for $100,000. The resulting gains would be as follows:

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[60] Pub. L. No. 105–34, § 31, 111 Stat. 831, 833 (codified at I.R.C. § 1(h) (2000)).
[61] I.R.C. § 1(h)(1)(E) (2012).
[62] *Id.* § 1250(b)(5); Treas. Reg. § 1.1250-2(b)(3) (2015).
[63] Treas. Reg. § 1.1250-2(b)(3).

	Section 1245	Section 1250
Property	Machine	Building
Amount Realized	$100,000	$100,000
Less Adjusted Basis ($100,000 cost less $50,000 depreciation)	(50,000)	(50,000)
Gain	$50,000	$50,000

While the gains associated with the sale of both pieces of property are equivalent (i.e., $50,000 gain recognized), the character of these gains yields substantial advantages for the real estate investment. The following chart highlights these differences:

	Section 1245	Section 1250
Property	Machine	Building
Recapture Income	$50,000	$0
Unrecaptured Income	$0	$50,000

Assuming that the ordinary income tax rate is 40%, the capital gains tax rate is 20%, and the unrecaptured § 1250 tax rate is 25%, the tax outcomes, as reflected in the chart below, are vastly different.

	Section 1245	Section 1250
Property	Machine	Building
Tax on Recapture Income	$20,000	$0
Tax on Unrecaptured Income	-0-	12,500
Total Tax	$20,000	$12,500

In percentage terms, the overall tax burden that befalls the machinery is 60%[64] higher than the tax burden that befalls the sale of the building even though the taxpayer is in exactly the same economic position with respect to each acquisition.

In Part III, we examine whether Congress's theoretical foundation in establishing § 1250 was on solid footing when it distinguished between personal property and real property and, moreover, whether the implementation of those provisions was correctly handled.

III. ANALYSIS OF § 1250

In deciding whether § 1250 merits retention, we analyze this question from several different vantage points. First, in Part III.A, we argue that § 1250 subverts both the tax benefit rule and the duty of consistency.

[64] ($20,000 – $12,500) / $12,500.

Second, in Part III.B, we assert that there are insufficient differences between personal property and real property to justify dramatically different tax outcomes inuring to each. Finally, in Part III.C, we demonstrate that § 1250, in its present form, produces inequitable outcomes, discriminating in favor of those taxpayers who are in the highest tax brackets.

A. *Section 1250 Subverts Both the Tax Benefit Rule and the Duty of Consistency*

Neither the tax benefit rule nor the duty of consistency is codified. They are instead founded on equitable principles and have been carefully assembled and refined by judges over the long history of the federal income tax. In the two parts below, we explore how § 1250 subverts them.

1. *Section 1250 Contravenes the Tax Benefit Rule*

The tax benefit rule is an amalgamation of numerous court cases.[65] Succinctly put, it posits that if taxpayers obtain a tax benefit in one tax year based on facts as known in that year, but find in a subsequent year that further developments are fundamentally inconsistent with allowance of the earlier tax benefit, then in that subsequent year a corrective inclusion in income must be made to offset the earlier benefit.[66] For close to a century, this rule has been an integral part of the Code's fabric,[67] seeking to ensure equity. The IRS has invoked the tax benefit rule in a wide range of applications, attesting to its broad applicability.[68]

A simple example will illustrate how the tax benefit rule applies. Suppose in Year 1 that Taxpayer A, which is in the banking business, loans $100,000 to Taxpayer B. The loan is for a ten-year period, interest payments are due annually, and the principal is to be paid entirely at the

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[65] *See* Wm. D. Elliott, *The Tax Benefit Rule: A Common Law of Recapture*, 39 SW. L.J. 845, 857 (1985) (stating that more recent interpretations of the tax benefit rule give the IRS more power than did previous interpretations); William T. Plumb, Jr., *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 132–33 (1943) (discussing the rule's historic development); Charles W. Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX L. REV. 329, 329–30 (1948) (noting that the Supreme Court narrowly construed the tax benefit rule in the early twentieth century).

[66] Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 381–82 (1983) (outlining the most recent comprehensive elaboration of the tax benefit rule by the Supreme Court); *see also* Boris I. Bittker & Stephen B. Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 267–71 (1978) (explaining that to accurately reflect income, taxpayers must make adjustments during the year of the recovery if it is found that the earlier deduction was unnecessary).

[67] Treas. Reg. 62, art. 51 (1922) (noting that the collection of previously written-off debt must be included in income); Treas. Reg. 33, art. 125 (1914) (same).

[68] *See, e.g.*, *Hillsboro*, 460 U.S. at 402 (stating that Congress intended that the same construction of the tax benefit rule apply in various contexts); Thomas J. Mahoney, Jr., Note, *The Tax Benefit Rule After Hillsboro*, 37 CASE W. RES. L. REV. 362, 377–82 (1986) (detailing the various contexts in which the tax benefit rule may be applicable).

maturity of the loan, without amortization. There is, however, an acceleration clause that calls for repayment of the principal in the event of default on the obligation to pay interest. In Year 3, Taxpayer B defaults on his interest payment. This triggers the acceleration clause, on which the debtor also defaults. After failing to collect the note's principal in Year 4, Taxpayer A takes a $100,000 business bad debt deduction. But if in any subsequent year Taxpayer B experiences a reversal of fortune and repays his debt to Taxpayer A, Taxpayer A must, pursuant to the tax benefit rule, treat Taxpayer B's repayment as income in the year of repayment, in the same amount and character as it had deducted—in this case, $100,000 of ordinary income.

It can be readily seen that, in the absence of statutory direction to the contrary, the tax benefit rule might well apply to depreciable asset deductions. In Year 1, Taxpayer A places a $100,000 asset into service in his trade or business and begins to take $10,000 annual depreciation deductions; these deductions offset Taxpayer A's taxable income, thereby producing a bona fide tax benefit. Ten years and $100,000 of depreciation deductions later, Taxpayer A is nevertheless able to sell this asset for $100,000, producing a $100,000 gain (i.e., $100,000 – $0). In retrospect, assuming depreciation deductions are supposed to reflect an asset's decline in value,[69] the depreciation deductions appear to have been unwarranted (akin to reporting the bad debt deduction in the prior example). A straightforward application of the tax benefit rule in this context would require that Taxpayer A report the sale proceeds in the same amount and character as he had deducted—to wit, $100,000 of ordinary income.

However, that approach was not generally sought by the IRS in litigation prior to the enactment of § 1250; and, following enactment, that approach could be said to be foreclosed by the provision of contrary statutory rules for handling the sale of depreciated assets. In conjunction with § 1016, § 1001 yields the appropriate *amount* of gain ($100,000) but does not preserve the appropriate *character* of that gain. Instead, the prior depreciation deductions are categorized as § 1231 gains, subject to a 25% preferential capital gains tax rate, approximately 37% less than the potential 39.6% tax rate applicable to ordinary income. The tax benefits that the taxpayer obtained, which are subsequently revealed to have been

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[69] Admittedly, over the last several decades, depreciation deductions, particularly those of an accelerated nature, have served other agendas such as spurring economic growth. See Simon v. Comm'r, 68 F.3d 41, 44–45 (2d Cir. 1995), for an alternative application. But depreciation schedules nevertheless remain calibrated to reflect an asset's decline in value. *See, e.g.*, Clinger v. Comm'r, 60 T.C.M. (CCH) 598, 600 (1990) ("[W]here respondent has determined that a taxpayer's assets have no determinable useful life and consequently are not depreciable, petitioner must establish that an asset used in a trade or business has a determinable useful life and prove the class of recovery property to which it is assigned.").

excessive, are only partially offset by the § 1250 gain.[70]

2. *Section 1250 Violates the Duty of Consistency*

The tax benefit rule shares close kinship with the duty of consistency, which likewise is not codified and which also has deep equitable roots. Succinctly stated, this duty declares that a taxpayer cannot take a position one year on a tax return and, after the statute of limitations has lapsed with respect to it, take an inconsistent position on a later tax return.[71] For many decades, the duty of consistency has been judicially sanctioned[72] and applied in a variety of situations.[73]

Cogent articulations of the duty of consistency are found in *McMillan v. United States*[74] and *Beltzer v. United States*.[75] These two court decisions posit three conditions that, if met, prevent taxpayers from taking a tax position in a subsequent tax year that is inconsistent with reporting for a previous tax year.

These three conditions are as follows:

1. The taxpayer has made a representation of fact or reported an item for tax purposes in one tax year.
2. The Service has acquiesced to or relied on that fact for that year.
3. The taxpayer desires to change the representation made in a later tax year after the first year has been closed by the statute of limitations.[76]

The duty of consistency may apply even when the subsequent inconsistent reporting is made by a different party with an interest in the same transaction or representation. In *Hess v. United States*,[77] for example, a decedent's executor submitted a federal estate tax return that reported the putative value of several of the estate's assets; presumably to minimize the

[70] H.R. REP. NO. 88-749, at 102–03 (1963).

[71] *See* Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 291 (1995) (listing three elements of taxpayer duty of consistency); Steve R. Johnson, *The Taxpayer's Duty of Consistency*, 46 TAX L. REV. 537, 549 (1991) (same).

[72] In past years, some courts have mistakenly labeled the duty of consistency "estoppel," *see, e.g.*, Joyce v. Gentsch, 141 F.2d 891, 896 (6th Cir. 1944), or "quasi-estoppel," *see, e.g.*, Cattle Co. v. United States, 79-1 U.S.T.C. (CCH) 86,616 (N.D. Tex. 1979).

[73] *See* Johnson, *supra* note 71, at 537 ("A hallmark of the duty is flexibility. It has been applied to prevent taxpayers from taking inconsistent positions in order to exclude from all tax periods income that clearly is taxable in some period, deduct the same expense in two or more periods, improperly inflate the basis of an asset, convert one type of income into a different, tax-favored type and profit from other sorts of tax abuses." (citations omitted)).

[74] 64-2 U.S.T.C. (CCH) 93,836 (S.D. W. Va. 1964).

[75] 495 F.2d 211 (8th Cir. 1974).

[76] *See McMillan*, 64-2 U.S.T.C. at 93,838–40.

[77] 537 F.2d 457 (Ct. Cl. 1976).

amount of the estate tax due, the executor of the decedent's estate chose to report the lowest defensible fair market value of these assets.[78] For purposes of computing subsequent gains/losses, however, these reported values had the effect of establishing the tax basis of these assets.[79] After the statute of limitations closed with respect to the decedent's estate tax return, one of the estate's beneficiaries claimed that the estate had undervalued one of the decedent's assets and that a higher value—yielding a higher basis in that beneficiary's hands—should have been reported. That higher value would have produced a larger estate tax, of course, but by the time of the sale of the asset by the beneficiary, the estate was closed and the statute of limitations for reopening it had long passed. In analyzing the legitimacy of the taxpayer's position, the Federal Claims Court held that because all three conditions of the duty of consistency were met,[80] the estate's beneficiary was bound by the tax return position reported by the estate's executor.

The duty of consistency could arguably apply to depreciable asset deductions in the following manner: in Year 1, Taxpayer A places a $100,000 asset into service in his trade or business and begins to take $10,000 annual depreciation deductions, thereby reducing both his taxable income[81] and the asset's tax basis.[82] Ten years and $100,000 of depreciation deductions later, the asset's tax basis would have been reduced to $0. Suppose, however, that Taxpayer A is nevertheless able to sell this asset for $100,000, producing a $100,000 gain (i.e., $100,000 – $0). Because depreciation deductions are intended to reflect an asset's decline in value,[83] the depreciation deductions appear to have been wholly unwarranted and the asset's tax basis should have remained unchanged. Because the statute of limitations is closed in the early years of asset ownership,[84] however, it would be impossible for the IRS to demand upward income adjustments for all of the asset ownership years in question.

In this situation, all three conditions for the duty of consistency are

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[78] *Id.* at 459–61; *see also* I.R.C. § 2031(a) (2012) ("The value of the gross estate of the decedent shall be determined by . . . the value at the time of his death of all property, real or personal, tangible or intangible . . . .").

[79] *See* I.R.C. § 1014(a) (2012) (detailing the way in which the tax basis of property acquired from a decedent is determined).

[80] *See Hess*, 537 F.2d at 463 ("First, the taxpayer must have made a representation or reported an item for tax purposes in one year; second, the Commissioner must have acquiesced or relied on that fact for that year; and third, the taxpayer must desire to change the representation, previously made, in a later year after the statute of limitations on assessment bars adjustment for the initial years.").

[81] The deduction is allowed pursuant to § 167(a), in an amount computed according to the rules of § 168(a).

[82] I.R.C. § 1016(a)(2) (2012).

[83] *See* sources cited *supra* note 2.

[84] *See* I.R.C. § 6501(a) (2012).

theoretically met:

1. The taxpayer took $10,000 of depreciation deductions, which correspondingly reduced the asset's tax basis.
2. The IRS acquiesced to this fact.
3. Ten years later (after the majority of tax years in question have been closed), the taxpayer is essentially asserting that (i) over the tenure of asset ownership, the depreciation deductions were too generous; and (ii) as a result, the asset's tax basis is too low, yielding "overstated" gain that should therefore be accorded preferential tax rate treatment.

But the duty of consistency would demand that the taxpayer live with his prior reporting choices. What this means is that since the taxpayer chose to report generous depreciation deductions that produced ordinary income tax deductions, the quid pro quo of taking these generous deductions requires that the taxpayer report any subsequent gains associated with such asset's disposition as ordinary income.

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These two prior subparts demonstrate some tension between § 1250 and the judicially crafted equity principles of the tax benefit rule and the duty of consistency. Of course, judicial tax principles, unless grounded in constitutional considerations, must yield to congressional enactments. For example, the judicially formulated assignment of income doctrine[85]—which taxes income to the service provider rather than to those taxpayers to whom he assigns it[86]—yields to §§ 351 and 721, which permit accounts receivable attributable to service income to be assigned tax free to the business entity and reported by it rather than to the actual service provider.[87] This result makes sense: Congress wants to promote business formation even if it comes at the possible expense of the assignment of income doctrine, the application of which might otherwise impede business development.

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[85] *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1930) (determining that an income tax cannot be avoided by anticipatory arrangements preventing the income to vest in the person who earned it); *see also* Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 264 (1958) (finding that the assignment of a payment right is taxable as ordinary income). For a general overview of this doctrine and its application, see Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962) and James S. Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964).

[86] Comm'r v. Culbertson, 337 U.S. 733, 739–40 (1949).

[87] *See, e.g.*, Schneer v. Comm'r, 97 T.C. 643, 657–58 (1991) (reasoning that the assignment of income doctrine must yield to the policy objectives sought to be achieved by § 721).

It must be admitted that the tax benefit rule and the duty of consistency yield to the provisions of § 1250, just as the assignment of income doctrine yields to §§ 351 and 751. In the case of § 1250, however, Congress offered no compelling case that the equitable principles embodied in the tax benefit rule and the duty of consistency be relegated or ignored. Instead, Congress unduly circumscribed the scope of § 1250 in reliance on unsubstantiated claims proffered by the real estate industry.[88]

As the next Part demonstrates, Congress not only failed to offer compelling justifications to override the tax benefit rule and the duty of consistency, but also drew false distinctions between personal property and real property in crafting the provisions of §§ 1245 and 1250.

B. *The Code's Distinction Between "Section 1245 Property" and "Section 1250 Property" Lacks Merit*

As noted previously, the Code draws a fundamental distinction between the tax treatment upon disposition of personal property (i.e., § 1245 property) and the tax treatment upon disposition of commercial and residential buildings and the structural components thereof (i.e., § 1250 property). A bit more detail on the distinctions among those categories of property will be helpful.

The Treasury Department has promulgated regulations that amplify the meaning of three salient terms: (i) *personal property*, (ii) *building*, and (iii) *structural components*. The Treasury regulations define the phrase *personal property*[89] referred to in § 1245[90] to mean "any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures)."[91] The Treasury regulations then amplify the meaning of the terms *building* and *structural components*:

> The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. . . .
>
> . . . The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as

[88] *See supra* note 34 and accompanying text (noting that members of the homebuilding industry exerted substantial efforts to influence the effect of § 1250).

[89] Treas. Reg. § 1.1245-3(b)(1) (2015) defines *personal property* as "(1) [t]angible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of 'section 38 property' for purposes of the investment credit)."

[90] I.R.C. § 1245(a)(3)(A) (2012).

[91] Treas. Reg. § 1.48-1(c) (2015).

> any permanent coverings therefor such as paneling or tiling; window and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts, plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.[92]

While these definitions are critical to help taxpayers and the IRS ascertain how to classify property for depreciation purposes,[93] they offer no compelling rationale as to why, when it comes to asset dispositions, Congress grants more favorable tax treatment to taxable gains related to one property classification than the other. All assets are subject to forces that tend to inflate their value, including but not limited to resource scarcity,[94] population growth,[95] and the monetary policy set by the U.S. Federal Reserve.[96] Simultaneously, however, there are competing forces

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[92] *Id.* § 1.48-1(e)(1), (2).

[93] For close to two decades, taxpayers and the IRS have adjudicated numerous cases over proper property classification. These battles typically arise in the following context: taxpayers purchase or construct a building and, to avoid subjecting the entire purchase price or construction costs to long-term depreciation periods (e.g., 27.5 and 39 years), they seek, through a process known as "cost segregation," to identify certain components of the building (e.g., carpeting) that are subject to shorter depreciation schedules. *See, e.g.*, AmeriSouth XXXII, Ltd. v. Comm'r, 103 T.C.M. 1324, 1325 (2012) (holding that a taxpayer could not segregate apartment fixtures, such as kitchen sinks, from the building at large, which was depreciable over 27.5 years); Hosp. Corp. of Am. v. Comm'r, 109 T.C. 21, 25 (1997) (determining that a taxpayer could not depreciate functionally or structurally related property items apart from a hospital, which was to be depreciated over thirty-nine years). Upon audit, the IRS typically challenges this process on the basis that the components that the taxpayer has identified are actual structural components of the building and thus do not qualify for shorter depreciation schedules. *See, e.g.*, Metro Nat'l Corp. v. Comm'r, 52 T.C.M. 1440, 1442 (1987) (reviewing the Commissioner's determination that outside lighting was a structural component of a medical building and could not be depreciated on a different schedule than that building).

[94] *See* Robert M. Solow, *The Economics of Resources or the Resources of Economics*, 64 AM. ECON. REV. 1, 3 (1974) (explaining the relationship between the demand for or use of a resource and its market price).

[95] *See* Edward L. Glaeser et al., *Housing Supply and Housing Bubbles,* 64 J. URB. ECON. 198, 199 (2008) (discussing the interchange between population growth and housing bubbles).

[96] *See* Ben S. Bernanke, *Deflation: Making Sure "It" Doesn't Happen Here*, FED. RES. BOARD (Nov. 21, 2002), http://www.federalreserve.gov/BoardDocs/speeches/2002/20021121/ [http://perma.cc/ZNS2-ETSN] ("Since World War II, inflation—the apparently inexorable rise in the prices of goods and services—has been the bane of central bankers."). In Treasury Department studies, the department has found that several categories of depreciable property increased in value over time. *See, e.g.*, DEPRECIATION ANALYSIS DIV., DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON THE DEPRECIATION OF FRUIT AND NUT TREES 21 (1990), http://www.treasury.gov/resource-center/tax-policy/Documents/depreci8study_fruitnuttrees.pdf [http://perma.cc/2YZR-TCHP]; DEPRECIATION ANALYSIS DIV., DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON THE DEPRECIATION OF

that act upon physical assets that tend to depress their value, such as wear and tear and technological obsolescence.[97] In most cases, these diminishing forces generally outweigh the appreciating forces, causing overall property values gradually to decline.[98]

Insofar as the foregoing proposition is concerned, it may or may not be true for real estate. Nevertheless, its veracity hardly matters for purposes of designing appropriate recapture rules. Indeed, if the value of real estate typically does *not* decline over time, that is an argument against allowing any depreciation at all, not an argument for a more generous depreciation recapture rule. Without a compelling rationale, Congress should not draw artificial distinctions among property classifications. It is true that some component of the gain on any asset sale may be related to inflation in general price levels. But if Congress deems it appropriate under such circumstances to grant nominal gains preferential tax treatment,[99] then such treatment should be universal across property classifications. Any other approach is arbitrary and distorts economic decision making.

C. *As Presently Designed, § 1250 Is Inequitable*

A generally unnoticed aspect of § 1250 is that it systematically favors high-bracket taxpayers.

An example demonstrates this point. Consider two taxpayers who invest in real estate. Taxpayer A has $1.3 million of taxable income, part of which is attributable to the sale of a building she had purchased for $4.5 million. She claimed $300,000 of depreciation during her ownership of the building and subsequently sold it for $5 million, thereby producing an $800,000 gain ($5,000,000 – $4,200,000). This $800,000 gain would have two character components: (i) $500,000 of § 1231 gain and (ii) $300,000 of § 1250 unrecaptured gain. On Schedule D of her tax return (which pertains to the computation of capital gains and losses), A would owe $100,000 of tax on the § 1231 gain ($500,000 x 20% capital gains tax rate) and $75,000 of tax on the § 1250 unrecaptured gain ($300,000 x 25%

HORSES 23–24 (1990), http://www.treasury.gov/resource-center/tax-policy/Documents/depreci8study_horses.pdf [http://perma.cc/W2F6-KZPL].

[97] *E.g.*, Liddle v. Comm'r, 103 T.C. 285, 289 (1994) (stating that the annual allocation of depreciation represents the wear and tear incurred over the year); Simon v. Comm'r, 103 T.C. 247, 253 (1994) (identifying the annual allocation for depreciation as a means of compensating for wear and tear incurred during that period).

[98] *See, e.g.*, Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. REV. 547, 547 (1999) ("A major issue under an accretion tax is how to treat depreciable assets, assets that tend to decline in value with time and use.").

[99] For one article discussing the arguments surrounding this possibility, see Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 337 (1993) ("One of the principal arguments used to support the preference is that capital gains are largely inflationary.").

§ 1250 unrecaptured tax rate). On both components of the gain, A enjoys a tax rate reduction relative to the ordinary income tax rate—namely, 39.6%[100]—that might otherwise bear upon her income.

In contrast, consider Taxpayer B, who has $30,000 of taxable income, part of which is attributable to the sale of a building she had purchased for $200,000. She claimed $15,000 of depreciation while she held this building and then sold it for $205,000, thereby producing a $20,000 gain ($205,000 – $185,000). This $20,000 gain would have two character components: (i) $5,000 of § 1231 gain and (ii) $15,000 of unrecaptured § 1250 gain. On Schedule D of her tax return, B would owe $0 of tax on the § 1231 gain ($5,000 x 0% capital gains tax rate) but $2,046 of tax on the § 1250 unrecaptured gain of $15,000 (($4,075 x 10%) + ($10,925 x 15%)).[101] This outcome produces no particular tax advantages for B because the unrecaptured § 1250 gain is not taxed at a preferential tax rate relative to the ordinary income tax rate.

The differences between the two taxpayers are the systematic result of the fact that there is a substantial spread between the otherwise applicable tax rate for high-bracket taxpayers (39.6%) and the unrecaptured § 1250 gain rate that applies to such taxpayers (25%). Lower-bracket taxpayers do not enjoy any spread at all since their applicable unrecaptured § 1250 gain rate is the same as their ordinary tax rate. The spread afforded to high-bracket taxpayers creates a tax-arbitrage opportunity that is diminished as the tax bracket of the taxpayer descends to 35%, 33%, and 28%—and finally disappears altogether for taxpayers at or below the 25% bracket.

The following table summarizes the value of the arbitrage opportunities available to taxpayers in varying marginal income tax brackets in terms of the percentage of tax savings compared to the otherwise applicable ordinary income tax rate for that taxpayer.

[100] I.R.C. § 1 (2012). This income tax rate will be imposed upon Taxpayer A no matter her filing status. *See id.* § 1(a)–(d). (listing possible income tax filing classifications and corresponding tax rates).

[101] *Id.* § 1(h)(1)(E).

Marginal Rate Bracket	Percentage Reduction in Applicable Tax Rate[102]
39.6%	36.9%
35%	28.6%
33%	24.2%
28%	10.7%
25% or below	0%

It is difficult to imagine a justification for such noxious favoritism—and, indeed, to our knowledge, none has ever been offered.

IV. REFORM OPPORTUNITIES

The case against § 1250's retention in its present state seems compelling. The situation is ripe for reform. Congress has several options at its disposal. Four possible candidates include (i) repealing § 1250 and expanding the scope of § 1245, (ii) making the § 1250 tax rate more graduated, (iii) raising the § 1250 tax rate generally, or (iv) improving depreciation rules.

A. *Repeal § 1250 and Expand the Scope of § 1245*

For the last half century, § 1245 has functioned efficiently and with little controversy. Taxpayers generally know and understand the protocol: depreciation deductions that give rise to ordinary deductions may subsequently trigger ordinary income when and if such assets are sold at a gain. This approach toward income characterization is equitable, simple, and economically nondistortive; in addition, this approach is consistent with the policy objective of eliminating the potential tax-arbitrage advantage outlined in this analysis's introduction.[103]

Given § 1245's merits, Congress should expand its application to the disposition of real property. This is not a radical reform measure. To the contrary, taxpayers are familiar with the concept of recapture and are

[102] The figures in the right column are derived in the following two-step process: first, we take the difference between the applicable marginal tax rate versus the preferential tax rate; second, we divide this difference by the otherwise applicable marginal rate. For example, in the top bracket, the applicable marginal tax rate is 39.6%, and the preferential tax rate is 25%; step one is to take the difference between these percentages, or 14.6 (39.6 – 25), and step two is to divide that difference by 39.6, which yields a rate discount of 36.9% (14.6 / 39.6).

[103] For a contrary view, see Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 48 (1979) ("In our current economy, much of the [§ 1245] gain will be attributable to inflation if the owner has held the asset for more than a few years. To tax inflationary gain at all is very close to a tax on capital, and to tax it at ordinary income rates is especially harsh.").

sometimes surprised to learn that its application does not extend to the disposition of real property. The contemplated reform would engender two Code adjustments: (i) the repeal of § 1250 and (ii) an expansion of the definition of *§ 1245 property*[104] to include commercial and residential buildings and their components. Were Congress to make these adjustments, neither it nor the IRS would have to engage in a mass education campaign; business taxpayers already know how § 1245 applies and would readily understand its expansion to include real estate.

Aside from improving equity, reducing complexity, eliminating a source of economic distortion, and curbing tax arbitrage, there is a serendipitous bonus associated with this reform approach: it can add substantial sums to the Treasury's coffers. Based upon a review of tax years 2009 to 2012, if § 1250 unrecaptured gains were taxed at the highest ordinary income tax rate (i.e., 39.6%) rather than the § 1250 unrecaptured gain tax rate (i.e., 25%), then the Treasury would stand to gain as much as $6.5 billion more annually in revenue.[105] This dollar figure is not mere pocket change; depending on political will, such additional revenue could be used to reduce taxes, diminish the deficit, and/or expand social programs.

B. *Make the § 1250 Tax Rate More Graduated*

Unrecaptured § 1250 gains are currently taxed at graduated tax rates, up to a point.[106] But at fairly low dollar thresholds (e.g., in 2014, for a single taxpayer, $36,900), the application of lower tax rates is inapplicable to § 1250 unrecaptured gains.[107] Put slightly differently, all gains earned above this fairly low dollar threshold are taxed at a flat 25% tax rate. Insofar as the tax treatment of § 1250 unrecaptured income is concerned, as an earlier example set forth in this analysis demonstrated,[108] this rate structure provides high-bracket taxpayers an undeserved arbitrage opportunity.

One possible way to ameliorate this inequity would be to make the § 1250 tax rate structure more progressive. This could be accomplished by adding new graduated tax rates to § 1250 unrecaptured gains. Of course, the ideal form of the new graduated rates would simply replicate the otherwise applicable ordinary income tax rates, in which case this solution

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[104] I.R.C. § 1245(a)(3) (2012).

[105] *See* Richard L. Schmalbeck & Jay A. Soled, *Reforming Real Estate Depreciation Recapture*, 2015 TAX NOTES TODAY 887, 889–93 (making revenue estimates associated with this reform measure that total $65 billion over a ten-year revenue-scoring period).

[106] I.R.C. § 1(h)(1)(E) (2012).

[107] *Id.*

[108] *See supra* note 85 and accompanying text (discussing the paucity of meaningful policy objectives for §§ 1245 and 1250 in comparison to other sections of the Internal Revenue Code).

would be identical to the previous suggestion. However, if Congress wished to compromise on this issue, it could select a rate structure that provided some break for unrecaptured § 1250 gain, but in a manner that provided more or less consistent percentage reductions for taxpayers in all brackets. While this reform measure would not eliminate the tax burden disparities between high- and low-income taxpayers, it would lessen the tax-arbitrage advantages that currently inure primarily to high-income taxpayers.

C. *Raise the § 1250 Tax Rate Generally*

For the past two decades, the § 1250 tax rate has remained at 25% despite the fact that the general § 1(h) capital gains tax rate was raised in 2012 from 15% to 20% for taxpayers in the highest bracket.[109] Consistent with this general capital gains tax rate increase, another option for Congress to consider is raising the § 1250 tax rate by a similar proportion, from 25% to 33%.

D. *Improve Depreciation Rules*

Of course, a fourth approach that would be highly desirable would be to adjust depreciation rules broadly so that they better tracked the actual decline in asset values over time. It would no doubt be impossible to craft depreciation rules that would accomplish this perfectly, but Congress could certainly do better than it has. Specific suggestions to that end are beyond the scope of this analysis, but it should be kept in mind that the extent of the tax-arbitrage problem inherent in § 1250 is directly related to the inaccuracy of current depreciation rules. Put differently, if real estate depreciation deductions better reflected actual losses in asset values, then the stakes involved in the recapture rules would diminish proportionately.

V. CONCLUSION

The ubiquitous use of § 1250 cannot be overstated. Millions of taxpayers own depreciable real estate, which they periodically sell or exchange, triggering § 1250's application. Despite its ubiquity, § 1250 has never achieved its purported objective of accurately recapturing excess depreciation deductions.[110] Instead, it continues to enable high-income taxpayers who invest in depreciable real estate to achieve a unique Code-sanctioned tax-arbitrage advantage.

Congress should reform this area of the law. Our strong preference,

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[109] *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313, 2318 (codified in scattered sections of 26 U.S.C.) (raising the capital gains tax rate from 15% to 20% on high-income taxpayers).

[110] Polito, *supra* note 2, at 93.

and our suggestion to Congress, is that it should eliminate § 1250 and expand the application of § 1245. Were Congress to repeal § 1250 and make the application of § 1245 universal, it would eliminate tax arbitrage related to depreciation deductions. This would produce across-the-board equitable results. Other options are available, along the lines of tinkering with the rate structure for unrecaptured § 1250 gains. However, such half-hearted measures would only reduce, but not eliminate, the inappropriate tax-arbitrage opportunities that the present rules afford to high-bracket taxpayers.

If this analysis indicates nothing else, one thing should be abundantly clear: retaining the status quo is unacceptable. A half-century is too long for Congress to allow a significant inequity to be perpetuated; waiting another fifty years to institute reforms would be truly shameful.