

TAX TREATMENT UPON DISPOSITION OF PROPERTY  
FOR WHICH A BUSINESS DEDUCTION WAS ALLOWED

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Mr. LONG, from the Committee on Finance,  
submitted the following

## REPORT

[To accompany H.R. 10936]

The Committee on Finance, to which was referred the bill (H.R. 10936) to provide for the income tax treatment of amounts received on the sale of property the cost of which was deducted as a business expense, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

## I. SUMMARY

This House-passed bill provides that where a deduction has been claimed for any part of the purchase price of property, any gain realized on the subsequent sale or exchange of that property is to be subject to recapture as ordinary income (to the extent of the amount of the deduction) in the same manner as in the case of recapture of depreciation on personal property or certain types of real property.

The committee agreed to the House-passed bill.

## II. GENERAL STATEMENT

*Present law*

Under present law (sec. 1245), gain realized upon the sale or exchange (or certain other dispositions) of section 1245 property (generally tangible personal property and certain other property subject to an allowance for depreciation or amortization) is subject to recapture as ordinary income (rather than as capital gain) to the extent of any depreciation or amortization allowed with respect to that property after December 31, 1961 (or in certain cases, later effective dates). Also, in the case of the contribution of property to charity, the deduction otherwise allowable with respect to that contribution is to be re-

duced by the amount of ordinary income which would have been realized by the taxpayer had the property been sold for its fair market value (sec. 170(e)). This has the effect of disallowing the deduction of any amounts which are subject to recapture under section 1245. However, present law does not provide that where the purchase price of property is deducted, instead of being depreciated or amortized, the amount deducted is to be subject to recapture as ordinary income if the property is later sold or otherwise disposed of at a gain.

#### *Reasons for the bill*

Under present law, as indicated above, where the cost of property is recovered through depreciation or amortization, it is generally subject to recapture as ordinary income where the property is later sold at a gain. However, there is no comparable recapture rule where the purchase price of the property is written off currently as a deductible expense. The committee sees no reason for this distinction. In both cases, the taxpayer has had the benefit of an ordinary deduction, which ought to be recaptured before any gain may be treated as capital gain. Thus, the bill provides that, where the price of property is deducted, the amount of the deduction is to be subject to recapture on the same basis as where the cost of the property is depreciated.

#### *Explanation of the bill*

Under the bill, in the case of property acquired after December 31, 1975, if the purchase price of the property was deducted as an expense (and the deduction was not disallowed), the purchase price is to be subject to recapture under section 1245. Thus, for example, if the taxpayer purchases a professional periodical which has a useful life of less than one year, and deducts the purchase price as a trade or business expense, any gain (up to the amount of the deduction) realized on the later sale of the property is to be treated as ordinary income. Also, if the property is contributed to a charitable (or religious, educational, etc.) organization, a charitable deduction is to be allowed only to the extent of the sum of (1) the remaining basis and (2) the excess of the unrealized appreciation over the trade or business deduction claimed previously.

Under the bill, the recapture rules are to apply only where the "purchase price" of property is deducted. These rules are not intended to apply, for example, to research and development expenses (allowed as a deduction under sec. 174), even though these expenses might be viewed as a "cost" of developing certain property. Also, the rules under the bill are not to apply to intangible drilling and development costs (allowed as a deduction under section 263(c)).

The bill does not change the rules as to what qualifies as a disposition, triggering a recapture. Of course, where property is used up in the taxpayer's trade or business, or is destroyed or thrown away (as trash) this is not the kind of disposition which is to result in recapture. (In any event, the fair market value of the property, for purposes of the rules of sec. 1245, would generally be zero under these circumstances.)

#### *Effective date*

This bill applies to the purchase price of property acquired after December 31, 1975, which is disposed of after the bill's enactment.

In applying the December 31, 1975, date, the test is when the property was acquired, not when the payment was made or the deduction was taken. For example, suppose a 3-year subscription to a professional periodical was entered and paid for in December 1975, the entire 3-year subscription price was deducted on the taxpayer's 1975 Federal income tax return, and no part of the deduction was disallowed. Further, assume that the subscription did not in fact begin until January 1976. In such a case, the entire deducted subscription price is to be treated as having been allowed for depreciation for purposes of the recapture rules of sec. 1245. The same result is to obtain if the subscription price is deducted in annual increments over the life of the subscription.

If the taxpayer subsequently sells some of these periodicals, then the gain (but not more than so much of the prior deduction as is properly allocable to those periodicals) is to be recaptured as ordinary income (sec. 1245(a)(1)). If the taxpayer subsequently contributes some of these periodicals to a charitable donee (e.g., the library of a tax-exempt university's professional school), then the taxpayer's charitable contribution deduction is to be reduced below fair market value by the amount that would have been recaptured if the taxpayer had sold the property for its fair market value (sec. 170(e)(1)(A)).

### III. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING H.R. 10936

#### *Revenue cost*

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 10936. The committee estimates that this bill will result in a revenue gain of about \$0.3 million the first year, \$0.7 million the second year, \$1 million the third year, rising to \$5 million per year after the 15th year. The Treasury Department agrees with this statement.

In accordance with section 403 of the Congressional Budget Act of 1974, the Director of the Congressional Budget Office has not made an estimate or comparison of the estimates of the cost of H.R. 10936, but has examined the committee's estimates and agrees with the methods and the dollar estimates resulting therefrom.

#### *Vote of the committee*

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 10936 was ordered reported by the committee by a voice vote.

#### *Tax expenditures*

With respect to the effects of the committee amendment on tax expenditures during the next five fiscal years, the following statement is made:

In accordance with section 308(a)(2) of the Congressional Budget Act of 1974, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

**IV. CHANGES IN EXISTING LAW MADE BY THE LAW**

In compliance with paragraph 4 of rule XXIX of the Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in *italic*, existing law in which no change is proposed is shown in roman) :

**INTERNAL REVENUE CODE OF 1954**

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**Subtitle A—Income Taxes**

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**CHAPTER 1—NORMAL TAXES AND SURTAXES**

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**Subchapter P—Capital Gains and Losses**

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**PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES**

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**SEC. 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY.**

(a) **GENERAL RULE.**—

(1) **ORDINARY INCOME.**—Except as otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of—

(A) the recomputed basis of the property, or

(B) (i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property, exceeds the adjusted basis of such property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) **RECOMPUTED BASIS.**—For purposes of this section, the term “recommended basis” means—

(A) with respect to any property referred to in paragraph

(3) (A) or (B), its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961,

(B) with respect to any property referred to in paragraph (3) (C), its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after June 30, 1963.

(C) with respect to livestock, its adjusted basis recomputed by adding thereto all adjustments attributable to periods after December 31, 1969, or

(D) with respect to any property referred to in paragraph (3) (D), its adjusted basis recomputed by adding thereto all adjustments attributable to periods beginning with the first month for which a deduction for amortization is allowed under section 169 or 185.

reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168, 169, 184, 185, 187, or 188. For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation, or for amortization under section 168, 169, 184, 185, 187, or 188, for any period was less than the amount allowable, the amount added for such period shall be the amount allowed. *For purposes of this section, if any portion of the purchase price of property acquired after December 31, 1975, was deducted as an expense and the deduction was not disallowed the amount so allowed as a deduction shall be treated as allowed for depreciation.*

(3) SECTION 1245 PROPERTY.—For purposes of this section, the term “section 1245 property” means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 (or subject to the allowance of amortization provided in section 185) and is either—

(A) personal property,

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) an elevator or an escalator, or

(D) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 185, or 188.

(b) EXCEPTIONS AND LIMITATIONS.—

(1) GIFTS.—Subsection (a) shall not apply to a disposition by gift.

(2) **TRANSFERS AT DEATH.**—Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

(3) **CERTAIN TAX-FREE TRANSACTIONS.**—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). Except as provided in paragraph (7), this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(4) **LIKE KIND EXCHANGES; INVOLUNTARY CONVERSIONS, ETC.**—If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of—

(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

(5) **SECTION 1071 AND 1081 TRANSACTIONS.**—Under regulations prescribed by the Secretary or his delegate, rules consistent with paragraphs (3) and (4) of this subsection shall apply in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to exchanges in obedience to SEC orders).

(6) **PROPERTY DISTRIBUTED BY A PARTNERSHIP TO A PARTNER.**—

(A) **IN GENERAL.**—For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) **ADJUSTMENTS ADDED BACK.**—In the case of any property described in subparagraph (A), for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

(ii) the amount of such gain to which section 751(b) applied.

(7) **TRANSFERS TO TAX-EXEMPT ORGANIZATION WHERE PROPERTY WILL BE USED IN UNRELATED BUSINESS.**—

(A) **IN GENERAL.**—The second sentence of paragraph (3) shall not apply to a disposition of section 1245 property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses

such property in an unrelated trade or business (as defined in section 513).

(B) **LATER CHANGE IN USE.**—If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

(c) **ADJUSTMENTS TO BASIS.**—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

(d) **APPLICATION OF SECTION.**—This section shall apply notwithstanding any other provision of this subtitle.

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