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# CAPITAL EXPENDITURES: A RESULT IN SEARCH OF A RATIONALE

John W. Lee\*

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## I. INTRODUCTION

A business may reduce its gross income by its expenses to arrive at taxable income;<sup>1</sup> however, not all money paid out by a business during its tax year is deductible in that year. The distinction between business expenses which are deductible under section 162<sup>2</sup> and capital expenditures which are not currently deductible under section 263<sup>3</sup> is probably the most difficult one to discern in the entire area of business deductions,<sup>4</sup> principally because so many disparate elements are encompassed within the capital expenditure doctrine.

Capital expenditures, defined as amounts paid for new buildings or for permanent improvements or betterments made to increase the value of property,<sup>5</sup> are not currently deductible, a rule designed primarily to ensure the proper matching of income and

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1. I.R.C. § 162. Citations unless otherwise noted are to the Int. Rev. Code of 1954 as amended.

2. *Id.*

3. I.R.C. § 263.

4. *See, e.g.,* Boagni v. Commissioner, 59 T.C. 708, 712 (1973).

5. Estate of Meade v. Commissioner, 489 F.2d 161, 164 n.7 (5th Cir. 1974); General Bancshares Corp. v. Commissioner, 326 F.2d 712, 716 (8th Cir. 1964); Boagni v. Commissioner, 59 T.C. at 711-12. *See generally* Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset*, 15 B. C. INDUS. & COM. L. REV. 443, 448-51 (1974) [hereinafter cited as Gunn].

expenses.<sup>6</sup> As the Supreme Court has explained, section 263 "serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."<sup>7</sup>

Accordingly, the issue in most capital expenditure cases is one of timing. Instead of obtaining a current deduction for the cost under section 162,<sup>8</sup> the taxpayer might be required to amortize or depreciate the cost over the useful life of the acquired or created asset so that an allocable part of the cost of the asset qualifies as an expense in each year of its business use.<sup>9</sup> Timing is important because immediate reduction in tax liability given by a current deduction is of greater value than a deferred deduction.<sup>10</sup> Cases involving the timing issue generally define a capital expenditure as one which creates or enhances a capital asset.<sup>11</sup>

The capital expenditure doctrine encompasses not only the timing of the deduction, but also considers the character and amount of income or loss realized in a transaction. This aspect of the doctrine attempts to prevent a double tax benefit: a capital gains deduction against an unreduced gain coupled with an ordinary deduction for the expenditure.<sup>12</sup> The clearest example of this element of the doctrine is the tax treatment of the costs of selling a capital asset. Such costs cannot generate an ordinary business expense deduction; rather they must be treated as a capital expenditure, either increasing basis or offsetting the sale proceeds, and thereby reducing the gain from the sale of the asset.<sup>13</sup> The rationale for this rule is that "all expenses which stem from a capital transaction should be 'matched', or equated, with all gains from the same capi-

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6. *Sharples v. United States*, 533 F.2d 550, 555 (Ct. Cl. 1976).

7. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

8. I.R.C. § 162. Section 212 might also permit a current deduction for any expenses connected with the production of income. I.R.C. § 212.

9. I.R.C. § 167.

10. "This deferral is the equivalent of an interest-free loan from the government, the economic benefits of which can be very significant." STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, *TAX SHELTERS* 6 (1976).

11. *See, e.g., Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

12. *Sharples v. United States*, 533 F.2d at 555; *see Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373 (Ct. Cl. 1960).

13. *Spreckels v. Commissioner*, 315 U.S. 626 (1942); *accord, Ward v. Commissioner*, 224 F.2d 547 (9th Cir. 1955).

tal transaction and the expenses should receive identical tax treatment as the gains."<sup>14</sup> This element of capital expenditures is alternatively described as the "origin-of-the-claim" doctrine<sup>15</sup> or the "tax benefit rule."<sup>16</sup>

The capital expenditure doctrine also extends to the tax treatment of the costs of organizing or reorganizing a corporation or a partnership. Courts frequently explain the required capitalization of these costs by viewing the formal structure of an entity as an intangible capital asset under the theory that a capital asset has been created.<sup>17</sup> Mandatory capitalization in these cases can be better explained by the tax benefit rule.<sup>18</sup>

The principle that expenses should be matched against income, *i.e.*, the clear reflection of income principle, sometimes allows the current deduction of an ostensibly capital expenditure.<sup>19</sup> Some of the repair-improvement cases as well as the minimum expense rule illustrate this principle.<sup>20</sup>

## II. CREATION OR ENHANCEMENT OF AN ASSET

Early cases frequently required capitalization whenever the benefits of the expenditure lasted longer than the taxpayer's yearly accounting period;<sup>21</sup> consequently, the classic definition of capital expenditure is a cost securing an advantage to the taxpayer which has a life of more than one year.<sup>22</sup> Conversely, where a necessary

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14. *Sharples v. United States*, 533 F.2d at 555.

15. *Id.*; *accord*, *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974).

16. *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976); *Dynamics Corp. of America v. United States*, 449 F.2d 402, 412 (Ct. Cl. 1971). *See generally* *Gunn, supra* note 5, at 449 n.29.

17. *See, e.g.*, *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir. 1964).

18. *See* text accompanying notes 141-83 *infra*. *See generally* *Gunn, supra* note 5, at 449 n.29.

19. *See* *Cincinnati, N. O. & Tex. Pac. Ry. Co. v. United States*, 424 F.2d 563, 572-73 (Ct. Cl. 1970); *Sharon v. Commissioner*, 66 T.C. 515 (1976).

20. *See* text accompanying notes 275-362 *infra*. *See also* *Gunn, supra* note 5, at 457-61.

21. *W. B. Harbeson Lumber Co. v. Commissioner*, 24 B.T.A. 542, 550 (1931); *Georgia Car & Locomotive Co. v. Commissioner*, 2 B.T.A. 986, 990 (1925); *Strauss Market, Inc. v. Commissioner*, 2 B.T.A. 1264 (1925). *See generally* *Note, Income Tax Accounting: Business Expense or Capital Outlay*, 47 HARV. L. REV. 669 (1934).

22. *United States v. Akin*, 248 F.2d 742, 744 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958); *accord*, *Fall River Gas Appliance Co. v. Commissioner*, 349 F.2d 515 (1st Cir. 1965).

business expenditure might otherwise be considered capital, a deduction has been allowed where the useful life of the property was less than one year.<sup>23</sup> More recently, however, the courts have analyzed the one-year rule of thumb as "intended to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year."<sup>24</sup>

The Supreme Court in *Commissioner v. Lincoln Savings & Loan Association*,<sup>25</sup> held that "the presence of an ensuing benefit that may have some future aspect is not controlling [as to whether an expenditure is capital or an ordinary business expense]: many expenses concededly deductible have prospective effect beyond the taxable year."<sup>26</sup> The Supreme Court enunciated the capital expenditure test as whether the payment served to create or enhance for the taxpayer "what is essentially a separate and distinct additional asset."<sup>27</sup> Such a payment is regarded as capital in nature and not even an expense, let alone an ordinary expense that would generally be deductible under section 162(a). Some subsequent decisions, notably that of the Second Circuit in *Briarcliff Candy Corp.*

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23. *Helvering v. Kansas City Am. Ass'n Baseball*, 75 F.2d 600, 604 (8th Cir. 1935); *Morris Nachman v. Commissioner*, 12 T.C. 1204, 1207 n.1 (1949), *aff'd*, 191 F.2d 934 (1951); *J.E. Mergott Co. v. Commissioner*, 11 T.C. 47, 50 (1948); *Pittsburgh Athletic Co. v. Commissioner*, 27 B.T.A. 1074, 1078 (1933), *aff'd*, 72 F.2d 883 (3d Cir. 1934); *W. B. Harbeson Lumber Co. v. Commissioner*, 24 B.T.A. at 550. *See* *Treas. Reg. § 1.263(a)-2(a)* (1958).

24. *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968); *accord*, *Sears Oil Co. v. Commissioner*, 359 F.2d 191 (2d Cir. 1966).

25. 403 U.S. 345.

26. *Id.* at 354.

27. *Id.* In *Lincoln Savings & Loan*, the taxpayer was required to pay an "additional premium" to the Federal Savings & Loan Insurance Corporation (FSLIC) by the National Housing Act § 404(d). This payment was to be made into a "Secondary Reserve" which was, in the words of the court, "available only for stated and circumscribed purposes." *Id.* at 355. The Commissioner allowed the taxpayer to deduct the premium paid into the "Primary Reserve" but disallowed it as to the § 404(d) payment. The Commissioner was upheld in the Tax Court, 51 T.C. 82 (1968), but the Ninth Circuit reversed, 422 F.2d 90 (9th Cir. 1970). The Supreme Court reversed the Ninth Circuit stating:

What is important and controlling, we feel, is that the § 404(d) payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense. . . .

403 U.S. at 354.

*v. Commissioner*,<sup>28</sup> have read *Lincoln Savings & Loan* as effectuating a radical shift in emphasis: directing the inquiry away from whether the benefit of the expenditure extended beyond the yearly tax accounting period, rather focusing upon whether it created or enhanced an essentially separate and distinct additional asset.<sup>29</sup> Moreover, the one-year rule of thumb had already been severely eroded. In *Van Iderstine Co. v. Commissioner*,<sup>30</sup> the Second Circuit had previously held that even expenditures of possible economic value beyond the tax year were currently deductible so long as they did not create distinct property rights: "a 'capital expenditure' . . . [must result] in the acquisition of 'capital,' *i.e.*, an addition to the payer's taxable wealth."<sup>31</sup> Other circuit courts followed the *Lincoln Savings & Loan* approach, allowing a current deduction for expenditures that generated future economic benefits if they did not result in the acquisition of, or improvement to, a distinct and recognizable property interest. For example, the Tenth Circuit, which had earlier adopted the one-year rule,<sup>32</sup> held in *Colorado Springs National Bank v. United States*<sup>33</sup> that start-up ex-

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28. 475 F.2d 775 (2d Cir. 1973).

29. *Id.* at 782. *Briarcliff* involved a retail candy company which sought to deduct the expenses of creating a wholesale "franchise division" by selling to "sales agents" such as drug stores. The Tax Court held against the taxpayer solely because the benefit of the franchise contracts would extend beyond the tax year. 31 T.C.M. 171 (1972). The circuit court reversed, applying the *Lincoln Savings & Loan* additional asset test and stating that "[t]he meagerness of [the taxpayer's] rights under these contracts made them only marginally enforceable." 475 F.2d at 786 n.5. *But see* Florida Publishing Co. v. Commissioner, 64 T.C. 269, 272 (1975), *aff'd in unpub. opinion*, (5th Cir. Apr. 26, 1977) where the Tax Court stated, "*Commissioner v. Lincoln Savings & Loan Ass'n* . . . did not redefine or otherwise alter the previously discussed, well-settled rules for determining whether an expenditure must be deducted or capitalized." 64 T.C. at 282. The Tax Court, in so holding, relied upon *United States v. Mississippi Chem. Corp.*, 405 U.S. 298 (1972), in which the taxpayer was required to buy stock in the farm credit system in proportion to interest on its loans. The stock was totally unmarketable because it paid no dividends, it was not freely transferable, and ownership bore no relation to voting power. The taxpayer sought to deduct the cost of the stock as interest expense. In rejecting this argument, the Supreme Court stated, "Since the security is of value in more than one taxable year, it is a capital asset within the meaning of § 1221 of the Internal Revenue Code, and its cost is nondeductible." 405 U.S. at 310. Although written one year after *Lincoln Savings & Loan*, the Court cited but did not discuss that case.

30. 261 F.2d 211 (2d Cir. 1958).

31. *Id.* at 213.

32. *See* Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950).

33. 505 F.2d 1185 (10th Cir. 1974). *Colorado Springs National Bank* sought to deduct costs incurred by participating in a then new charge card system, Master Charge. The start-

penditures enabling the taxpayer to modify an existing business are currently deductible.

The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable. They are recurring. At the most they introduced a more efficient method of conducting an old business. The government suggests no way in which they could be amortized. The government's theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.<sup>34</sup>

More recent cases in the Fourth, Eighth and Ninth Circuits have clarified the *Lincoln Savings & Loan* standard and its relation to the one-year rule. In *First National Bank of South Carolina v. United States*,<sup>35</sup> the Fourth Circuit adopted the reasoning of the Tenth Circuit in *Colorado Springs*, noting that the two cases were "indistinguishable."<sup>36</sup> Later, in *Jack's Cookie Co. v. Commissioner*,<sup>37</sup> the Fourth Circuit explained its view. In this case, the taxpayer claimed a business expense deduction for amounts paid under a lease on a building financed by industrial revenue bonds. The Internal Revenue Service disallowed the deduction as to the amounts allocated to a mandatory reserve because this fund was not used to satisfy bond obligations during the tax year. The taxpayer argued that the reserve amounts were rent in effect, since the reserve was required by the terms of its lease. Furthermore,

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up costs included computer costs, credit checks, and promotional activities. The government argued that these were preoperation expenses of entering a new business and should therefore be capitalized. Although the trial court found as a fact that Master Charge was a "new type of business . . . not just an extension of the lending field," the court held for the bank. *Id.* at 1189. The government appealed the adverse result based on that inconsistency, but the Tenth Circuit affirmed, relying on *Lincoln Savings & Loan* and *Briarcliff*.

34. 505 F.2d at 1192. The Tax Court, as well, adopted this approach. *First Security Bank of Idaho, N.A. v. Commissioner*, 63 T.C. 644, 650-51 (1975), *aff'd*, 592 F.2d 1050, 1052 (9th Cir. 1979); *Iowa-Des Moines Nat'l Bank v. Commissioner*, 68 T.C. 872 (1977), *aff'd*, 592 F.2d 433 (8th Cir. 1979); *accord*, *First Nat'l Bank of South Carolina v. United States*, 558 F.2d 721 (4th Cir. 1977) *per curiam*; *Jack's Cookie Co. v. Commissioner*, 597 F.2d 395 (4th Cir. 1979).

35. 558 F.2d 721 (4th Cir. 1977).

36. *Id.* at 723.

37. 597 F.2d 395 (4th Cir. 1979).

relying on *First National Bank*, the taxpayer argued that the mere fact of the reserve's future economic benefit did not require its capitalization. The court held against the taxpayer, stating, "In our opinion, *First [National] Bank* did not abrogate the rule followed in our prior decisions, but merely refined and made explicit certain limitations which have always been inherent in its application."<sup>38</sup> The court further explained:

[U]nless an expenditure which would otherwise be treated as a section 162(a) business expense results in benefits which are not realized and exhausted within the taxable year, its capitalization would be inappropriate in any event. . . . The one-year rule is useful because it serves to segregate from all business costs those which cannot possibly be considered capital in nature because of their transitory utility to the taxpayer. The rule, however, cannot be applied inexorably in the other direction. . . .

It is apparent that the "separate assets" test of *Lincoln Savings & Loan* . . . necessarily incorporates the one-year rule and that in order to warrant capitalization of an expense, one integral characteristic of the "separate and distinct asset" which is "created or enhanced" by the outlay, is that it will serve the taxpayer in subsequent years.<sup>39</sup>

Similarly, in *Iowa-Des Moines National Bank v. Commissioner*,<sup>40</sup> the Tax Court stated:

Generally, expenditures to acquire assets or secure benefits which last beyond the taxable year must be capitalized. Nevertheless, the mere presence of some possible future benefit from an expenditure is not controlling where such payment was made to promote the taxpayer's existing business and does not create or enhance a separate and distinct asset or property interest.<sup>41</sup>

On appeal, the Eighth Circuit cited *Colorado Springs* and *Lincoln Savings & Loan* in affirming the decision as well as the analysis of

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38. *Id.* at 403.

39. *Id.* at 405.

40. 68 T.C. 872 (1977).

41. *Id.* at 878-89 (citing *Lincoln Savings & Loan*, *Mississippi Chem. Corp.*, *Florida Publishing Co.*, *Briarcliff Candy*, *Colorado Springs Nat'l Bank*, and *First Security Bank of Idaho*, N.A.).



the Tax Court.<sup>42</sup> In *First Security Bank of Idaho, N.A. v. Commissioner*,<sup>43</sup> the Ninth Circuit was faced with a similar fact situation and "adopted" *Colorado Springs* as the law of the Ninth Circuit, citing *First National Bank* and *Iowa-Des Moines Bank* with explicit approval.<sup>44</sup> The court noted that "nothing in *Lincoln Savings & Loan* . . . is contrary to these decisions."<sup>45</sup> Perhaps the most concise formulation of the synthesis of *Lincoln Savings & Loan* and the one-year rule is Judge Wiles' opinion for the Tax Court in *Nagy v. Commissioner*.<sup>46</sup> "The controlling issue is whether the expenditure serves to create or enhance a separate and distinct asset which lasts beyond the end of the taxable year."<sup>47</sup>

Accordingly, the test under this aspect of the capital expenditure doctrine has two elements, *viz.*, whether the expenditure creates or enhances a separate asset and whether this asset benefits the taxpayer in future years. The acquisition of a separate capital asset can be seen clearly where the taxpayer purchases a new business.<sup>48</sup> Moreover, payment of obligations assumed in connection with a purchase of an existing business, which might otherwise be deductible, are capital expenditures if an integral part of the acquisition.<sup>49</sup> Under this analysis, shareholders who acquired corporate assets in a liquidation and then made pension payments to employees of the dissolved corporation were required to treat the payments as part of their acquisition costs for the assets.<sup>50</sup> Likewise, royalties paid by a taxpayer in settlement of a claim against its predecessor whose assets it acquired had to be capitalized.<sup>51</sup> As the

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42. 592 F.2d 433 (8th Cir. 1979). The case involved the costs of instituting a bank credit card system similar to that involved in *Colorado Springs*.

43. 592 F.2d 1050 (9th Cir. 1979), *aff'g* 63 T.C. 644 (1975).

44. 592 F.2d at 1052.

45. *Id.*

46. 37 T.C.M. 1326 (1978).

47. *Id.* at 1328.

48. *See, e.g.*, *Vermont Transit Co. v. Commissioner*, 218 F.2d 468 (2d Cir. 1955), *cert. denied*, 349 U.S. 945 (1955); *Sevremes v. United States*, 209 F. Supp. 837 (W.D. Ky. 1962); *Hudgins v. Commissioner*, 55 T.C. 534, 538 (1970).

49. *See, e.g.*, *United States v. Smith*, 418 F.2d 589, 596 (5th Cir. 1969); *W. D. Haden Co. v. Commissioner*, 165 F.2d 588, 591 (5th Cir. 1948); *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323, 324 (8th Cir. 1946); *Caldwell & Co. v. Commissioner*, 26 B.T.A. 790, 793 (1932).

50. Rev. Rul. 59-228, 1959-2 C.B. 59.

51. *Watab Paper Co. v. Commissioner*, 27 B.T.A. 488, 505-06 (1932).

Tax Court pointed out in *M. Buten & Sons, Inc. v. Commissioner*,<sup>52</sup> an expenditure accrued by a former owner but paid by the new owner constitutes a part of his cost of acquisition regardless of what would have been the tax character of the expenditure as to the former owner. The cost of installing or acquiring distinct assets used in the taxpayer's business just as clearly is encompassed within the "acquisition of capital asset" rule.<sup>53</sup> Of course, acquisition also includes self-construction of capital assets, such as buildings and driveways.<sup>54</sup> Premiums or overtime paid or incurred solely to expedite capital construction also must be capitalized.<sup>55</sup>

Several significant decisions have allowed a current deduction for expenditures that would produce benefits in future tax years but that did not enhance or create a separate and distinct additional asset. In *Briarcliff Candy Corp. v. Commissioner*,<sup>56</sup> the taxpayer incurred substantial costs in developing suburban markets for its products by contracting with local proprietors to display its goods. The Second Circuit described these expenditures as intangible contributions to intangible assets — advertising designed to increase distribution — and ruled that they were currently deductible. Not dissimilarly, in *Colorado Springs National Bank v. United States*,<sup>57</sup> the Tenth Circuit held that start-up costs (con-

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52. 31 T.C.M. 178, 181 (1972).

53. *Biggs v. Commissioner*, 27 T.C.M. 1177 (1968), *aff'd*, 440 F.2d 1 (6th Cir. 1971) (typewriter capital expenditure); *Pessin v. Commissioner*, 44 T.C. 590, 597 (1965) (purchase of colt); *Southern Ford Tractor Corp. v. Commissioner*, 29 T.C. 833 (1958) (purchase of sprinkler system); Rev. Rul. 70-26, 1970-1 C.B. 55 (purchase of title files).

54. *Jones v. Commissioner*, 25 T.C. 1100 (1956), *rev'd on other grounds*, 259 F.2d 300 (5th Cir. 1958) (construction of concrete driveway); *Boardman Coal Mining Co. v. Commissioner*, 18 B.T.A. 160 (1929) (purchase of miners' houses and mining equipment). See *Coors v. Commissioner*, 60 T.C. 368 (1973) (internal construction of production facilities), *acq.* 1974 - 2 C.B. 2.

55. *W. B. Brown & Sons Lumber Co. v. Commissioner*, 26 B.T.A. 1192, 1199-1200 (1932); *Buedingen v. Commissioner*, 6 B.T.A. 335, 338 (1927); Rev. Rul. 70-332, 1970-1 C.B. 31. The early Third Circuit cases were erroneous in allowing a current deduction for the cost of expediting construction, either as a one-shot reasonable depreciation charge, as in *Atwater Kent Mfg. Co. v. Commissioner*, 43 F.2d 331, 333 (3rd Cir. 1930), or as a *necessary* business expense, as in *Frank & Seder Co. v. Commissioner*, 44 F.2d 147, 149 (3rd Cir. 1930). Clearly, an expedition premium constitutes a cost of acquisition, hence a capital expenditure under § 263, *W. B. Brown & Sons Lumber Co.*, 26 B.T.A. at 1192, and must be depreciated over the useful life of the asset acquired, *Sears Oil Co. v. Commissioner*, 359 F.2d at 197-98.

56. 475 F.2d 775 (2d Cir. 1973).

57. 505 F.2d 1185 (10th Cir. 1974).

sisting of computer costs, credit checks, and promotional activities) for a new Master Charge program were currently deductible even though they generated future economic benefits. The court concluded that these start-up expenditures did not create a separate property interest. The Tax Court has followed *Colorado Springs National Bank*, but has indicated that start-up costs must be capitalized when incurred in a new venture unrelated to the existing business of the taxpayer.<sup>58</sup> Moreover, the Tax Court has applied a consistently narrow definition of an existing business.<sup>59</sup> Furthermore, the Tax Court has held both *Briarcliff* and *Lincoln Savings & Loan* inapplicable when the challenged expenditure relates to a tangible asset, such as preliminary plans for an office-showroom complex<sup>60</sup> or the acquisition of another newspaper by a publishing company.<sup>61</sup>

The Tax Court has treated as acquisition costs expenditures that only awkwardly fit the mold, *e.g.*, cleaning expenses paid to prepare a shopping center for its grand opening as well as insurance premiums paid for fire and extended coverage on buildings in the center during the construction;<sup>62</sup> such payments hardly seem to have created or enhanced the shopping center.<sup>63</sup> Similarly in *George L. Schultz*,<sup>64</sup> the Tax Court treated insurance costs, storage charges, and estimated ad valorem taxes paid during the four year aging period for whiskey purchased as an investment as part of the sales price of acquisition of four year old whiskey.

Such expenditures clearly do not enhance a capital asset; and it is difficult to regard them simply as a cost of acquisition. Perhaps if these types of expenditures were always reflected in the purchase price of the completed asset, whether a turnkey shopping center or

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58. *First Security Bank of Idaho, N.A. v. Commissioner*, 63 T.C. 644, 649 n.16 (1975), *aff'd*, 592 F.2d 1050 (9th Cir. 1979). I.R.C. § 195, added by § 102(a), Pub. L. 96-605 (1980), allows five-year amortization of start-up costs.

59. *York v. Commissioner*, 29 T.C. 520 (1957), *rev'd*, 261 F.2d 421 (4th Cir. 1958); *accord O'Donnell v. Commissioner*, 62 T.C. 781 (1974), *aff'd in unpub. op.* (7th Cir. July 23, 1975).

60. *Cagle v. Commissioner*, 63 T.C. 86, 97 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976).

61. *Florida Publishing Co. v. Commissioner*, 64 T.C. 269, 281 (1975), *aff'd in unpub. op.*, (5th Cir. Apr. 26, 1977).

62. *Shainberg v. Commissioner*, 33 T.C. 241 (1959).

63. *See Cagle v. Commissioner*, 63 T.C. at 96-97 (analyzing *Shainberg* as involving an expenditure made in connection with the acquisition of a capital asset).

64. 50 T.C. 688, 696 (1968).

four year old whiskey, they could be viewed as acquisition costs in order to place the taxpayer who self-constructs such assets on a par with the taxpayer who purchases them.<sup>65</sup> Commentators have suggested that the rationale, if any, for these decisions must be found in the clear reflection of income aspect of the capital expenditure doctrine discussed below.<sup>66</sup>

Other cases involving expenditures that usually constitute ordinary and necessary business expenses fit more readily into the mold of acquisition of a capital asset. For example in *Stevens v. Commissioner*,<sup>67</sup> the taxpayer, the operator of a stable, obtained a one-half interest in certain race horses under an arrangement in which his joint venturer paid the purchase price of horses selected by taxpayer and thereafter the taxpayer paid all the training and maintenance costs of such horses. One-half of the cost of the upkeep was deductible by the joint venturer; the other half, however, was considered the taxpayer's portion of the purchase price and required to be capitalized. Other cases — which are difficult to fit into the traditional repair-improvement dichotomy<sup>68</sup> — may be better explained on the basis that the expenditures constitute part of the purchase price of a capital asset. For example, in *Mt. Morris Drive-In Theater Co. v. Commissioner*,<sup>69</sup> the taxpayer purchased land which it had intended to use for a drive-in theater, knowing that when the theater was constructed without a proper drainage system, the water flow would cause excess run-off onto adjacent property. The adjoining landowners sued the taxpayer for erosion damages due to the run-off; the suit was settled by providing for construction of a drainage system to carry the water to a public drain. The majority opinion in the Tax Court required capitalization of the costs of the drainage system, reasoning that had such costs been included in the original construction plans, they would have been capital in nature. At the time the drive-in theater was

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65. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

66. Gunn, *supra* note 5. See notes 177-93, 347-62 *infra* and accompanying text.

67. 388 F.2d 298 (6th Cir. 1968).

68. See notes 275-362 *infra* and accompanying text. One line of cases would allow a deduction for seemingly capital expenditures that restore a business asset to its usual operating efficiency, particularly where a casualty-like event has destroyed its effectiveness. See *Mt. Morris Drive-In Theatre Co. v. Commissioner*, 25 T.C. 272 (1955), *aff'd*, 238 F.2d 85 (5th Cir. 1956).

69. *Id.*

constructed, it was obvious that a proper drainage system would be required and "until this was accomplished, [the taxpayer's] capital investment was incomplete."<sup>70</sup>

### III. ORIGIN-OF-THE-CLAIM DOCTRINE

The tax benefit or origin-of-the-claim aspect of the capital expenditure doctrine differs from the acquisition or enhancement of a capital asset aspect in that the basis for requiring capitalization is the integral relationship between the expenditure and a capital asset, albeit not a cost of acquiring or improving the asset. To allow a current deduction for such an expenditure while taxing related gain from the capital asset as capital gain, unreduced for the expenditure, would distort the taxpayer's income through a double deduction, or at least a deduction and a half (an ordinary deduction for the expenditure and a capital gain deduction on the gain under section 1202).<sup>71</sup> Widely applied tax rules — e.g., the requirement of offsetting gains (or increasing losses) from sales of capital assets by the costs of sale, capitalization of expenditures under the origin-of-the-claim test, the tax benefit rule of *Arrowsmith v. Commissioner*<sup>72</sup> and *United States v. Skelly Oil Company*,<sup>73</sup> and even the classic tax benefit doctrine<sup>74</sup> — all rest, at least in part, upon this same conceptual footing. Expenditures which are integrally related to an income or loss item or transaction must possess the same character for tax purposes as that item or transaction in order to prevent a distortion of the taxpayer's income.

Treasury Regulation section 1.263(a)-2(e) provides that commissions paid in selling securities constitute an offset against the selling price, except as to securities dealers, who may treat them as ordinary and necessary business expenses. Similar treatment is accorded to commissions paid by the seller in real estate sales<sup>75</sup> and to attorney and appraiser fees incurred in obtaining remuneration

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70. *Id.* at 275.

71. I.R.C. § 1202. Currently, the capital gain deduction allowed is 60% of the total gain.

72. 344 U.S. 6 (1952).

73. 394 U.S. 678 (1969).

74. The classic tax benefit doctrine deals with recovery of previously deducted items.

75. See, e.g., *Hunt v. Commissioner*, 47 B.T.A. 829, 839 (1942); *Cavanaugh v. Commissioner*, 19 B.T.A. 1251 (1930); *Griffin v. Commissioner*, 19 B.T.A. 1243 (1930).

for a condemnation of the taxpayer's property.<sup>76</sup> This offset to sales proceeds rule cannot be brought within the traditional definition of a capital expenditure as creating or enhancing a capital asset, except perhaps under the fiction that such commissions serve to increase the sale price of the property and hence constitute capital expenditures.<sup>77</sup> In many cases the seller is not engaged in a trade or business, particularly where securities are involved, so that the expenses could not be business deductions in any event,<sup>78</sup> but it requires considerable mental gymnastics to exclude such expenses from the penumbra of section 212<sup>79</sup> on grounds other than that they are not ordinary.<sup>80</sup> Costs of sale must be applied as an offset not because they serve to increase the selling price, but because a distortion in income would result if non-dealers were allowed to treat the expenditures as ordinary deductions while taking into account only forty percent<sup>81</sup> of the related gain.<sup>82</sup> The

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76. See, e.g., *Isaac G. Johnson & Co. v. United States*, 149 F.2d 851 (2d Cir. 1945); *Williams v. Burnet*, 59 F.2d 357 (D.C. Cir. 1932). But see *Madden v. Commissioner*, 57 T.C. 513, 518 (1972), *rev'd*, 514 F.2d 1149 (9th Cir. 1975), *cert. denied*, 424 U.S. 912 (1976), where the Tax Court held that legal fees expended by the taxpayer in unsuccessfully attempting to limit condemnation of their commercial orchard property were deductible under § 162(a). The Tax Court later repudiated its *Madden* analysis in *Soelling v. Commissioner*, 70 T.C. 1052 (1978) where it stated:

In *Madden* the Ninth Circuit clarified the law in this area basing its opinion on those of the Supreme Court in *Woodward v. Commissioner . . . and United States v. Gilmore*, 372 U.S. 39 (1963). The cumulative result of these opinions places a difficult burden on the taxpayer to prove that a Section 212 expense is ordinary and necessary rather than capital in nature when incurred in connection with an investment, be it an acquisition or a disposition thereof. The facts and circumstances herein are indistinguishable from those in *Madden*. However, in our decision in *Madden* we applied the primary purpose test, rejected by *Woodward* and the Ninth Circuit in their reversal of *Madden*, rather than the origin and character test herein employed. We will, therefore, no longer follow our decision in that case. . . .

70 T.C. at 1055-56. The primary purpose test and the origin of claim test are discussed *infra*.

77. See *Ward v. Commissioner*, 224 F.2d 547, 555 (9th Cir. 1955).

78. See *Spreckels v. Commissioner*, 315 U.S. 626 (1942).

79. I.R.C. § 212 allows a deduction for expenses incurred in the production of income with no requirement that the taxpayer be engaged in a trade or business.

80. For an attempt to do so, see *Ward v. Commissioner*, 224 F.2d at 555. Focusing primarily on the production of (capital gain) income aspect of § 212, one commentator has concluded that most expenses of sale authorities are incorrect. See *Teschner, Expense of Sale: Law-Making by the Commissioner*, 35 TAXES 574 (1957).

81. For purposes of illustration, it is assumed throughout this section (unless otherwise specifically stated) that the taxpayer is an individual and that the alternative capital gains tax of I.R.C. § 1201 does not apply.

proper rationale is that "[e]xpenses necessarily incurred to realize a capital gain reduce the amount of that gain and partake of the nature of the gain to which they relate."<sup>83</sup>

The origin-of-the-claim doctrine developed comparatively late. Prior to *Woodward v. Commissioner*<sup>84</sup> and *United States v. Hilton Hotels Corp.*,<sup>85</sup> courts had applied two conflicting tests to determine whether legal expenses should be treated as a current business expense or a capital or personal expenditure: the primary-purpose test<sup>86</sup> and the origin-of-the-claim test.<sup>87</sup> The primary purpose test has been stated in the context of litigation expenses as follows:

[I]f the primary or sole purpose of the suit is to perfect or defend title, the expenditures are not deductible. . . . On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses.<sup>88</sup>

The explicit genesis of the origin-of-the-claim test lies in *United States v. Gilmore*,<sup>89</sup> where the Supreme Court resolved the ques-

82. See *Spreckels v. Commissioner*, 315 U.S. 626, 630 n.11 (1942); *Petit v. Commissioner*, 8 T.C. 228, 237 (1947).

83. *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373, 378 (Ct. Cl. 1960). The Court of Claims, in basing this analysis on *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), appears to have been the first court to recognize the relationship between the cost of sale offset rule and the *Arrowsmith* tax benefit doctrine.

84. 397 U.S. 572 (1970).

85. 397 U.S. 580 (1970). Both *Woodward* and *Hilton Hotels* involved legal fees incurred during stockholder appraisal litigation.

86. See, e.g., *Industrial Aggregate Co. v. United States*, 284 F.2d 639 (8th Cir. 1960); *Lewis v. Commissioner*, 253 F.2d 821, 827 (2d Cir. 1958); *Rassenfoss v. Commissioner*, 158 F.2d 764 (7th Cir. 1946); *Galewitz v. Commissioner*, 50 T.C. 104 (1968), *rev'd*, 411 F.2d 1374 (2d Cir.), *cert. denied*, 396 U.S. 906 (1969).

87. See, e.g., *Estate of Morgan v. Commissioner*, 332 F.2d 144, 151 (5th Cir. 1964); *Spangler v. Commissioner*, 323 F.2d 913, 918 (9th Cir. 1963); *Mitchell v. United States*, 408 F.2d 435, 441 (Ct. Cl. 1969).

88. *Industrial Aggregate Co. v. United States*, 284 F.2d at 645. The regulation referred to by the court is Treas. Reg. § 1.263(a)-2(c) which states that "[t]he cost of defending or perfecting title to property" is a capital expenditure.

89. 372 U.S. 39 (1963). In *Gilmore*, the taxpayer sought to deduct legal expenses incurred in defending a divorce suit on the grounds that the suit was necessary to protect income producing property from the claims of his wife. The court concluded that to decide for the taxpayer would lead to "capricious results," i.e., deductibility would depend on whether a judgment stood to be satisfied out of income or non-income producing assets. *Id.* at 48. In so

tion of deductibility of business versus personal litigation costs by turning to the "origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer."<sup>90</sup> Thereafter, courts were divided as to the proper scope and application of the *Gilmore* test.<sup>91</sup> The Supreme Court resolved this conflict in *Woodward v. Commissioner*<sup>92</sup> to determine whether expenses paid in connection with appraisal litigation arising from a redemption of stock were capital expenditures incurred in the acquisition of a capital asset. The Supreme Court explicitly rejected the primary-purpose test:

We agree with the Tax Court and the Court of Appeals that the "primary purpose" test has no application here. That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be "defending or perfecting title." Such uncertainty is not called for in applying the regulation that makes the "cost of acquisition" of a capital asset a capital expense. In our view application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acqui-

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deciding, the Court relied upon *Lykes v. United States*, 343 U.S. 118 (1952). There, the Court held improper a deduction of legal expenses incurred in contesting a gift tax assessment. The taxpayer had based his claim on the fact that payment of the tax would necessitate liquidation of income producing securities. The Supreme Court refused to consider the consequences of litigation and in effect looked to the origin of the claim. See *Reed v. Commissioner*, 55 T.C. 32, 39 n.10 (1970).

90. 372 U.S. at 49.

91. See, e.g., *Moore Trust v. Commissioner*, 49 T.C. 430 (1970), where the Tax Court decided that legal expenses incurred by the trustee were not capital expenditures, based solely on the primary purpose test. Judge Tannenwald noted in a concurring opinion:

I think the use of a "primary purpose" test in cases of this type is inappropriate, because it implies that the subjective intent of the parties ought to be taken into account. I believe that, in the area of litigation expenses, it is "the origin and character of the claim with respect to which [the] expense was incurred" which controls. See *United States v. Gilmore*, 372 U.S. 39, 49 (1963). The rationale which underpins this mandate of the Supreme Court is equally applicable in determining whether an expenditure is a nondeductible capital item or a deductible expense within the purview of section 212 and in determining whether the expenditure is a nondeductible personal item or a section 212 deduction.

49 T.C. at 443.

92. 397 U.S. 572 (1970); accord, *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).



tion itself.<sup>93</sup>

The origin-of-the-claim test was also immediately applied by several circuit courts to the cost of *disposition* of a capital asset although *Woodward* and its companion case, *United States v. Hilton Hotels Corp.*,<sup>94</sup> involved only the cost of *acquisition* of a capital asset.<sup>95</sup> The Supreme Court itself had telegraphed this result in *Woodward*:

It has long been recognized, as a general matter, that costs incurred in the acquisition or *disposition* of a capital asset are to be treated as capital expenditures. The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, as explicitly provided by a long standing Treasury regulation. . . .

The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or *disposing* of an asset are as much part of the cost of that asset as is the price paid for it.<sup>96</sup>

It appears clear, therefore, that the basis for the capitalization of costs incurred in the disposition of a capital asset, including commissions, is the origin-of-the-claim test.<sup>97</sup>

The rationale of the origin-of-the-claim test is that all expenses which stem from a capital transaction should be "matched" or

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93. 397 U.S. 572, 577.

94. 397 U.S. 580.

95. See *Helgerson v. United States*, 426 F.2d 1293 (8th Cir. 1970); *accord*, *Estate of Baier v. Commissioner*, 533 F.2d 117, 120 (3d Cir. 1976); *Third National Bank of Nashville v. United States*, 427 F.2d 343 (6th Cir. 1970); *Great Lakes Pipe Line Co. v. United States*, 352 F. Supp. 1159, 1172 (W.D. Mo. 1972), *aff'd in unpub. order*, (8th Cir. May 23, 1974).

96. 397 U.S. at 575-76 (emphasis added). The regulation referred to by the Court, Treas. Reg. § 1.263(a)-2(e), states that "[c]ommissions paid in purchasing securities" are capital expenditures, and that "[c]ommissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense." *Accord*, *Third National Bank in Nashville v. United States*, 427 F.2d 343, 344 (6th Cir. 1970) ("[w]hile we recognize that in the instant case the taxpayers are sellers of stock rather than purchasers, as is true in the *Woodward* and *Hilton Hotel* cases, we believe the Supreme Court clearly intended its ruling to apply to both. The words 'or disposition' indicate this, as does the use of the 'familiar example' of 'the capitalization of brokerage fees for the sale or purchase of securities'").

97. See *Estate of Meade v. Commissioner*, 489 F.2d 161, 164 (5th Cir.), *cert. denied*, 419 U.S. 882, *reh. denied*, 419 U.S. 1060 (1974).

equated with all gains from the same capital transaction and that such expenses and related gains should receive identical tax treatment.<sup>98</sup> As the Court of Claims pointed out in *Munn v. United States*,<sup>99</sup> when an expense is incurred in the process of acquisition or disposition of a capital asset, the primary purpose test does not apply. "If such a connection exists, the expenses simply take the character of the asset to which they relate."<sup>100</sup> This approach severely erodes the prior distinction under section 212<sup>101</sup> between expenses incident to the disposition of property and those incident to collection of the proceeds of the sale.<sup>102</sup>

While the related transaction theory appears the primary premise of the origin-of-the-claim test, the Supreme Court in both *Gilmore* and *Woodward* appears to have relied in part on a need to avoid "capricious results"; in *Gilmore*, the Court so stated.<sup>103</sup> For example, should each of two taxpayers be sued for an automobile accident while driving for pleasure, deductibility of the litigation costs would turn on the mere circumstance of the character of the assets each would happen to possess. Under the rejected "consequences" test, the court would look to "whether the judgments

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98. *Sharples v. United States*, 533 F.2d 550, 555 (Ct. Cl. 1976).

99. 455 F.2d 1028 (Ct. Cl. 1972).

100. *Id.* at 1033.

101. I.R.C. § 212.

102. 455 F.2d at 1033. The court explained,

It is clear to us that the expenses were incurred as a direct result of the sale of capital assets and were prompted out of a desire to collect the proceeds of that sale. We, therefore, feel the best approach to take in this case is to follow not only the *Woodward* and *Hilton Hotels* cases, but also to recognize the wisdom of the proposition that the distinction between expenses incident to a disposition of property and those incident to collection of the proceeds of the sale is a tenuous distinction in all respects.

*Id.* But see *Southland Royalty Co. v. United States*, 582 F.2d 604 (Ct. Cl. 1978) where the court allowed deduction of litigation expenses incurred in connection with a suit for royalty payments because title was not in dispute. See also *Helgerson v. United States*, 426 F.2d 1293, 1298 (8th Cir. 1970), stating,

The strict distinction drawn in *Naylor* [v. Commissioner, 203 F.2d 346 (5th Cir. 1953)] between expenses incident to disposition of property and expenses incident to collection of the proceeds of the sale, the former accorded a capital and the latter a deductible nonbusiness expense status is tenuous in light of *Woodward* and *Hilton Hotels*, and consequently we decline to observe it here.

*Id.* The court opted instead for an "expansive application, rather than a narrow circumscription, of the phrase 'incurred in the . . . disposition of a capital asset.'" *Id.*

103. 372 U.S. at 48.

against them stood to be satisfied out of income- or non-income-producing property."<sup>104</sup> Similarly, in *Woodward* the Supreme Court noted that "[a] test based upon the taxpayer's 'purpose' in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions."<sup>105</sup> Nevertheless, the Court reserved judgment as to the tax treatment of costs incurred in litigation that may only indirectly affect the title to property.<sup>106</sup> Subsequently, the Ninth Circuit supplied an answer in *Madden v. Commissioner*,<sup>107</sup> applying an origin-of-the-claim standard to the expense of litigation concerning the rights of the government to take a fee interest by a condemnation proceeding instead of a less drastic alternative with no regard to the use of the land in the taxpayer's business.

The agency initiated the condemnation proceedings here for a tax-neutral purpose. Where this is so, there is no inherent unfairness to the taxpayer. Furthermore, all taxpayers with capital assets affected by the agency's actions will be similarly treated. Finally, the element of certainty, particularly desirable in tax law, is enhanced.<sup>108</sup>

The application of the origin-of-the-claim test is still developing. In the context of litigation, the Tax Court has held

Quite plainly, the "origin-of-the-claim" rule does not contemplate a mechanical search for the first in the chain of events which lead to the litigation but, rather, requires an examination of all the facts.

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104. *Id.*

105. 397 U.S. at 577.

106. *Id.* at 578.

107. *Madden v. Commissioner*, 514 F.2d 1149 (9th Cir. 1975). See also *Estate of Baier v. Commissioner*, 533 F.2d 117 (3d Cir. 1976); *Anchor Coupling Co. v. United States*, 427 F.2d 429, 433 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

108. 514 F.2d at 1152. When the Tax Court decided *Madden v. Commissioner*, 57 T.C. 513 (1972), it had reluctantly followed *Reakirt v. Commissioner*, 29 B.T.A. 1296 (1934), *aff'd per curiam*, 84 F.2d 996 (6th Cir. 1936). In *Reakirt*, the Board of Tax Appeals held that litigation similar to *Madden's* was not in defense of title, but was for the primary purpose of preventing "the taking of the land itself by the exercise of the power of condemnation." 29 B.T.A. at 1297. On appeal, the Ninth Circuit held that the Tax Court's application of the primary purpose analysis was incorrect. The court reversed the Tax Court's holding, applying the origin-of-the-claim test and finding that *Madden's* litigation ultimately involved the sale and acquisition of the land; consequently, the expenses were not currently deductible. 514 F.2d 1149.

The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. . . . Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.<sup>109</sup>

The search for the origin of an expenditure is not always easy.<sup>110</sup> Even pre-*Woodward* cases which purported to apply an origin-of-the-claim or related test tended to bifurcate claims arising out of arguably related capital transactions. For instance, in *Beerman v. United States*,<sup>111</sup> the taxpayer guaranteed a purchase contract in which his controlled corporation was the purchaser; as security for the purchase price, he had deposited in escrow a negotiable note payable to him. After execution of the sales agreement, the seller sued both the corporate purchaser and the taxpayer, alleging that they had failed to fulfill certain obligations, claiming entitlement to the escrowed note, and claiming that interest payments therefrom to the taxpayer should cease as well. Purportedly relying upon *Gilmore*, the Sixth Circuit in *Beerman* concluded that the expenses originated in the taxpayer's business activities and that the income producing property, *viz.*, the negotiable note, was the subject of the suit. Consequently, the court held the legal expenditures were deductible as directly related to the management, con-

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109. *Boagni v. Commissioner*, 59 T.C. 708, 713 (1973); *accord*, *Estate of Baier v. Commissioner*, 63 T.C. 513, 520 (1975), *aff'd*, 533 F.2d 117 (3d Cir. 1976).

110. *See Lykes v. United States*, 343 U.S. 118 (1952). In *Lykes*, the taxpayer deducted legal expenses incurred in contesting a gift tax assessment, characterizing them as a cost of conservation of income producing property. The Supreme Court, in an opinion relied upon in its *Gilmore* decision, decided to look only to the origin of the claim, not to the potential consequences of the litigation. Justice Jackson, in a dissenting opinion, disagreed with the Court's notion of the claim's origin:

Of course one can reason, as my brethren do, that if there had been no gifts there would have been no tax, if there had been no tax there would have been no deficiency, if there were no deficiency there would have been no contest, if there were no contest there would have been no expense. And so the gifts caused the expense. The fallacy of such logic is that it would be just as possible to employ it to prove that the lawyer's fees were caused by having children . . . . So treacherous is this kind of reasoning that in most fields the law rests its conclusion only on proximate cause and declines to follow the winding trail of remote and multiple causations.

*Id.* at 128.

111. 390 F.2d 638 (6th Cir. 1968).

servation and maintenance of income producing property. In contrast, on substantially similar facts, but after the Supreme Court's decision in *Woodward*, the Eighth Circuit properly held in *Helger-son v. United States*<sup>112</sup> that the origin of a claim against similarly escrowed assets originated in the process of disposition of a capital asset and suggested that *Beerman* had been eroded by *Woodward*.<sup>113</sup> Similarly, capitalization has been required of legal expenses which ordinarily might be deductible where the related claim, although not a part of the process of disposition, was integrally related to acquisition or disposition of a capital asset. In *Great Lakes Pipeline Co. v. United States*,<sup>114</sup> a corporate taxpayer entered into employment contracts with its key executives securing their positions in the event of a negotiated sale of the corporate assets. Subsequently the taxpayer was required to make payments to the purchaser (which had assumed these contractual obligations) so that it would retain the executives. Such payments by the corporation were held capital expenditures since they were made in connection with the sale (and at the time of the sale) and constituted an integral part of the transaction whereby the taxpayer disposed of all of its capital assets.<sup>115</sup>

Other pre-*Woodward* decisions bifurcated what would probably be treated under *Woodward* as a related transaction subject to the origin-of-the-claim test. For example, in *Naylor v. Commissioner*,<sup>116</sup> an option to purchase capital assets was exercised; thereafter, a dispute arose as to valuation of the assets. Regarding the disposition of the capital assets as consummated and the subsequent controversy as no more than enforcement of the terms of the agreement, the Fifth Circuit held that the expenses of its enforcement were deductible under section 212 as expended in collection of income. Similarly, where a corporation was liquidated but the transaction was held open<sup>117</sup> for collection of a contingent claim,

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112. 426 F.2d 1293 (8th Cir. 1970).

113. *Id.* at 1297.

114. 352 F. Supp. 1159 (W.D. Mo. 1972), *aff'd in unpub. order*, (8th Cir. May 23, 1974).

115. *Id.* at 1172. In *Plym v. United States*, 338 F. Supp. 717 (W.D. Mich. 1971), the court held that a compromise settlement of a finder's fee claimed in a transaction that resulted in a merger had its origin in and its character determined by the merger and, hence, was capital.

116. 203 F.2d 346 (5th Cir. 1953).

117. The classic statement of open-transaction is contained in *Burnet v. Logan*, 283 U.S.

and a former shareholder incurred litigation expenses in effecting a settlement of the portion of that claim distributed to him, the legal expenses were held currently deductible as costs of collecting sums due the taxpayer under a "fully executed and enforceable contract."<sup>118</sup> The Second Circuit reasoned that the only disposition of a capital asset was the exchange of stock in the liquidation for a share of the liquidated company's assets; further repayments under the contingent claim were capital gains not because they represented the sale or exchange of a capital asset but because their collection constituted part of the gain from the sale or disposition of the shareholder's stock in the corporation.<sup>119</sup>

The better view is that the expenses of collecting the proceeds of a disposition of property should be treated no differently than the other expenses incident to that disposition.<sup>120</sup> Moreover, in *Estate of Meade v. Commissioner*,<sup>121</sup> the Fifth Circuit held that stockholders' legal expenses in connection with settlement of an anti-trust damage claim distributed to them upon liquidation of the corporation were not deductible as ordinary and necessary business expenses nor as expenses for production of income; rather, such

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404 (1931):

The promise [to pay annually based on amount of ore mined, without a stated minimum] was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. . . . [Taxpayer] might never recoup her capital investment from payments only conditionally promised. . . . [Taxpayer] properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

*Id.* at 413.

The courts have used this notion of "open" transactions in liquidation cases where the amount of consideration was uncertain. *See, e.g., Commissioner v. Carter*, 170 F.2d 911 (2d Cir. 1948) (involving oil brokerage commission contracts); *Dorsey v. Commissioner*, 49 T.C. 606 (1968) (involving patent royalty rights). The position of the Internal Revenue Service is contained in Rev. Rul. 58-402, 1958-2 C.B. 15: The Commissioner will "continue to require valuation of contracts and claims to receive indefinite amounts of income, such as those acquired with respect to stock in liquidation of a corporation, except in rare and extraordinary cases." *See also* Treas. Reg. § 1.1001-1(a). The rules in this area may have been altered fundamentally by the Installment Sales Revision Act of 1980. *See generally* Goldberg, *Open Transaction Treatment for Deferred Payment Sales after the Installment Sales Act of 1980*, 34 TAX LAW. 605 (1981).

118. *Commissioner v. Doering*, 39 T.C. 647, 650 (1963), *aff'd*, 335 F.2d 738 (2d Cir. 1964).

119. 335 F.2d 738, 741 (2d Cir. 1964).

120. *See Munn v. United States*, 455 F.2d 1028 (Ct. Cl. 1972); *Helgerson v. United States*, 426 F.2d 1293 (8th Cir. 1970).

121. 489 F.2d 161 (5th Cir.), *cert. denied*, 419 U.S. 882, *reh. denied*, 419 U.S. 1060 (1974).

payments were required to be capitalized and offset against the long-term capital gain realized by the stockholders under the open transaction doctrine from settlement of the claims. The court reasoned that the antitrust claim in the hands of the shareholders originated in the process of the disposition of their stock in the liquidated corporation; the claim was part of the assets received in the liquidation and the liquidation was an open transaction for purposes of collection of the proceeds of the settlement.

Thus, the valuation of the claim . . . was vital to the disposition of taxpayer's stock, and the litigation necessary for this determination was an integral part of the overall transaction. Hence, the expenses incurred in the settlement litigation are properly treated as part of the cost of the stock exchanged in the liquidation.<sup>122</sup>

Certainly where the distributed claim involves a dispute over the terms of the disposition of a capital asset, expenditures arising from the dispute are integrally related with the capital asset; and analysis in terms of collection of a contract right is inappropriate.<sup>123</sup>

A growing number of origin-of-the-claim cases follow a "proximate cause" analysis. For example, in *Munn v. United States*,<sup>124</sup> the taxpayer incurred legal expenses in a suit to establish the percentage of the sales proceeds of certain stock sold by a trust allocable to him as income beneficiary. He relied upon a number of cases holding that a trust beneficiary's legal expenses to settle disputes as to the exact portion of trust distributions to be received are deductible expenses under section 212 as incurred for the management, conservation or maintenance of property held for the production of income, rather than expenses which must be capitalized as incurred for the acquisition or disposition of property or for de-

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122. *Id.* at 166. While both the Fifth Circuit in *Estate of Meade* and the Tax Court in *Estate of Baier v. Commissioner*, 63 T.C. 513, 522 (1975), *aff'd*, 533 F.2d 117 (3d Cir. 1976), attempted to distinguish *Doering*, its precedential value has been eroded severely, probably fatally, by progeny of *Woodward* such as *Munn* and *Helgerson* as well as *Estate of Meade*. Moreover, *Naylor* was thought questionable even prior to *Woodward*. See *Spangler v. Commissioner*, 323 F.2d 913, 919-20 n.15 (9th Cir. 1963).

123. *Estate of Baier v. Commissioner*, 533 F.2d 117, 120 (3d Cir. 1976).

124. 455 F.2d 1028 (Ct. Cl. 1972).

fending or perfecting his interest in property.<sup>125</sup> The Court of Claims distinguished these cases on the basis that the transaction was essentially a sale of a capital asset:

It cannot be disputed that without the sale of stock there would have been no reason to instigate the legal action for collection of the proceeds of that sale. . . .

It is clear to us that the expenses were incurred as a direct result of the sale of capital assets and were prompted out of a desire to collect the proceeds of that sale. We, therefore, feel the best approach to take in this case is . . . to recognize the wisdom of the proposition that the distinction between expenses incident to a disposition of property and those incident to collection of the proceeds of the sale is a tenuous distinction in all respects.<sup>126</sup>

Similarly, in *Ransburg v. United States*,<sup>127</sup> litigation arose out of a buy-sell agreement entered into between the taxpayer and his father and two brothers. The Tenth Circuit concluded that since the buy-sell agreement concerned the disposition and acquisition of corporate stock, the litigation expenses were not deductible under section 162 or section 212.<sup>128</sup>

Any "proximate cause" analysis is unlikely to prevail without substantial litigation. In *Newark Morning Ledger Co. v. United States*,<sup>129</sup> the corporate taxpayer purchased a majority interest in a publishing company at a time when it may have known that litigation against the existing management would be necessary to protect its purchase. Shortly after consummating the transaction, the taxpayer did in fact bring an action against the management anal-

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125. See, e.g., *Rowe v. Commissioner*, 24 T.C. 382 (1955); *Tyler v. Commissioner*, 6 T.C. 135 (1946).

126. 455 F.2d at 1033 (Ct. Cl. 1972).

127. 440 F.2d 1140 (10th Cir. 1971). See *Reed*, 55 T.C. 32 (1970).

128. 440 F.2d at 1144. The court also refused to allow the expenses to be added to the basis of the taxpayer's existing stock in the corporation because the litigation involved neither the acquisition nor the preservation and defense of the taxpayer's stock interest in the corporation. Were the district court's conclusion based on the premise that the expenses related to the other 80% stock interest, this refusal would appear incorrect. See *Anchor Coupling Co. v. United States*, 427 F.2d 429, 434 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971). It appears more likely that the district court in *Ransburg* viewed the litigation as actually personal in origin. See 69-2 U.S.T.C. (D. Kansas July 24, 1969). See generally [1974] 4 TAX MNGM'T (BNA) § 4.

129. 539 F.2d 929 (3d Cir. 1976).



ogous to a shareholders' derivative suit. The Third Circuit held that the costs of such litigation were deductible since the origin of the claim lay neither in the price paid by the taxpayer for the stock nor in the value received when it purchased the stock. This approach would limit *Woodward* and its progeny to situations in which the factors of price and value in either the acquisition or disposition of a capital asset gave rise to litigation. The *Newark Ledger* application of the "origin of the claim" test appears contrary to the approach taken in cases such as *Great Lakes Pipeline Co. v. United States*,<sup>130</sup> where the district held that payments by the corporate taxpayer to secure its release from employment contracts of its former executives and to assure their employment by the purchaser of its assets were capital expenditures because the employment contracts were executed contemporaneously and in connection with the sale of the taxpayer's assets. In short, *Newark Ledger* is contrary to a proximate cause approach and seems to rest upon the erroneous premise that certain expenditures are inherently section 162 (business expenses) or section 212 (expenses for the production of income), while others are inherently capital.<sup>131</sup>

Similar problems in searching for the origin of the claim are epitomized by cases such as *Mitchell v. United States*,<sup>132</sup> where the taxpayer was the chief executive officer and controlling shareholder of a corporation acquired by a second corporation in a taxable transaction. He and the acquired corporation made certain warranties as to contingent liabilities of the acquired corporation. Since the taxpayer was chief executive officer, the acquiring company also sought information from him regarding the acquired company's operations and financial condition. After the sale, the taxpayer continued to conduct business as a corporate official of numerous corporations. Approximately three years after the sale, the acquiring company sued the taxpayer and other former shareholders of the acquired company, alleging that all of them, and in particular the taxpayer, had fraudulently misrepresented facts re-

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130. 352 F. Supp. 1159, 1172 (W.D. Mo. 1972), *aff'd in unpub. opinion*, (8th Cir. May 23, 1974). See text accompanying notes 114-15 *supra*.

131. 539 F.2d 929 (3d Cir. 1976).

132. 408 F.2d 435 (Ct. Cl. 1969).

lating to the acquired company's contingent liabilities; and that fraud, deceit, misrepresentations and concealment caused the acquiring company to suffer damages in excess of twice the amount it had paid for the stock itself and in excess of six times the amount which the taxpayer had personally received. The government contended that the taxpayer's legal expenses were incurred in connection with a capital transaction (the sale of the acquired company's stock to the acquiring company) and, hence, were non-deductible capital expenditures. The Court of Claims responded that the government's automatic application of a "but for" rule ignored the acquired company's allegations of fraudulent misrepresentation and breach of fiduciary obligation to the acquired company by the taxpayer *in his capacity as its president and director*. The Court of Claims held for the taxpayer, basically on the ground that the origin of the suit was more than just the capital transaction:

[The acquiring company] went for much bigger game alleging that, because of [the taxpayer] Mitchell's fraudulent misrepresentations, it was entitled to damages in excess of \$3,700,000, considerably more than twice the amount [the acquiring company] . . . had paid for the [acquired company's] . . . stock in the first place. To reiterate, it was in his unsuccessful defense of these charges that Mitchell incurred the expenses in question. The fact that later [the acquiring company] . . . and Mitchell settled their dispute on the basis of revising the stock purchase price is of no moment.<sup>133</sup>

In *Locke v. Commissioner*,<sup>134</sup> an insider was sued for failure to inform a seller of securities of facts affecting their value. Distinguishing *Mitchell*, the Tax Court held that the origin of the claim was in the process of acquisition itself, because the taxpayer did not possess the requisite business relationship as a corporate executive to the corporation. In such circumstances, an insider's failure to inform cannot be divorced from any purchase or sale by him of securities.<sup>135</sup> Moreover, *Mitchell's* suggested distinction that ex-

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133. *Id.* at 442.

134. 65 T.C. 1004 (1976), *aff'd*, 568 F.2d 663 (9th Cir. 1978).

135. 65 T.C. at 1011-12. More recently, in *Bradford v. Commissioner*, 70 T.C. 584 (1978), the taxpayer sought to deduct the amount paid in settlement of a suit against him by the Securities Exchange Commission. The case involved the use of inside information in violation of § 10(b)5 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1976), by a bro-

penses to defend a claim arising from a breach of duty by the taxpayer *in his separate capacity as a corporate executive* are deductible appears questionable in light of recent developments as to deductibility of payments by an insider for violations of the short-swing sales provisions of section 16(b) of the Securities Exchange Act of 1934.<sup>136</sup> The majority view in that area refuses to bifurcate the sale or exchange and the subsequent payment of the penalty on the basis of the taxpayer's dual capacities, officer and shareholder.<sup>137</sup>

On the other hand, the origin of the claim may be non-capital where in the course of litigation relating to a capital transaction, the character of the controversy is altered by the introduction of a claim or counterclaim against or by the taxpayer totally unrelated to the capital transaction, but capable of being traced to it under a but-for test. For example, in *Eisler v. Commissioner*,<sup>138</sup> the taxpayer accepted employment conditioned upon a right to acquire a substantial equity interest in his new corporate employer, which right he subsequently exercised. Upon his termination of employment, the former employer sued to reacquire the stock. The initial litigation, therefore, was related solely to a capital transaction; but its character altered when discovery revealed a potential negligence

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ker-dealer in the purchase of stock for his personal account. The taxpayer argued that his purpose in making prompt settlement (the case was settled in less than a month) was to protect his reputation as a broker-dealer. He attempted to distinguish *Locke* in order to avoid its emphasis on the origin of the claim. The court rejected this argument and held that the expense related to the acquisition of a capital asset, the stock. Similarly, in *Redwood Empire Sav. & Loan Ass'n v. Commissioner*, 68 T.C. 960 (1977), the taxpayer sought to deduct litigation expenses of a suit arising out of its purchase of land. The plaintiff sought punitive damages based on an allegation of fraud and payment of the purchase price or return of the land. The attorney testified that he advised settlement in order to avoid exposure to punitive damages. The court held that motive was irrelevant, and that the taxpayer had failed to convince the court that the "claim was based on something that would directly affect petitioner's business aside from casting doubt on the title to one of petitioner's assets." 68 T.C. at 978.

136. 15 U.S.C. § 78p(b)(1976). The section prohibits speculation by insiders in the securities of their corporation by requiring them to forfeit all "short-swing" profits; *i.e.*, profits realized from any purchase and sale of the corporation's securities within any period of less than six months, regardless of any subjective intent to gain from speculation.

137. See *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976) and authorities cited therein. For a discussion of the *Arrowsmith* tax benefit doctrine relied upon therein and the origin-of-the-claim test see notes 141-83 *infra* and accompanying text.

138. 59 T.C. 634 (1973).

claim by the former employer against the taxpayer arising out of his employment. The *Eisler* court concluded that the taxpayer's settlement payment secured releases from both the stock claim and the potential negligence claim, holding the part of the settlement related to the stock claim as "deductible only as a capital outlay and the remaining portion represented a business expenditure deductible in full from ordinary income."<sup>139</sup> But for the original suit to regain the stock, the negligence claim would probably never have been discovered; however, the court appears correct in its conclusion regarding the business rather than capital transaction origin of the negligence claim. Significantly, while the *Eisler* court began its analysis with the origin of the claim test, it also reasoned that

[t]o the extent that the payment is properly allocable to the stock, it represents in the context of this case nothing more than a charge against the capital gain that he realized upon the sale of the stock, cf. *Arrowsmith v. Commissioner*, 344 U.S. 6, and not a business loss, cf. *United States v. Generes*, 405 U.S. 93.<sup>140</sup>

The court then pointed out that the tax character of the legal expenditures must be determined pursuant to the same principles that governed the nature of the settlement payment, relying on *Woodward* and its progeny. This relationship between *Arrowsmith* and the origin-of-the-claim test is highly significant. It focuses upon the underlying principles at the heart of the capitalization doctrine with respect to those expenditures that do not literally enhance or create a capital asset.

#### IV. TAX BENEFIT RULE

In *Arrowsmith v. Commissioner*,<sup>141</sup> the shareholder-taxpayers paid a judgment in 1944 against a dissolved corporation, whose assets had been distributed to them in the years 1937 through 1940. The taxpayers had reported the liquidating distributions as capital gains, thereby paying "less income tax than would have been required had the income been attributed to ordinary business trans-

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139. *Id.* at 640.

140. *Id.* at 641.

141. 344 U.S. 6 (1952).

actions for profit."<sup>142</sup> The taxpayers then deducted the payment in satisfaction of the judgment as an ordinary business deduction, claiming the full amount paid because of their transferee liability. The Commissioner viewed the deduction in the subsequent year as part of the original liquidation transaction, requiring classification as a capital loss, just as the taxpayer had treated the original liquidating distributions as capital gains. The Supreme Court reasoned that the payment was not based on any ordinary business transaction of the taxpayers apart from the liquidating proceedings. The taxpayers did not deny that had payments been made in the same tax years as the liquidating distributions, the losses would have been properly treated as capital, reducing the amount of capital gains received during those tax years. The taxpayers urged, however, that because the judgment was paid in a subsequent year, even though it would have constituted a capital transaction in the prior year, it was effectively transformed into an ordinary business deduction under the well-established principle that each taxable year is a separate unit for tax accounting purposes. The Supreme Court rejected their reasoning, replying:

[T]his principle is not breached by considering all of the 1937-1940 liquidation transaction events in order to properly classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937-1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.<sup>143</sup>

Many early cases interpreted *Arrowsmith* as applicable only where the original transaction was not fully closed and the subsequent transaction was a part of the original transaction. For example, in *Wener v. Commissioner*,<sup>144</sup> the Ninth Circuit treated an agreement by retiring partners as partially executory as to the remaining partners who were yet required to pay the balance of the sales price. The court viewed their subsequent release as a part of the original transaction. "It not only grew out of it, but its very existence related back to the agreement of dissolution of partner-

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142. *Id.* at 7.

143. *Id.* at 8-9.

144. 242 F.2d 938 (9th Cir. 1957).

ship and the Bill of Sale which transferred the capital assets. . . .”<sup>145</sup> Similarly, other early cases held that such a subsequent transaction was an “adjustment”,<sup>146</sup> or “renegotiation” and “revision” of the original sale.<sup>147</sup> Some more recent decisions still follow this approach. *Estate of McGlothlin v. Commissioner*<sup>148</sup> applied *Arrowsmith* to an indemnity paid in a later year because it was made in discharge of an obligation that was part of the original transaction in the prior year. The court viewed the payment as part of the purchase price, a capital expenditure that must be added to the cost basis and reflected in the gain or loss realized from the ultimate disposition of the investment. As the Fifth Circuit explicitly stated in *Alvarez v. United States*,<sup>149</sup> “[s]ituations in which there has been a relation back to prior transactions in earlier tax years to determine the taxable nature of a subsequent transaction have been cases where the subsequent transaction was an amendment or modification of the original one.”<sup>150</sup> The majority of Tax Court decisions also seem to view *Arrowsmith* as applicable only where the transaction in the subsequent year is “merely an adjustment” of the prior transaction, and not a new and independent transaction.<sup>151</sup>

The adjustment or modification view is too narrow and, more significantly, has led to apparently erroneous limitations of *Arrowsmith*. For example, in *Campagna v. United States*,<sup>152</sup> the Second Circuit refused to apply *Arrowsmith* to determine the character of payments received in excess of the value set in “closing” a liquidation transaction. Consequently, the excess was taxed as ordinary income rather than sharing the capital gain treatment of the original transaction. The court held that: (a) payment of such excess did not qualify as a sale or exchange; and (b) *Arrowsmith* did not apply since it involved situations where the tax treatment accorded a subsequent adjustment to an earlier sale or liquidation was de-

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145. *Id.* at 946.

146. *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422, 424 (1953).

147. *Wener v. Commissioner*, 24 T.C. 529, 533 (1955), *aff'd*, 242 F.2d 938 (9th Cir. 1957).

148. 370 F.2d 729, 732 (5th Cir. 1967).

149. 431 F.2d 1261 (5th Cir. 1970), *cert. denied*, 401 U.S. 913 (1971).

150. *Id.* at 1264.

151. *See, e.g.*, *Bresler v. Commissioner*, 65 T.C. 182, 187 (1975); *Arthur H. DuGrenier, Inc. v. Commissioner*, 58 T.C. 931, 939 (1972).

152. 290 F.2d 682 (2d Cir. 1961).

terminated by considering the nature of the earlier transaction.<sup>153</sup> In a closed transaction situation, the *Campagna* court reasoned, there was no subsequent adjustment. The payments actually made in the subsequent tax year were at all times unconditionally required to be made by the terms of the original transaction; they were merely in excess of the fair market value established when the original transaction was closed.<sup>154</sup> The analysis relating *Arrowsmith* to only open transactions has also led to a bifurcation of transactions, epitomized in a series of Tax Court decisions (all of which were reversed on appeal) involving payments pursuant to the short-swing profits rule of section 16(b) of the Securities Exchange Act of 1934.<sup>155</sup>

The better view of this aspect of *Arrowsmith* is that where an integral relationship exists between the earlier transaction and a subsequent event, the earlier year may be examined to determine the character of the subsequent event.<sup>156</sup> In *Rees Blow Pipe Manufacturing Co. v. Commissioner*,<sup>157</sup> the Tax Court stated,

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153. *Id.*

154. Of course, *Arrowsmith* applies to gains as well as losses. See, e.g., *Bresler v. Commissioner*, 65 T.C. 182, 186 (1975); *Lowe v. Commissioner*, 44 T.C. 363, 374 (1965). See also Rev. Rul. 79-278, 1979-2 C.B. 303, where the service applied *Arrowsmith* "to a gain that was integrally related to an earlier loss transaction." An accrual method taxpayer incurred a loss on the sale of stock. The taxpayer filed suit against the issuer alleging that the loss was due to a violation of federal securities law. The Commissioner ruled that the settlement payment would take the character of the earlier capital loss, and, therefore, would constitute capital gain in the year the court approved the settlement.

155. 15 U.S.C. § 78p(b) (1976). See notes 136-37 *supra* and accompanying text; *Mitchell v. Commissioner*, 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971). In that case, a vice-president of General Motors Corp. sold some GM stock in 1962, reporting long term capital gain on the transaction. Later, in 1963, he bought more GM stock. Because the two transactions took place within 6 months, the taxpayer was forced, under § 16(b) of the Securities Exchange Act of 1934, to pay over to his employer the "profit" he made on the transaction. The Tax Court held that the repayment would lead to a deduction against ordinary income, finding "no relationship" between the 1962 capital gain and the 1963 § 16(b) payment. See also *Cummings v. Commissioner*, 61 T.C. 1 (1973), *rev'd*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975); *Brown v. Commissioner*, 32 T.C.M. 1300 (1973), *rev'd*, 526 F.2d 609 (10th Cir. 1976); *Anderson v. Commissioner*, 56 T.C. 1370 (1971), *rev'd*, 480 F.2d 1304 (7th Cir. 1973).

156. See, e.g., note 154 *supra* and cases cited therein; Rabinowitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 *Tax. L. Rev.* 85, 97 (1972).

157. 41 T.C. 598 (1964), *aff'd*, 342 F.2d 990 (9th Cir. 1965).

The rule that each year stands on its own feet does not mean, however, that an examination of a previous year's return may not be made in order to determine the nature of the new fact for the purpose of ascertaining how the new fact is to be classified in computing taxable income for the year in which the new fact . . . happened.<sup>158</sup>

Looking to prior years is only one aspect of *Arrowsmith*. Another is that where such an integral relationship exists between the two transactions, the character of the transaction in the earlier year will flavor the character of the transaction in the subsequent year. If the payment would have been capital if made in an earlier year, it still must be capital when actually made in a subsequent year. "[I]n applying the *Arrowsmith* doctrine [it makes no difference] whether the expenditures were made voluntarily or under a legal obligation to make them. The relationship of the payments to the sale transaction here is what determines the character of the deduction."<sup>159</sup> This aspect of *Arrowsmith* rests on the same principles as the origin-of-the-claim test. As the Court of Claims articulated in *Towanda Textiles, Inc. v. United States*,<sup>160</sup> in reliance on *Arrowsmith*, "[e]xpenses necessarily incurred to realize a capital gain reduce the amount of that gain and partake of the nature of the gain to which they relate."<sup>161</sup> Subsequently, the Court of Claims explicitly linked together *Arrowsmith* and *Woodward and Hilton Hotels*.

In *Arrowsmith*, the Supreme Court looked to the nature of the original transaction to deny business expense deductions claimed under the predecessor of subsection 162(a). Since the expenses in question arose from a capital transaction, reasoned the Court, expenses incident thereto should have been treated as capital items. This doctrine was later applied in both sub-section 162(a) and 212(2) contexts in *Woodward and Hilton Hotels*. Again, the nature of the original transaction was crucial to the determination. Where the original transaction was a capital transaction, expenses flowing

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158. *Id.* at 603.

159. *Turco v. Commissioner*, 52 T.C. 631, 635 (1969); *accord*, *Kimbell v. United States*, 490 F.2d 203, 205 (5th Cir.), *cert. denied*, 419 U.S. 833 (1974).

160. 180 F. Supp. 373 (Ct. Cl. 1960).

161. *Id.* at 378.



therefrom had to be capitalized.<sup>162</sup>

The origin-of-the-claim aspect of *Arrowsmith* undermines the cases which refused to apply *Arrowsmith* where the taxpayer, motivated by a business purpose, made a payment in a subsequent year which arose out of a prior capital transaction.<sup>163</sup> Similarly, any threshold requirements to the application of the *Arrowsmith* rule — such as legal obligation for payment or a limitation which would turn on the capacity in which the taxpayer made the payment — would be erroneous.<sup>164</sup> In short, *Arrowsmith* applies the origin-of-the-claim doctrine in all cases where the payment is made in a year subsequent to the original transaction. It is not limited to subsequent payments that are actually a portion of the earlier transaction; nor can the *Arrowsmith* rule be explained solely on the basis of characterizing those payments that are a part of the acquisition cost or enhancement of a capital asset, a portion of which is paid in a subsequent year. *Arrowsmith* is applicable as well where the expense does not create or enhance a capital asset, but is integrally related to a capital transaction and flavored by it because failure to equate the tax character of the two transactions would result in a distortion of income.

In *United States v. Skelly Oil Co.*,<sup>165</sup> the Supreme Court described *Arrowsmith* as preventing unfair tax windfalls otherwise created by the annual accounting principle. In *Skelly Oil*, the taxpayer had received income, subject to a potential return requirement, reported the income in the year received under the “claim-of-right” doctrine,<sup>166</sup> and claimed offsetting percentage depletion

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162. *Sharples v. United States*, 533 F.2d 550, 554 (Ct. Cl. 1976). *Accord*, *Kimbell v. United States*, 490 F.2d 203, 204 (5th Cir.), *cert. denied*, 419 U.S. 833 (1974).

163. *See, e.g., Mitchell v. Commissioner*, 52 T.C. 170, 175-76 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

164. *See, e.g., Anderson v. Commissioner*, 480 F.2d 1304, 1308 (7th Cir. 1973), where the Tax Court's distinctions drawn along those lines were rejected. The Tax Court had stated that the taxpayer was not *required* to pay his short-swing profits back, there being no judgment against him; therefore, he must have been motivated by a business purpose (to retain his job). Moreover, the Tax Court had attempted to distinguish the taxpayer's sale of the stock in his capacity as shareholder from his pay back of the profits as an “insider” subject to § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976).

165. 394 U.S. 678 (1969).

166. In *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) the Court formulated what is now known as the “claim-of-right” doctrine:

deductions. In a subsequent year, the taxpayer was forced to return the income previously reported, and it claimed a deduction under a corollary to the claim-of-right doctrine.<sup>167</sup> Originally judicially created, the doctrine had been partially codified in section 1341,<sup>168</sup> and the taxpayer in *Skelly* claimed a deduction in the year of repayment under section 1341 for the full amount of the item previously reported. The Supreme Court held that the Internal Revenue Code should not be interpreted to allow the taxpayer "the practical equivalent of a double deduction."<sup>169</sup> Accordingly, the Court required that the section 1341 deduction allowable in the year of repayment be reduced by the percentage depletion allowance previously claimed by the taxpayer.

The claim-of-right doctrine itself and the deduction in the subsequent year result from the annual accounting principle whereby each year's tax must be definitively calculable at the end of the tax year.<sup>170</sup> The Supreme Court pointed out in *Skelly Oil*, however, that:

the annual accounting concept does not require us to close our eyes as to what happened in prior years. For instance, it is well settled that the prior year may be examined to determine whether the re-

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If a taxpayer received earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

*Id.* at 424.

167. If the taxpayer who has reported income under the claim of right doctrine is forced to return it, a deduction is allowed in the year of the repayment. *Id.*

168. I.R.C. § 1341.

169. 394 U.S. at 680 (quoting *Charles Ifeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934)).

The operation of § 1341 is illustrated in *Shipley v. United States*, 608 F.2d 770 (9th Cir. 1979). The taxpayer received money in 1967 that he treated as a gift and did not report. Four years later, a state court determined that the donor lacked capacity and that the taxpayer would have to return the money. The I.R.S. issued a notice of deficiency, classifying the money as income in the year of receipt, which the taxpayer challenged in Tax Court. The taxpayer also instituted a refund suit in district court, asserting a deduction under § 1341 by reason of the repayment. Citing *Skelly Oil*, the Ninth Circuit held that the deduction under § 1341 was limited to the extent the amount repaid was previously subjected to taxation, but that it was not necessary for the taxpayer to voluntarily report the amount. The court stayed the refund suit pending a decision in the Tax Court, refusing to grant a refund until it was determined that the amount should have been reported in the year of receipt.

170. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

payment gives rise to a regular loss or a capital loss. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result.

Accordingly, *Arrowsmith* teaches that the full amount of repayment cannot . . . be allowed as a deduction.

This result does no violence to the annual accounting system. Here, as in *Arrowsmith*, the earlier returns are not being reopened. And no attempt is being made to require the tax savings from the deduction to equal the tax consequences of the receipts in prior years.<sup>171</sup>

The Supreme Court next compared the analogous approach of the classic "tax benefit" doctrine<sup>172</sup> citing *Alice Phelan Sullivan Corp. v. United States*,<sup>173</sup> where the Court of Claims stated:

The return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery. . . . The only limitation upon that principle is the so-called "tax-benefit rule." This rule permits exclusion of the recovered item from income so long as its initial use as a deduction did not provide a tax saving. . . . But where full tax use of a deduction was made and a tax saving thereby obtained, then the extent of saving is considered immaterial. The recovery is viewed as income to the full extent of the deduction previously allowed.<sup>174</sup>

Several cases have described the rule of *Skelly Oil* and *Arrowsmith* as a tax benefit rule.<sup>175</sup> Indeed, the Court of Claims has gone so far as to attempt to force *Arrowsmith* and its progeny into the classic tax benefit rule or restoration to income format. The apparent rationale is that a capital gain or other special deduction followed by

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171. 394 U.S. 678, 684-86.

172. *Id.* at 686 n.5.

173. 381 F.2d 399 (Ct. Cl. 1967).

174. *Id.* at 401-02.

175. See, e.g., *Brown v. Commissioner*, 529 F.2d 609, 612 (10th Cir. 1976); *Anderson v. Commissioner*, 56 T.C. 1370, 1375 (1971), *rev'd*, 480 F.2d 1304 (7th Cir. 1973).

another payment in a subsequent year amounts to a recovery of the earlier tax benefit from the capital gain deduction, which recovery must be used to reduce the subsequent payment.<sup>176</sup> *Arrowsmith* and the tax benefit doctrine are closely related, but the principle should not be so strained to show the relationship.

The true relationship between the tax benefit aspect of *Arrowsmith* and the classic tax benefit rule is twofold: both are necessary corollaries of the annual accounting principle, and both require a matching across tax years of transactions that are integrally related in order to prevent a distortion of income. Such a distortion, in many instances, would produce the practical effect of a double deduction although a literal double deduction is not necessary to trigger the tax benefit doctrine.<sup>177</sup> The annual accounting principle

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176. *Dynamics Corp. of America v. United States*, 449 F.2d 402, 412 (Ct. Cl. 1971).

177. See, e.g., *Estate of McGlothlin v. Commissioner*, 370 F.2d 729, 732 (5th Cir. 1967); accord, *Arthur H. DuGrenier, Inc. v. Commissioner*, 58 T.C. 931, 938-39 (1972). However, avoidance of a "double deduction" will not always prompt the court to apply *Arrowsmith*. In *Continental Ill. Nat'l Bank v. Commissioner*, 69 T.C. 357 (1977), acq., 1978-2 C.B. 1, the Tax Court confronted "the intersection between the tax benefit rule and the closed transaction rule." 69 T.C. at 371. The court rejected the Commissioner's position, based on the "double deduction" argument of *Arrowsmith* and *Skelly Oil*, stating: "[T]his simply begs the question, assuming that we have one integrated transaction rather than two separate transactions in two different tax years, which is the very point at issue." *Id.* (emphasis added). In that case, the taxpayer purchased in 1963 a two-thirds interest in almost \$3 million of conditional sales contracts and chattel mortgages. The contracts represented sales of "stores on wheels" to Tastee Freez franchisees, and they were guaranteed by Tastee Freez Industries and by Allied Business Credit Corp. and Carrol's, Inc. (both subsidiaries of Tastee Freez). When all three companies filed Chapter XI petitions, the taxpayer filed a claim in bankruptcy court based on the guarantees. It received subordinated debentures and common stock in Tastee Freez, which it considered worthless. The Tastee Freez stock and debentures were valued at \$3.00 and the remainder was charged off against a bad debt reserve. The taxpayer received some additional recovery on the sale of collateral which it credited to the reserve. Later, Tastee Freez wanted to buy in its outstanding debentures and arranged an exchange of stock of the debentures held by the taxpayer (erroneously reported as capital gain). The taxpayer then contributed all of its Tastee Freez stock to a charitable foundation and deducted its then current value of over \$14 per share. The Internal Revenue Service viewed the 1964 bad debt writeoff and the 1968 charitable contribution deduction as a double deduction and argued that the subsequent appreciation in the value of the stock should relate back to the bad debt write-off under the tax benefit rule. The taxpayer contended that the substitution of the stock and debentures for the original guarantee obligation closed that transaction and required computation of gain or loss. Any subsequent gain, the taxpayer argued, should relate to the appreciation of the securities and constitute a separate transaction. The Tax Court agreed with the taxpayer, but admitted its result was "hardly free from doubt." *Id.* at 365-66. The Commissioner subsequently acquiesced in the result. 1978-2 C.B. 1.

requires transactions that might be subject to further developments substantially altering their tax character nevertheless to be treated as final and closed so that their tax consequences can be determined at the end of the tax year.<sup>178</sup> On the other hand, when the subsequent event in fact occurs, a taxpayer should not be permitted to take advantage of the annual accounting principle to establish a distorted picture of income for tax purposes. "When the tax benefit rule is viewed in its true character—as a necessary counterweight to the consequences of the annual accounting principle—much of the difficulty [of searching for a recovery of "property"] disappears."<sup>179</sup> Similarly, *Arrowsmith* entails closing a transaction in an earlier year and then making adjustments in the subsequent year for subsequent related transactions. Normally, the "adjustment" simply characterizes the deduction in the subsequent year.

The facts in *Skelly Oil* constituted the reverse of the classic tax benefit rule. Income was recognized in the earlier tax year under the claim of right doctrine and in accordance with the annual accounting principle. When the facts revealed that the amount had to be returned in a subsequent tax year, a deduction was allowed for the income previously recognized. The tax benefit aspect of *Arrowsmith* required that the subsequent deduction be matched with the earlier income and, accordingly, reduced by the earlier depletion deduction.<sup>180</sup> Under the classic tax benefit doctrine, a deduction is claimed in a prior year; and when subsequent events reveal that the deduction should not have been allowed, a corresponding adjustment is made to income in the later tax year, i.e., a restoration to income. In all cases, the adjustment is made in the subsequent year, rather than reopening the prior year and requiring an amended return, because of the exigencies of the annual accounting principle.<sup>181</sup>

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178. *Arrowsmith v. Commissioner*, 344 U.S. at 8-9.

179. *Estate of Munter v. Commissioner*, 63 T.C. 663, 678-79 (1975) (Tannenwald, J., concurring); accord, *Mayfair Minerals, Inc. v. Commissioner*, 56 T.C. 82, 86 (1971), *aff'd per curiam*, 456 F.2d 622 (5th Cir. 1972).

180. See notes 166-69 *supra* and accompanying text.

181. See *Montgomery v. Commissioner*, 65 T.C. 511 (1975). Adjustments, rather than amended returns, are made whether the subsequent event results in a deduction as a counterbalance to income recognition under the claim of right doctrine, "restoration" to income under the classic tax benefit doctrine to counterbalance a prior deduction, or altered charac-

The second and more significant connection among the origin-of-the-claim, the *Arrowsmith* tax benefit rule, and the classic tax benefit doctrine, is that two transactions must sometimes be considered together in order to prevent a distortion of the taxpayer's income. This is the basis for the requirement of capitalization under the claim-of-right doctrine, as well as the usual requirement that a loss be capitalized under the *Arrowsmith* doctrine.<sup>182</sup> The underlying similarity to the classic tax benefit doctrine is manifested when its "principles" are applied to items that are deducted and recovered ("restored") in the same tax year, requiring the deduction and restoration to be matched to prevent a distortion of income.<sup>183</sup>

## V. CHANGES IN CORPORATE STRUCTURE AND STOCK TRANSACTIONS

Although courts have applied an enhancement of capital asset analysis, still another area of capitalization in which the results of the cases can be reconciled, if at all, under the tax benefit doctrine is the proper tax treatment of expenditures associated with changes in a corporation's capital structure.

Organizational expenses have long been denied status as ordinary and necessary business expenses under section 162(a) and its predecessors. The early decisions did not articulate any rationale for requiring capitalization of organization expenditures; but a clue as to the premise of this rule may be seen in the first decision treating the issue. In *F. Tinker & Sons Co.*,<sup>184</sup> a corporate taxpayer had assumed certain liabilities in incorporating a predecessor partnership. The Board of Tax Appeals reasoned correctly that the liquidation of a liability assumed by a corporation as part consideration for the purchase or acquisition of assets was not an ordinary and necessary expense of doing business, but instead constituted a capital transaction. The court went on to state that the same was

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terization of a gain or loss item under *Arrowsmith*.

182. *Arrowsmith* applies to income items as well, *Lowe v. Commissioner*, 44 T.C. 363 (1966), sometimes requiring what would otherwise be a capital item to be treated as an ordinary item where the earlier transaction was ordinary. See *Bresler v. Commissioner*, 65 T.C. 182 (1975); see also *Arthur A. DuGrenier, Inc. v. Commissioner*, 58 T.C. 931 (1972).

183. *Anders v. United States*, 462 F.2d 1147, 1149 (Ct. Cl.), cert. denied, 409 U.S. 1064 (1972), reh. denied, 410 U.S. 947 (1973); *Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972); *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970).

184. 1 B.T.A. 799 (1925).

true of legal expenses paid in connection with the organization of a corporation.<sup>185</sup>

In subsequent decisions, it was explicitly stated that the capital asset acquired was not the property received in exchange for stock of the new corporation, but the corporate charter itself.<sup>186</sup> Almost from the beginning of this development, the proper treatment of corporate expenses of organization and reorganization were considered by authorities as a single issue.<sup>187</sup> The rationale of such decisions was that expenses of a reorganization or expenses of initial organization constitute amounts expended for assets that would continue to be useful in the business over several years, "presumably . . . increasing and maintaining the earning power of the taxpayer[;] and thus throughout its corporate life the taxpayer will enjoy the fruits of these expenditures."<sup>188</sup>

A parallel early development was the disallowance of the expenses of issuing stock. In contrast with the organization and reorganization cases, the theory supporting capitalization in these cases received considerable judicial attention.

Expenses incurred by a corporation in selling its capital stock, the proceeds from which are to be permanently invested in property or otherwise used in the operation of the business, subject to all its risks and hazards, are not deductible expenses, for the reason that such expenses are incurred in connection with a capital transaction. The only effect of expenses of this character, as in the case of discount at which the shares of stock may be sold, is to reduce the capital available to the corporation, and they can not be used to reduce the income from operation. They represent a capital expenditure which should be charged against the proceeds of the stock and not recouped out of operating earnings. Further, it is clear to us that the revenue of a day or a year should not be burdened with the cost of acquiring additional capital, the benefits from which will inure to the corporation over a long period of years. This is the doctrine generally recognized and adopted in the treatment of expenses incident to the procuring of temporary capital through the flotation

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185. *Id.* at 803.

186. *See* *Malta Temple Ass'n v. Commissioner*, 16 B.T.A. 409 (1929).

187. *See, e.g., First Nat'l Bank of St. Louis v. Commissioner*, 3 B.T.A. 807 (1926).

188. *Id.* at 808.

of bonds and other term securities, and in such cases the expenses are written off over the life of the indebtedness.<sup>189</sup>

The courts recognized the discord between the revenue acts and the best accounting principles in calculating net income of a corporation. Existing accounting practices would not permit commissions on the sale of stock to be carried as assets on a corporation's books; consequently, such costs would be charged off as quickly as profits permitted in order to reflect the true financial condition of the corporation.<sup>190</sup> The authorities also viewed the expenses of issuing stock as relating to capital and not to current operations; hence, such expenses "should be charged against the proceeds of the stock, and not be recouped out of operating earnings."<sup>191</sup> Clearly, the courts were concerned that allowing deduction of such commissions against operating expenses would produce a distortion of income.

[T]he controlling consideration [is] that such a commission is a capital expenditure to be charged against the proceeds of the stock, not recovered from operating earnings. It merely reduces the net returns from the sale of the stock and reduces the available capital. It has no relation to operating expenses. It is equivalent for income tax purposes to the sale of stock at a discount. There can be no substantial difference between the two. The discount in one instance represents the difference between the par value of the stock and the amount received for it; the commission represents that difference in the other. A capital expenditure cannot be charged income.<sup>192</sup>

Taxpayers argued unsuccessfully that the accounting prohibition against capitalizing such costs as a separate asset on the corporate balance sheet dictated the ordinary nature of those expenses for tax purposes. That the expenditure did not create a capital addition or investment for accounting purposes did not render the item

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189. *Emerson Elec. Mfg. Co. v. Commissioner*, 3 B.T.A. 932, 935 (1926).

190. *Simmons Co. v. Commissioner*, 8 B.T.A. 631, 650 (1927), *aff'd*, 33 F.2d 75 (1st Cir. 1929).

191. *Corning Glass Works v. Lucas*, 37 F.2d 798, 799 (D.C. Cir. 1929), *cert. denied*, 281 U.S. 742 (1930); *accord*, *Commercial Inv. Trust Corp. v. Commissioner*, 28 B.T.A. 143, 148 (1933), *aff'd per curiam*, 74 F.2d 1015 (2d Cir. 1935).

192. *Barbour Coal Co. v. Commissioner*, 74 F.2d 163, 164 (10th Cir. 1934), *cert. denied*, 295 U.S. 731 (1935).



a deductible expense for tax purposes.<sup>193</sup>

A similar problem of the absence of a definite capital asset arose when the corporate charter was amended to authorize an increase in capital stock. "It can be argued, and not without merit, that no capital asset is acquired when attorneys' fees are paid in connection with an increase in capitalization, but it does not follow that the payments are ordinary and necessary expenses of the year when made."<sup>194</sup> Moreover, even if capitalization is increased for a business purpose, resultant expenses are considered a cost of acquiring capital and consequently non-deductible.<sup>195</sup> With regard to expenses of merging or reorganizing a corporation, some courts appeared doubtful that a distinct capital asset could be found, but still allowed no current deduction, drawing an analogy to the treatment of costs incident to the acquisition or sale of property<sup>196</sup> — the prime example of the origin-of-the-claim test.<sup>197</sup>

It was easier for the courts to find that expenses incurred by a corporation in connection with a redemption of its stock constituted a capital expenditure to be treated as part of the cost of the stock so purchased. "Certainly, the cost of the stock itself was a capital expenditure rather than a deductible expense, and the accompanying legal fee must be similarly classified."<sup>198</sup>

Although these various expenditures were held to be capital in nature, the cases, with one exception,<sup>199</sup> did not allow deductions for amortization. This result was usually based on the theory that the corporate franchise had no determinable life — in the case of

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193. *Van Keuren v. Commissioner*, 28 B.T.A. 480, 486 (1933); *Baltimore & O.R.R.*, 29 B.T.A. 368, 372-73 (1933), *aff'd*, 78 F.2d 460 (4th Cir. 1935).

194. *Holeproof Hosiery Co. v. Commissioner*, 11 B.T.A. 547, 556 (1928); *accord*, *Fireman's Ins. Co. v. Commissioner*, 30 B.T.A. 1004, 1014 (1934).

195. *Fishing Tackle Prod. Co. v. Commissioner*, 27 T.C. 638, 645 (1957).

196. *See, e.g.*, *Odorono Co. v. Commissioner*, 26 B.T.A. 1355, 1359 (1932).

197. *See Woodward v. Commissioner*, 397 U.S. 572, 575-76 (1970); notes 76, 92-140 *supra* and accompanying text.

198. *Atzingen-Whitehouse Dairy, Inc. v. Commissioner*, 36 T.C. 173, 183 (1961). *But see Five Star Mfg. Co. v. Commissioner*, 355 F.2d 724, 727 (5th Cir. 1966) (citing *Corn Prod. Refining Co. v. Commissioner*, 350 U.S. 46 (1955)). The doubtful precedential value of *Five Star* is discussed in note 258 *infra* and accompanying text.

199. *Hershey Mfg. Co. v. Commissioner*, 14 B.T.A. 867 (1928), *modified*, 43 F.2d 298 (10th Cir. 1930) (organizational expenses amortized by corporation with a specified period of existence fixed by charter).

organization and reorganization expenditures — or the theory that there was no separate capital asset which could be amortized—in the case of stock issues.<sup>200</sup>

In *Malta Temple Association*,<sup>201</sup> the Tax Court early held, however, that corporate organization expenses were deductible under the loss provisions of the Code upon *dissolution* of the corporation and abandonment of its corporate franchise. In dealing with organizational expenses, the “loss” approach was easy to fit into a capital asset acquisition framework. Viewing the organization expenses as creating a franchise right, the franchise became worthless and there was a loss when that right terminated.<sup>202</sup> The courts also held that legal fees incurred in connection with dissolution of a corporation were deductible expenses.<sup>203</sup> The articulated rationale for deductibility of the liquidation expenses was not that the cost of liquidation constituted a deductible loss, but that the costs of dissolution and liquidation were ordinary and necessary business expenses. In *Pacific Coast Biscuit Company v. Commissioner*,<sup>204</sup> the Board of Tax Appeals stated:

Dissolution and liquidation will of course occur but once in the case of any particular corporation, but it is an everyday happening in the business world. . . . Consequently we are of the opinion that costs of dissolution and liquidation are both ordinary and necessary expenses within the meaning of the statute.<sup>205</sup>

Subsequent cases based the deduction of liquidation expenses upon the aberrant and misleading theory that such expenditures did not create or enhance a capital asset.<sup>206</sup> So articulated, deductibility conflicted with disallowing deductions for expenditures in-

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200. See generally FED. TAX COORDINATOR 2d ¶ L-3007 (corporate organizational costs), ¶ L-3101 (cost of stock-issue), and cases cited therein.

201. 16 B.T.A. 409, 411 (1929).

202. *Shellabarger Grain Prod. Co. v. Commissioner*, 146 F.2d 177, 185 (7th Cir. 1944); *accord*, *Liquidating Co. v. Commissioner*, 33 B.T.A. 1173, 1189 (1936).

203. See, e.g., *Pacific Coast Biscuit Co. v. Commissioner*, 32 B.T.A. 39, 42 (1935); *accord*, *E.C. Laster v. Commissioner*, 43 B.T.A. 159, 177 (1940), *aff'd and rev'd on other grounds*, 128 F.2d 4 (5th Cir. 1942).

204. 32 B.T.A. 39 (1935).

205. *Id.* at 43.

206. *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872 (2d Cir. 1936).

curred in increasing capitalization or issuing stock. More significantly, the rationale led to faulty reasoning in the partial liquidation cases.<sup>207</sup>

In contrast to the deductibility of organizational expenses in the case of a liquidation, the authorities ruled that no deduction for such expenses was allowable when the taxpayer merged with another corporation. The early theory was that, whereas in a liquidation a complete extinction of the corporation occurred, all of the "rights, powers, liabilities and assets" survived in a merger, except the "indicia and attributes of a corporate body distinct from that into which it was merged."<sup>208</sup>

In contrast to the treatment of organizational expenses upon liquidation, previously capitalized costs of issuing stock were held not deductible upon liquidation under the theory that the costs of raising capital did not result in a separate asset which could be "lost."

It may fairly be said that money expended to form a corporation results in the acquisition of an asset, namely, the corporate franchise, which may be considered as a balancing asset, but money paid out to acquire capital does not result in the acquisition of any asset other than the capital itself.<sup>209</sup>

Where plans for a merger are abandoned, the expenses are deductible as an abandonment loss in a transaction entered into for profit.<sup>210</sup> This result does not change where the taxpayer ultimately does enter into a capital transaction, such as a merger or reorganization, provided that proposals or other steps for a merger were in fact definitely abandoned.<sup>211</sup> But where the various proposals do not have a separate vitality and part of them can be said to have been used in the ultimate capital transaction, no abandon-

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207. See, e.g., *United States v. General Bancshares Corp.*, 388 F.2d 184 (8th Cir. 1968).

208. *Citizens Trust Co.*, 20 B.T.A. 392, 393-94 (1930). For disallowance of expenses of a merger see *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872 (2d Cir. 1936).

209. *Van Keuren v. Commissioner*, 28 B.T.A. 480, 487 (1933).

210. *Doernbecher Mfg. Co. v. Commissioner*, 30 B.T.A. 973, 986 (1934), *aff'd and remanded*, 80 F.2d 573 (9th Cir. 1936), *aff'd*, 95 F.2d 296 (9th Cir. 1938).

211. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950); *accord*, *Picker v. United States*, 371 F.2d 486, 498 (Ct. Cl. 1967); *Portland Furniture Mfg. Co. v. Commissioner*, 30 B.T.A. 878 (1934).

ment loss is deductible.<sup>212</sup>

For the most part, the above conclusions were not changed by the decisions in *Woodward v. Commissioner*<sup>213</sup> and *United States v. Hilton Hotels Corp.*<sup>214</sup> or other capital expenditure developments, although the reasoning of some of the cases appears to have lost its force. On the other hand, the results of cases decided in the area of partial liquidations, divisive reorganizations and similar areas which display elements both of liquidations and of reorganizations, may well have been undercut both by changes in the 1954 Code and by *Woodward* and *Hilton Hotels*.

Under the Internal Revenue Code of 1939, all stock redemptions constituted partial liquidations; additionally, there was no explicit statutory provision for carryover of corporate attributes in a reorganization analogous to section 381 of the 1954 Code.<sup>215</sup> In the 1954 Code, Congress also sought (although not wholly successfully) to separate partial liquidations or corporate contractions — in which distributions were to be characterized solely at the corporate level<sup>216</sup> — from redemptions in which tax characteristics were to be determined at the shareholder level.<sup>217</sup>

The first case in this development was *Mills Estate, Inc. v. Commissioner*,<sup>218</sup> wherein the Tax Court acknowledged two lines of decisions pointing in opposite directions:

On the one hand, it is firmly recognized that the costs incurred in organizing or reorganizing a corporation, or of altering its stock structure, or of selling or disposing of a stock issue, or of acquiring and retiring outstanding stock, are treated as capital expenditures rather than as ordinary and necessary business expenses which are deductible from current income. . . . On the other hand, expendi-

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212. *Haspel v. Commissioner*, 62 T.C. 59, 72-73 (1974), *aff'd in unpub. opinion*, (8th Cir. Mar. 20, 1975).

213. 397 U.S. 572 (1970). See notes 76, 92-140 *supra* and accompanying text.

214. 397 U.S. 580 (1970). See notes 92-140 *supra* and accompanying text.

215. I.R.C. § 381.

216. I.R.C. § 346 defines a partial liquidation. I.R.C. § 331(a)(a) provides that “[a]mounts distributed in partial liquidation of a corporation . . . shall be treated as in part or full payment in exchange for stock.”

217. I.R.C. § 302(b)(1) - (4) sets forth four situations in which a redemption of stock receives capital rather than dividend treatment.

218. 17 T.C. 910 (1951), *rev'd*, 206 F.2d 244 (2d Cir. 1953).

tures incurred in connection with the complete liquidation of a corporation have been held deductible as ordinary and necessary expenses.<sup>219</sup>

The corporate taxpayer engaged in two activities, owning all of the stock in a corporate subsidiary and also operating substantial real estate. It sold the real estate and distributed the proceeds to shareholders pro rata in exchange for almost fifty percent of their stock and then issued new stock in exchange for the remainder of their old stock. Mechanically, the transaction was accomplished through an amendment to the corporate charter reducing the authorized and outstanding capital; the bulk of the distribution was allocated to the reduction in capital stock; the remainder was charged to contributed surplus. The taxpayer deducted the legal fees and expenses incurred in the transaction. The Tax Court reasoned that the expenditures had characteristics of both lines of decisions.

Petitioner's legal expenses were undoubtedly incurred in substantial part in order to amend its charter and reduce authorized capitalization, thereby providing for the acquisition and retirement of its stock followed by the issuance of new stock in reduced amount. This aspect of the transaction certainly brings the case within the first line of authority. However, the actual distribution of assets in partial liquidation was also a significant factor with respect to which the legal fees were paid, and it is difficult to perceive why the cost of a partial liquidation should be any less an ordinary and necessary business expense than the cost of a complete liquidation.<sup>220</sup>

Accordingly, the Tax Court allowed the taxpayer to deduct half the legal expenses (as allocable to the distribution of assets) and required capitalization of the remaining half. The Second Circuit reversed because it did not think that the legal fees should be split into parts and viewed separately to determine their deductibility. Viewing the entire proceedings as a single transaction under the step-transaction doctrine,<sup>221</sup> it concluded that the recapitalization

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219. 17 T.C. at 914 (citations omitted).

220. *Id.* at 915.

221. 206 F.2d at 246 (quoting *Case v. Commissioner*, 103 F.2d 283, 286 (9th Cir. 1939) where the court stated, "For income tax purposes the entire proceeding must be viewed as a single transaction. Substance and not form controls in applying a tax statute.").

was undertaken in order to give the taxpayer a corporate structure best suited to carrying on the continued portion of its business and that the legal services were all necessary steps to that end. "What occurred was essentially a reorganization—a change in the corporate structure for the benefit of future operations—and the expenses of that sort of a corporate change are not deductible as ordinary and necessary expenses in carrying on a trade or business."<sup>222</sup> The court held the costs were "part of the expenditure needed to give the corporation an intangible asset we may call its altered corporate structure; and, as were the costs of its original organization, these expenditures were capital in nature."<sup>223</sup>

Formalism triumphed in the decade between *Mills Estates* and the next landmark partial liquidation decision, *Gravois Planing Mill Co. v. Commissioner*.<sup>224</sup> Several courts held that where a corporation was dissolved and its assets transferred to a new corporation in exchange for stock issued proportionately to the shareholders of the old corporation, the entire transaction did not constitute a reorganization, but amounted to a liquidation of the old corporation the expenses of which were deductible.<sup>225</sup> Furthermore, a number of cases decided under the 1939 Code held that where a subsidiary corporation was liquidated and its assets distributed to its parent, various expenses (including the organizational costs and the cost of liquidation) were deductible in the year of dissolution, notwithstanding the continuity of business in the hands of the liquidated corporation's parent.<sup>226</sup>

In *Tobacco Products Export Corp. v. Commissioner*,<sup>227</sup> decided

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222. 206 F.2d at 246.

223. *Id.*

224. 299 F.2d 199 (8th Cir. 1962).

225. *United States v. Arcade Co.*, 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *accord*, *Braicks v. Henriksen*, 43 F. Supp. 254 (W.D. Wash. 1942), *aff'd*, 137 F.2d 632 (9th Cir. 1943). Under the liquidation-reincorporation doctrine, largely developed under the 1954 Code, these transactions would have been treated as constituting an "F" reorganization and the costs would have been capitalized.

226. *Koppers Co. v. United States*, 278 F.2d 946 (Ct. Cl. 1960); *accord*, *Bryant Heater Co. v. Commissioner*, 231 F.2d 938 (6th Cir. 1956); *Commissioner v. Wayne Coal Mining Co.*, 209 F.2d 152 (3d Cir. 1954); *Dragon Cement Co. v. United States*, 144 F. Supp. 188 (S.D. Me. 1956), *remanded*, 244 F.2d 513 (1st Cir.), *cert. denied*, 255 U.S. 833 (1957), *on remand*, 163 F. Supp. 168 (S.D. Me. 1958).

227. 18 T.C. 1100 (1952).

before the Second Circuit's reversing opinion in *Mills Estate*, the Tax Court maintained its earlier view and allocated the expenses of a partial liquidation between the reduction in stated capital and the distribution to shareholders. However, in *Standard Linen Service, Inc. v. Commissioner*,<sup>228</sup> decided after the Second Circuit's reversal of *Mills Estate*, the Tax Court appears to have adopted the Second Circuit's approach of viewing the entire proceeding as a single transaction, the "dominant aspect" of which governs the tax character of the expenditures.

In *Gravois Planing Mill Co. v. Commissioner*,<sup>229</sup> decided under the 1939 Code, a fifty percent shareholder in a closely held corporation retired from the business. Because the corporation did not have sufficient cash to cover the "purchase" of his shares, it transferred land and improvements in part payment for the shares. The Eighth Circuit surveyed the existing cases calling for capitalization of expenses of a reorganization or recapitalization and concluded that the theory usually expressed to support the result was that such expenditures related to a continuing asset. Deductibility of liquidation expenses was based on the theory that such expenditures did not concern the creation or continuance of a capital asset. Surveying the partial liquidation cases decided under the 1939 Code, the court noted that since a partial liquidation (under the 1939 Code) was inevitably accompanied by a change in corporate structure, its expenses would just as inevitably have some connection with the continuing corporate operation. The *Gravois* court concluded that while the shareholders and the corporation desired to keep the organization going, the basic problem with which they struggled was the disposition of the outstanding stock of the fifty percent shareholder and not the "change or any desired improvement in the form of the corporate structure."<sup>230</sup> The court reasoned:

Stock retirement, that is, partial liquidation, was the problem and it was the essence of what transpired. . . . Of course, the transaction involved a reduction in the corporation's stated capital and a continuance of the corporate activity. . . . These additional facts, how-

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228. 33 T.C. 1 (1959).

229. 299 F.2d 199 (8th Cir. 1962).

230. *Id.* at 209.

ever, are necessary concomitants of this type of partial liquidation. We regard them as constituting only a secondary and not a dominant aspect of the entire transaction.<sup>231</sup>

The Eighth Circuit concluded that the dominant aspect of the transaction was the liquidation of the fifty percent shareholder's shares and not recapitalization. Although the court neither agreed nor disagreed explicitly with the Second Circuit's conclusion in *Mills Estate*, the tenor of its opinion was that the Second Circuit's conclusion (or at least its approach) was incorrect.

*Gravois Planing Mill* did not address the 1939 Code line of cases holding that a straight redemption of a shareholder's stock constituted a capital transaction because it was attributable to a capital asset, *viz.*, the stock.<sup>232</sup> Commentators have properly suggested that under the 1954 Code, the question of deductibility of costs of liquidation versus merger should turn on whether the capitalized organization expenditures, and inferentially the costs of the transaction, would be carried over to the successor organization.<sup>233</sup> Other commentators have argued that the partial liquidation cases should turn on whether the "dominant aspect" of the transaction more closely resembles a section 346 corporate contraction or a section 302 redemption determined at the shareholder level.<sup>234</sup>

It appears that the courts are still following formalism in the area of merger versus liquidation. On the one hand, the Fifth Circuit has ruled that dissolution expenditures of a corporation are not deductible when the corporation becomes a constituent of the surviving corporation in a merger, since the "assets" are not lost but continue beyond the corporate existence of the constituent corporation and persist as capital assets of the surviving corpora-

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231. *Id.*

232. See, e.g., *Atzinger-Whitehouse Dairy, Inc. v. Commissioner*, 36 T.C. 173 (1961); *Commerce Photo-Print Corp.*, 6 T.C.M. 386 (1947). See generally Cohen, *The Deductibility of Stock Redemption Expenses*, 24 CASE W. RES. L. REV. 431, 435 (1973); Phillips, *Deductibility of Legal Expenses Incurred in Corporate Stock Redemptions, Partial Liquidations, and Separations*, 1976 DUKE L.J. 941.

233. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 5-34, 5-35 (4th ed. 1979).

234. Cohen, *The Deductibility of Stock Redemption Expenses*, 24 CASE W. RES. L. REV. 431, 444 (1973). See notes 215-17 *supra* and accompanying text.



tion.<sup>235</sup> While the reorganization considered by the Fifth Circuit was a "statutory merger,"<sup>236</sup> the analysis of whether the attributes carry over would appear applicable to any reorganization to which section 381(c) applies.<sup>237</sup> On the other hand, the Tax Court has ruled that in a so-called practical merger,<sup>238</sup> the old corporation could be treated as liquidated because only the assets of the "liquidated" corporation were transferred to the surviving corporation and none of its corporate attributes, rights, privileges, powers, or franchises were passed to the surviving corporation. The organizational expenses in controversy were therefore a proper deduction in the final tax return of the liquidated corporation.<sup>239</sup> The rationale of the Tax Court was that where an ordinary liquidation is followed by a surrender of the corporate charter, "a loss deduction has been allowed on the theory that when complete liquidation and dissolution occurred a capital asset acquired at the time of organization (the corporate franchise) was lost."<sup>240</sup> In the case of a statutory merger or consolidation, "no loss deduction has been allowed because the surviving or merged corporation continues to receive the benefit of the corporation expenditures."<sup>241</sup> On the other hand, in a "C" reorganization, such expenditures, if capitalized, should carry over to the transferee corporation under section 381(c).<sup>242</sup> Similarly, in the liquidation of a subsidiary into its parent such assets would carry over unless the strictures of section 334(b)(2) are met.<sup>243</sup> The courts have yet to focus directly upon this apparent conflict between the cases.

The partial liquidation cases under the 1954 Code continue to be resolved on the basis of whether the transaction results in a benefit

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235. *Vulcan Materials Co. v. United States*, 446 F.2d 690 (5th Cir.), *cert. denied*, 404 U.S. 942, *reh. denied*, 404 U.S. 1006 (1971). The lower court drew an apparently proper distinction between assets which continue to exist and those which cease upon the act of merger. 308 F. Supp. 53, 58 (N.D. Ala. 1969).

236. See I.R.C. § 368(a)(1)(A).

237. I.R.C. § 381(c).

238. See I.R.C. § 368(a)(1)(C).

239. *Kingsford Co. v. Commissioner*, 41 T.C. 646, 661-62 (1964).

240. *Id.* at 661.

241. *Id.*

242. A "C" reorganization, a "practical merger," is defined in I.R.C. § 368(a)(1)(C). See I.R.C. § 381(c).

243. I.R.C. § 334(b)(2).

to the old corporation in its future operations. In *United States v. General Bancshares Corp.*,<sup>244</sup> the taxpayer was required by statute to divest itself of its non-banking operations. The taxpayer transferred all of its non-banking assets and stock in non-banking corporations to a newly created subsidiary pursuant to section 351.<sup>245</sup> Then, under a special relief provision of the 1954 Code,<sup>246</sup> all of the stock in the new non-banking subsidiary was distributed pro rata to the shareholders without redeeming any shares or issuing additional shares. The Eighth Circuit returned to the rationale that organizational expenditures must be capitalized because they were associated with the corporation's continued operations and betterment for the duration of its existence (or for the indefinite future), in contrast to being devoted to income production or more immediate corporate needs. The court then applied this rule in the framework of the "dominant aspect" test of *Mills Estate*, concluding that while "any distribution or liquidation of capital assets effects some change in the corporate structure, . . . such a change [must] be of some benefit, tangible or intangible, to the [corporation] in its future operations before it can be deemed more than incidental to the distribution or liquidation."<sup>247</sup> The conclusion in *General Bancshares* was that the taxpayer's benefit from the transaction added nothing of value to its corporate structure and that it acquired no additional rights from the divestment. The taxpayer's only benefit was the preservation of its banking business for future business purposes, but the overriding aspect of the plan of divestment was the *distribution* of its non-banking assets.<sup>248</sup>

One objection to the *General Bancshares* analysis is the difficulty of predicting results. For example, in *Bilar Tool & Die Corp. v. Commissioner*,<sup>249</sup> the Tax Court applied a "dominant purpose" test to the expenses of a split-up undertaken to divide the corporation's business and assets between two equal shareholders in order to continue the business remaining in the old corporation and to

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244. 388 F.2d 184, 191 (8th Cir. 1968); *accord*, *Transamerica Corp. v. United States*, 254 F. Supp. 504 (N.D. Cal. 1966), *aff'd*, 392 F.2d 522 (9th Cir. 1968).

245. I.R.C. § 351.

246. I.R.C. §§ 1101-1103 (distributions pursuant to Bank Holding Company Act).

247. 388 F.2d at 191.

248. *Id.*

249. 62 T.C. 213, 218-19 (1974), *rev'd*, 530 F.2d 708 (6th Cir. 1976).

eliminate the friction that was obstructing the proper conduct of the business.<sup>250</sup> The Tax Court found no improvement or betterment of any capital asset owned by the corporation, nor any acquisition of capital assets, nor any changes in the corporate structure for the benefit of future operations. Instead, the dominant aspect of the transaction was a partial liquidation in that the corporation "divested itself of part of its assets in return for part of its stock and continued in business on a reduced basis."<sup>251</sup> On appeal, the Sixth Circuit found to the contrary that the divisive reorganization of a corporation that had been "going down the drain" to produce two viable corporations clearly added value to the capital structure of both the original corporation and the successor corporations. Because of this benefit to the corporations, and because there was no retirement and withdrawal of capital as in *Gravois Planing Mill*, the Sixth Circuit in *Bilar Tool & Die* held that the expenditures benefited the old corporation by terminating the dissension which threatened to destroy it. Furthermore, the expenditures were of capital benefit to both the successor corporations in making possible their creation.<sup>252</sup>

The greater difficulty in resolving partial liquidation cases on the basis of whether the transaction results in a benefit to the corporation extending for more than one year lies in the conflicts that this rationale produces with other corporate structure cases. Moreover, this approach is not wholly consistent with the theories and results in other capital expenditure areas. The conflicts are readily apparent from the holdings in many of the early corporate structure cases that expenditures which did not result in a definite capital asset were nonetheless disallowed as deductible ordinary and necessary business expenses.<sup>253</sup> The inconsistency can be seen by the fact that such expenditures in many instances are actually creating or enhancing only an intangible asset that produces future income and, as such, would be allowed as ordinary deductions outside the corporate organization and reorganization area.<sup>254</sup>

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250. The Plan of Corporate Separation adopted by Bilar's board of directors is set out at 62 T.C. at 214-15.

251. *Id.* at 220.

252. 530 F.2d at 712-13.

253. *See, e.g.,* Holeproof Hosiery Co. v. Commissioner, 11 B.T.A. 547, 556 (1928).

254. *See* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973) (discussed

In addition, it is difficult to reconcile the reasoning of some of these lines of cases, particularly the partial liquidation cases, with the analysis in *Woodward and Hilton Hotels*. For example, in *Jim Walter Corp. v. United States*,<sup>255</sup> the Fifth Circuit reasoned that the rationale for capitalization of expenses incurred in connection with the acquisition of issuance of corporate stock and other reorganization or recapitalization expenditures is to be derived from *Woodward and Hilton Hotels*. The court also cited *Estate of Meade v. Commissioner*,<sup>256</sup> which had pointed out that a shareholder's expenditures in a liquidation must be capitalized because they are incident to the disposition of a capital asset—his stock. According to this analysis, the business reasons and benefits for the change in capital structure, partial liquidation or reorganization are irrelevant. Since the expenditures are associated with a capital asset, *viz.*, the shares of the corporation, they are non-deductible.

The taxpayer in *Jim Walter Corp.* also argued that *Five Star Manufacturing Corp. v. Commissioner*<sup>257</sup> established that although expenses of recapitalization or other capital structure changes are generally non-deductible capital expenses, they are nevertheless deductible when they arise for a valid business purpose other than altering the capital structure. The Fifth Circuit replied that due to the recent rejection of the primary purpose test, it read *Five Star* as being "limited to situations where a payment to purchase a capital asset, though capital in nature, is necessary to the taxpayer's survival."<sup>258</sup> The Third Circuit was faced with a similar argument

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at notes 28-33, 56-61 *supra* and accompanying text).

255. 498 F.2d 631, 638-39 (5th Cir. 1974).

256. 489 F.2d 161 (5th Cir. 1974), *discussed* 498 F.2d at 639.

257. 355 F.2d 724 (5th Cir. 1966).

258. 498 F.2d at 639. The taxpayer in *Jim Walter Corp.* also based its argument on *United States v. Smith*, 418 F.2d 589 (5th Cir. 1969). However, the court limited both cases to their particular facts, stating

The final fatal flaw in [the taxpayer's] arguments is that *Five Star* and *Smith* [discussed *infra*] simply do not establish that any type of primary business purpose will suffice to convert an otherwise non-deductible expense of recapitalization or other changes in capital structures into a deductible item. The expenditures in those two cases were made to save the corporation from dire and threatening consequences. The court in *Five Star* stressed the extraordinary factual situation which showed a business emergency . . . . We think the principle followed in the two cited cases should not be extended beyond the facts of the cases.

in *H. & G. Industries, Inc. v. Commissioner*.<sup>259</sup> The court did not decide whether a redemption or other capital transaction necessary to the survival of a corporate taxpayer would be deductible because the stock redemption in that case was no more than an astute business decision to take advantage of improved business and monetary conditions. If *Five Star* retains any validity, it is probably only as a manifestation of one of the rationales apparently underlying the insolvency exception to recognizing income from cancellation of indebtedness—it's not nice to kick a man who is already down.<sup>260</sup>

If the question of capitalization of organizational expenditures, reorganization expenditures, expenditures in connection with the issuance of corporate stock or redemption or transfers of stock were all approached from the *Woodward and Hilton Hotels* tax benefit viewpoint of avoiding distortion of income, many of the complexities in this area disappear. In all of these transactions, the corporation recognizes no gain;<sup>261</sup> accordingly, to allow it a deduction would produce a distortion of its income.<sup>262</sup> Some decisions have implicitly recognized this rationale. In *Arthur H. DuGrenier, Inc. v. Commissioner*<sup>263</sup> a corporation in a year subsequent to a redemption made an additional payment to the redeemed shareholder. The court, under the *Arrowsmith* doctrine, treated the payment as an additional portion of the purchase price and, hence, characterized it as a capital expenditure. The Tax Court noted that, unlike the usual *Arrowsmith* transaction, it had not allowed a capital loss.<sup>264</sup> Instead, the court classified the additional redemption payment as a capital expenditure even though the year of redemption was closed. "The reason is that we are not here con-

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498 F.2d at 638-39 (emphasis added). See also *H & G Indus., Inc. v. Commissioner*, 495 F.2d 653, 656-57 (3d Cir. 1974); *Skaggs Co., Inc. v. Commissioner*, 59 T.C. 201, 205 (1972).

259. 495 F.2d 653 (3d Cir. 1974).

260. See Treas. Reg. § 1.61-12(b).

261. See, e.g., I.R.C. § 337 (12 month liquidation); I.R.C. § 361 (corporate reorganization).

262. See *Gunn*, *supra* note 5, at 492-95.

263. 58 T.C. 931 (1972).

264. In the usual situation, a capital loss is allowed where the prior transaction is closed because the additional expense cannot be added to basis. In such circumstances, to prohibit recognition of a loss would in effect cause the taxpayer to be "subject to a double tax, i.e., the payment of additional funds without a commensurate increase in basis." 58 T.C. at 939 n.9.

cerned with a sale, but rather, the redemption by a corporation of its own stock. Therefore, there is no question of a double tax since a corporation recognizes no gain in dealing with its own stock."<sup>265</sup> Analogously, the Fifth Circuit in *Estate of McGlothlin v. Commissioner*,<sup>266</sup> required a shareholder who had been a party to a corporate reorganization to capitalize an additional payment in a subsequent tax year that arose out of the original reorganization. Relying on *Arrowsmith*, the court refused to allow a capital loss, since the payment was made in discharge of an obligation created in the original tax-free reorganization.

In summary, case law supports the view that expenditures made in connection with a tax-free transaction (which incidentally constitutes a capital transaction as well) are not currently deductible, but must be capitalized. To allow a current deduction where the corresponding "income" is not recognized, would produce a distortion of the taxpayer's income. Such distortion is precluded by *Woodward*, *Arrowsmith* and other authorities comprising the origin-of-the-claim and the tax benefit doctrines. Under this rationale, the various organization, reorganization, redemption, and stock issuance authorities can be reconciled without creating disharmony with the enhancement of intangible asset cases. Analysis of the organization/reorganization cases on this basis removes their conflict with *Briarcliff Candy*; but the next question is whether such an analysis is consistent with the tax benefit rule.

Application of the origin-of-the-claim analysis to the facts in *Briarcliff Candy* would not result in capitalization of the expenditures. In *Briarcliff Candy*, the promotion and advertising expenses were basically designed to produce ordinary income through future profits and sales. Consequently, no issue arose therein as to the propriety of coupling ordinary deductions with capital gains or a nonrecognition transaction. Of course, a sale of the business itself, thereby including the intangible asset enhanced by the *Briarcliff Candy* expenditures, would to a degree<sup>267</sup> produce capital gain. However, in the normal business situation, the taxpayer is not

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265. *Id.*

266. 370 F.2d 729 (5th Cir. 1967).

267. The sale of an entire business must be fragmented asset by asset into ordinary income and capital gain components. *Williams v. McGowan*, 152 F.2d 770 (2d Cir. 1945).

looking towards capital gains from the sale of the business but towards ongoing profits in making such expenditures.

The deductibility of liquidation costs rests on a completely different rationale; namely, where a capital asset is abandoned or ceases to exist, a loss is allowed under section 165.<sup>268</sup> Application of this rationale is easy where organizational expenditures are involved, either viewing the franchise as the capital asset or more properly analyzing the expenditures themselves as constituting the asset.<sup>269</sup> Furthermore, the expenses of the liquidation itself fits into the former mold if conceptualized as made incident to a capital transaction and then added to the basis of the intangible corporate assets to which the expenses are incident (*e.g.*, corporate structure, earning power), which assets are then lost upon the liquidation. The deduction is available at liquidation, simply because it is the last opportunity to take the deduction. Viewed in this manner, whenever such capitalized cost can be carried over to a successor corporation as a corporate attribute under section 381,<sup>270</sup> regardless of the type of reorganization or liquidation, any loss deduction should be deferred until final liquidation. From such perspective, the partial liquidation cases are in error because the corporation still exists and, ultimately, can take the deduction. Similarly, capitalized organization expenses are carried over in divisive reorganization under section 355;<sup>271</sup> and the successor corporations can take the deduction.

Generally, expenditures or commissions for issuing stock are not deductible by a corporation upon its liquidation;<sup>272</sup> however, the Tax Court has held that a corporation is entitled to a deduction at the time of its liquidation for expenses of issuing shares for promotional activities which constituted, in effect, organizational expenditures.<sup>273</sup> The court pointed out that a corporation can deduct the fair market value of stock paid as compensation for services. In this instance, the stock was for services, but no current deduction

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268. I.R.C. § 165.

269. See notes 184-88 *supra* and accompanying text.

270. I.R.C. § 381.

271. I.R.C. § 355.

272. See note 209 *supra* and accompanying text.

273. *Hollywood Baseball Assoc. v. Commissioner*, 42 T.C. 234, 270-71, *acq.* 1964-2 C.B. 6, *aff'd*, 352 F.2d 350 (9th Cir. 1964).

had been allowed because the shares had been issued for organizational services. In another decision, the Tax Court held that notwithstanding the rule that corporate expenditures to redeem shares must be capitalized (since incurred in a capital transaction), when the redeemed shares are cancelled, the corporate taxpayer is entitled to an ordinary loss. The court's theory was that cancellation of the redeemed stock eliminates the asset whose basis can be increased. "The amount is in the nature of an amount expended in an effort to acquire a capital asset which results in a failure to acquire the asset."<sup>274</sup>

## VI. REPAIR OR REPLACEMENT

Treasury Regulation section 1.162-4 sets forth a positive precept: the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its useful life, but only keep it in an ordinarily efficient operating condition, are deductible currently as a business expense, provided that the basis of the taxpayer's plant, equipment, or other property is not increased by the amount of such expenditures. It also contains a negative precept: repairs which are in the nature of replacements must be capitalized to the extent that they arrest deterioration and appreciably prolong the life of business property. Moreover, Treasury Regulation section 1.263(a)-1(b) requires capitalization of amounts paid or incurred that either (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt such property to a new or different use. Paralleling the positive statement of section 1.162-4, the capital expenditures regulation continues to announce that amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.

Together, these regulations catalogue the traditional guideposts for determining whether a particular expenditure qualifies as a deductible repair or must be capitalized. In summary, if an expenditure falls within any one of the following categories, it must be capitalized:

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274. *Foster v. Commissioner*, 1966 T.C.M. (P-H) ¶ 66,273.



- (1) Materially adds to the value of property;
- (2) Appreciably extends the life of property;
- (3) Constitutes a repair in the nature of a replacement; or
- (4) Adapts property to a new or different use.

Conversely, an expenditure is deductible as a repair if it maintains the ordinarily efficient operating condition of property used in a business or constitutes an incidental repair, such as replacement of a recurring minor item. In addition to these major regulatory principles, the cases have added a gloss under which an otherwise deductible repair is capitalized if part of an overall pattern of rehabilitation.<sup>275</sup> The leading repair case, *Illinois Merchants Trust Co. v. Commissioner*,<sup>276</sup> summarizes these rules:

In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.<sup>277</sup>

The following analysis discusses each of these items and then considers the principles that may underlie the often conflicting re-

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275. See notes 332-46 *infra* and accompanying text.

276. 4 B.T.A. 103 (1926).

277. *Id.* at 106. The Board of Tax Appeals relied upon its prior decision, *Simmons & Hammond Mfg. Co. v. Commissioner*, 1 B.T.A. 803, 806 (1925), where it had looked to Supreme Court railroad rate cases [*Illinois Central R.R. v. I.C.C.*, 206 U.S. 441, 462 (1907); *Union Pacific R.R. v. United States*, 99 U.S. 402, 420 (1878)] for the meaning of capital expenditures in the context of repairs.

sults in this area, suggesting a resolution to the otherwise endlessly litigated issue of what is deductible in the area of repairs.<sup>278</sup>

#### A. *Expenditures Which Materially Add to the Value of Property*

The material addition to value criterion frequently is indivisible from the rule that an expenditure to create or enhance a tangible asset with a useful life of more than one year must be capitalized.<sup>279</sup> For example, in *Hotel Kingkade v. Commissioner*,<sup>280</sup> the Tenth Circuit held that certain expenditures incurred for items such as carpets, refrigerators, refueling and repair of heating and water boilers, closet tanks bowls, cooking ranges, and tile work in a hotel were capital in nature. "Some were for repairs of a permanent nature which materially added to the value of the property and appreciably prolonged its life as an operating hotel; and others were for replacements of furnishings and equipment having a useful life in excess of one year."<sup>281</sup> The difficulty of drawing lines in this area is increased by the fact that any proper repair increases the value of property as compared with the situation immediately before the repair.<sup>282</sup> Accordingly, one line of Tax Court cases holds that the question is whether the expenditure *materially* increases the value of the property.<sup>283</sup>

Some cases have held that an expenditure is not capital in nature where some aspects of the property are permanently improved, but the process of repair itself creates an offsetting detriment, resulting in no *net* increase in value.<sup>284</sup> Allowing a current deduction for expenditures that do not add additional value has been carried to the extreme of permitting a current deduction for the cost of microfilming back issues of a newspaper; even though the microfilm had a useful life in excess of one year, the acquisition

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278. See Gunn, *supra* note 5.

279. See notes 21-24 *supra* and accompanying text.

280. 180 F.2d 310 (10th Cir. 1950).

281. *Id.* at 312.

282. The Board of Tax Appeals recognized this fact as early as 1926. See *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 107 (1926).

283. See, e.g., *Oberman Mfg. Co. v. Commissioner*, 47 T.C. 471 (1967); *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962).

284. *W.C. Hudlow, Jr. v. Commissioner*, 30 T.C.M. 894 (1971).

did not improve the original plant of the newspaper publisher because the microfilm was a duplication of existing copies.<sup>285</sup> Perhaps the most frequent example of deductibility of expenditures which do not add to the value of the property are those expenditures incurred in repairs of sudden casualties.<sup>286</sup> Cases frequently articulate that such expenditures are deductible because they do not increase the value of the property as it was before the occurrence of the sudden event that necessitated the repair or restoration.<sup>287</sup>

In *American Bemberg Corporation v. Commissioner*,<sup>288</sup> the Tax Court allowed a deduction for substantial expenditures to drill holes and pour cement beneath a basement floor in which sudden cave-ins had occurred. The taxpayer's purpose was not to improve or prolong the life of the original plant, but to continue operation of the plant on the same scale and as efficiently as it had been before the sudden cave-in. Similarly, oil-proofing a basement to prevent sudden seepage of oil arising from adjacent oil refinery activities was held deductible in *Midland Empire Packing Co. v. Commissioner*<sup>289</sup> because the addition of a concrete lining to floor and walls of the basement did not add to the value or prolong the expected life of the property beyond what they had been before the event which made the repairs necessary.

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285. *United States v. Times Mirror Co.*, 231 F.2d 876 (9th Cir. 1956).

286. The "no increase in value" cases are careful to point out that this rule is not limited to casualty cases. *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 340-41 (1962). For example, in *Niagara Mohawk Power Corp. v. United States*, 558 F.2d 1379 (Ct. Cl. 1977) the court held that the costs incurred in repairing leaks in gas lines were deductible because the repairs did not increase the value of the pipelines, nor adapt them to a new use. The leaks were not caused by any sudden event, but by the gradual drying out of a material used to seal the joints of the 12-foot sections of iron pipe.

287. See, e.g., *Regenstein v. Edwards*, 121 F. Supp. 952, 954 (M.D. Ga. 1954); *Kansas City S. Ry. v. United States*, 112 F. Supp. 164 (Ct. Cl. 1953); *Hensler v. Commissioner*, 73 T.C. 168 (1979); *Southern Ford Tractor Corp. v. Commissioner*, 29 T.C. 833 (1958); *J.F. Wilcox & Sons v. Commissioner*, 28 B.T.A. 878 (1933); *Munroe Land Co. v. Commissioner*, 25 T.C.M. 3 (1966). But see *Hubinger v. Commissioner*, 13 B.T.A. 960, 964 (1928), *aff'd*, 36 F.2d 724 (2d Cir. 1929), *cert. denied sub nom*, *New Haven Bank, Ex'r v. Commissioner*, 281 U.S. 741 (1930) (unlike costs of maintaining property through repairs necessitated by a casualty, the restoration of a major part of the property itself must be capitalized where the restoration has a useful life of several years); Rev. Rul. 77-478, 1977-2 C.B. 81 (distinguishing *Kansas City S. Ry.* where railroad undertook similar repairs as a part of a general plan of improvement of its track embankments).

288. 10 T.C. 361 (1948), *aff'd per curiam*, 177 F.2d 200 (6th Cir. 1949).

289. 14 T.C. 635 (1950); *accord*, *Collingwood v. Commissioner*, 20 T.C. 937 (1953).

Yet, the no increase in value approach ignores certain basic factors. For example, a businessman usually will not incur *substantial* expenditures unless they enhance the value of property in the business.<sup>290</sup> In *Hotel Sulgrave, Inc. v. Commissioner*,<sup>291</sup> the taxpayer argued that the installation of a sprinkler system was a repair because it did not add to the value of the hotel property or prolong its life. The Tax Court pointed out that the sprinkler system was required by local law and constituted an improvement having a life extending beyond the tax year in which it was made. "While it may not have increased the value of the hotel property or prolonged its useful life, the property became more valuable for use in the petitioner's business by reason of compliance with the city's order."<sup>292</sup> Similarly, the taxpayer's contention in *Russell Box Co. v. Commissioner*<sup>293</sup> that construction of a fence was a current deduction because it did not enhance the value of the property in the long run was rejected on the grounds that it did increase the value of the property as to the taxpayer for war work presently performed by the company.<sup>294</sup> The clearest example of the conflict between the criteria of no increase in value and adaptation to the taxpayer's use is found in *Connally Realty Co. v. Commissioner*.<sup>295</sup> There the city raised the level of a street, cutting off access to the taxpayer's building from that street. Changes were made to permit entrance from the new level, but the value of the property was not increased, nor its life prolonged, compared to its condition before the change in street level. The court stated:

This outlay of money is not an expense of business likely to happen any year, but *was occasioned by an unusual occurrence*, one that does not often happen at all. Repairs to a building are necessary, and regarded as ordinary although occasioned in unusual degree by storm, flood, or the like. But this building fell into no disre-

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290. *Stoeltzing v. Commissioner*, 266 F.2d 374, 376 (3d Cir. 1959).

291. 21 T.C. 619 (1954).

292. *Id.* at 621; *accord*, *Red Star Yeast & Prods. Co. v. Commissioner*, 25 T.C. 321 (1955); *Difco Laboratories, Inc. v. Commissioner*, 10 T.C. 660 (1948); *Bonwit Teller & Co. v. Commissioner*, 17 B.T.A. 1019 (1929), *rev'd*, 53 F.2d 381 (2d Cir.), *cert. denied*, 284 U.S. 690 (1931).

293. 208 F.2d 452 (1st Cir. 1953).

294. *Id.* at 454. *Accord*, *Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599 (1931), *rev'd on other grounds*, 64 F.2d 424 (4th Cir. 1933).

295. 81 F.2d 221 (5th Cir. 1936).

pair, nor was it physically injured in any way requiring restoration. The city altered its street with detriment to the desirability of portions of the building for rent, but, so far as appears, without touching the building. The *outlay was made in an effort to adapt the building to changed surroundings, but not to repair any physical damage to it.* The withdrawal of a railroad frontage or the change of a neighborhood from residential to business or the like sometimes requires remodeling or altering buildings to maintain their rentability. These are not ordinary expenses, although necessary, but are additional investments; not repairs, but improvements. If they do not make the property worth more, or to rent for more than before the change of conditions which required the alterations, they make it worth much more than it would be without the alterations. The added investment may forecast a loss, but the loss for income tax purposes is realized only when the building is disposed of. There is here a physical structure representing the investment. The benefit is not limited to the year of the expenditure, but is expected to continue for the life of the property. The expenditure, being considerable, cannot be regarded as an ordinary expense of a single year, but must be treated as an additional capital investment.<sup>296</sup>

The second major criticism of the material addition to the value of property criterion is that it fails to take into account a material expenditure that adds only minor value to the property.<sup>297</sup>

### B. *Expenditures which Appreciably Extend the Life of Property*

Occasionally, expenditures are so extensive that they appreciably extend the life of the entire property. Thus, in *Jones v. Commissioner*,<sup>298</sup> the taxpayer renovated an historic building that had become so run down its useful life had ended. The court concluded that the expenditures gave the building a new useful life. More frequently, expenditures involve replacements of portions of the property. Where the replacement is of a major segment and it has a useful life or more than one year, the courts generally conclude

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296. *Id.* at 221-22 (emphasis added).

297. *See, e.g.,* *Regenstein v. Edwards*, 121 F. Supp. 952 (M.D. Ga. 1954); *Buckland v. United States*, 66 F. Supp. 681 (D. Conn. 1946); *Oberman Mfg. Co. v. Commissioner*, 47 T.C. 471 (1967) (deduction allowed); *Farmers Creamery Co. of Fredericksburg, Va. v. Commissioner*, 14 T.C. 879 (1950) (deduction allowed). For a criticism of *Oberman Mfg. Co.* on this ground, *see* *Gunn, supra* note 5 at 459.

298. 24 T.C. 563 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957).

that the improvement constitutes a capital expenditure.<sup>299</sup> Consequently, starting a new useful life for a substantial segment of the whole property is indicative of capital improvement.<sup>300</sup>

Any expenditure beyond maintenance itself obviously extends the life of property. Were the sole focal point the life of the property before the repair, all repairs would be capital since they extend the life of the property. Conversely, the test should not be whether the original life of the property is extended<sup>301</sup> since few expenditures, even if clearly capital, would extend the original life of the property after substantial depreciation has occurred. Many cases take the middle road in determining whether the expenditures enhance the life expectancy of the property as compared with its status prior to the condition which necessitated the expenditure.<sup>302</sup> The sudden event or casualty cases can be reconciled with the extension of the life of the property principle under this analysis.

### C. *Repairs in the Nature of Replacements*

The replacement of a major unit or segment of a capital asset constitutes an improvement. Classic examples are replacement of a roof,<sup>303</sup> floor,<sup>304</sup> or wall.<sup>305</sup> Some cases look to see whether the expenditure involved a substantial amount of structural work, in which case it constitutes a replacement and improvement.<sup>306</sup> Some

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299. *Denver & Rio Grande Western R.R. v. Commissioner*, 279 F.2d 368 (10th Cir. 1960). Other decisions reach contrary conclusions by erroneously focusing solely on whether the expenditure with respect to a part of the property resulted in the entire property gaining appreciably in value. See *Buckland v. United States*, 66 F. Supp. 681, 683 (D. Conn. 1946).

300. *West Virginia Steel Corp. v. Commissioner*, 34 T.C. 851 (1960).

301. *But see Farmers Creamery Co. of Fredericksburg, Va. v. Commissioner*, 14 T.C. 879 (1950).

302. See, e.g., *Oberman Mfg. Co. v. Commissioner*, 47 T.C. 471 (1967); *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962). The Tax Court in *Red Star Yeast & Prods. Co. v. Commissioner*, 25 T.C. 321, 349 (1955), explained that a "repair involves something more in the nature of a substitution of new parts or restoration of certain parts of a given whole, whereas . . . [a capital item is created when] the entire structural unit was replaced and a new one substituted therefor without relation to the original physical facility."

303. *Georgia Car & Locomotive Co. v. Commissioner*, 2 B.T.A. 986 (1925).

304. *Phillips & Easton Supply Co. v. Commissioner*, 20 T.C. 455 (1953).

305. *Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599 (1931), *rev'd on other grounds*, 64 F.2d 424 (4th Cir. 1933).

306. *Honigman v. Commissioner*, 55 T.C. 1067 (1971), *rev'd in part on another point*, 466

structural expenditures have been held deductible on the grounds that they did not prolong the life of the property or increase its value, but only restored the property to the its condition before the event which demanded the expenditure.<sup>307</sup> Other decisions point out that the benefits of the replacements extend over a major period and, hence, must be capitalized.<sup>308</sup> Since the regulations and leading authorities speak of "incidental repairs,"<sup>309</sup> the primary criterion has been whether a *major* portion of the property is replaced.<sup>310</sup>

Most repair would necessarily involve substitution of new parts or ingredients for old. If the substitution is of a major unit or structural part of the nature of a floor, wall or roof, or large part thereof, so that the building as a whole may be considered to have gained appreciably in expectancy of useful life, it is a substitution so great in degree that we may well place it on the "replacement" side of the line.

Where the substitutions, though numerous, are of relatively minor proportions of the physical structure and of any of its major parts, even though high in cost, where the building as a whole may not be considered to have gained appreciably in expectancy of useful life over its expectancy when built, it falls more naturally on the "repair" side of the line. . . .<sup>311</sup>

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F.2d 69 (6th Cir. 1972). See *Farmers Creamery Co. of Fredericksburg, Va. v. Commissioner*, 14 T.C. 879 (1950) (deduction allowed where repairs never replaced as much as 50% of a floor or a wall).

307. *Oberman Mfg. Co. v. Commissioner*, 47 T.C. 471 (1967); *accord*, *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962).

308. *P. Dougherty Co. v. Commissioner*, 5 T.C. 791 (1945), *aff'd*, 159 F.2d 269 (4th Cir. 1946), *cert. denied*, 331 U.S. 838 (1947).

309. See *Treas. Reg. § 1.162-4*. See also *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979). There the court required amortization of maintenance expenses over a 10 year period. Even though the repairs only restored the irrigation ditches to normal operating condition and did not alter or expand the system, the court refused to allow current deduction of the expense because to do so would distort the year's income (the expense of "drag-lining" an irrigation ditch was about the same as building one). The court reasoned that the expenditure was more than an "incidental" repair; rather, it was a replacement. 72 T.C. at 18.

310. *Denver & Rio Grande Western R.R. v. Commissioner*, 279 F.2d 368 (10th Cir. 1958).

311. *Buckland v. United States*, 66 F. Supp. 681, 683 (D. Conn. 1946); *accord*, *Red Star Yeast & Prods. Co. v. Commissioner*, 25 T.C. 321 (1955).

Viewed from another perspective, substitution of major parts must be capitalized when the purpose of the expenditure is not to repair but to put machines in such a condition that they are no longer unduly susceptible, for example, to breakdowns.<sup>312</sup> This analysis appears closely related to the "put-keep" dichotomy discussed below.<sup>313</sup>

#### D. *Adaptation to a New or Different Use*

Many cases involve the cost of altering or improving a particular piece of equipment so that it can function in a different manner, in which case such cost constitutes a permanent improvement.<sup>314</sup> Other cases involve expenditures, though less substantial, which nonetheless render an entire piece of property (such as a building) adaptable to the taxpayer's particular business or use and, hence, constitute an adaptation to a new or different use.<sup>315</sup> The expenditure itself may constitute a permanent change or improvement, such as rewiring an old building to new commercial standards.<sup>316</sup> The better view is that the expenditure need not constitute a separate improvement rendering the property more valuable so long as it adapts the property to the taxpayer's business, which is different from a prior business use.<sup>317</sup> The rationale of these decisions is that the adaptation of a piece of equipment or an entire property to the taxpayer's use is analogous to a taxpayer's purchase of a new asset, in which event the purchase price must be capitalized.<sup>318</sup> Indeed, this appears the proper rationale for capitalization of the cost of any adaptation to a new or different use so long as the expenditure is substantial. Apparently correct are those cases effectively hold-

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312. *Hudlow v. Commissioner*, 40 T.C.M. 935 (1971). See also *West Virginia Steel Corp. v. Commissioner*, 34 T.C. 851 (1960).

313. See text accompanying notes 322-27 *infra*.

314. See, e.g., *Coors Porcelain Co. v. Commissioner*, 52 T.C. 682 (1969), *aff'd*, 429 F.2d 1 (10th Cir. 1970).

315. *West Virginia Steel Corp. v. Commissioner*, 34 T.C. 851 (1960); *Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599, 619 (1931), *rev'd on other grounds*, 64 F.2d 424 (4th Cir. 1933).

316. *West Virginia Steel Corp. v. Commissioner*, 34 T.C. 851 (1960).

317. See, e.g., *Connally Realty Co. v. Commissioner*, 81 F.2d 221 (5th Cir. 1936); *Black Hardware Co. v. Commissioner*, 39 F.2d 460 (5th Cir.), *cert. denied*, 282 U.S. 841 (1930); *Difco Laboratories, Inc. v. Commissioner*, 10 T.C. 660 (1948).

318. *Stoeltzing v. Commissioner*, 266 F.2d 374 (3d Cir. 1959).



ing that an adaptation to the taxpayer's business is deductible even though it does not enhance the value or prolong the useful life of the property.<sup>319</sup>

### E. *Expenditures to Maintain Ordinarily Efficient Operating Conditions*

Cases allowing deduction of expenditures on the grounds that they are made to maintain the ordinarily efficient operating conditions of property frequently touch all of the bases in explaining why the expenditures are not capital. Those cases conclude that the expenditures are not an alteration to structural parts, do not prolong the useful life, are not part of a general remodeling, do not convert the property to some new use or add a new element of a structural nature, and do not increase the value of the property.<sup>320</sup> Once such decisions exhaust the reasons that an expenditure is not capital, most conclude that it is deductible because incurred in the maintenance of ordinarily efficient operating condition. The reported cases undoubtedly present a distorted picture in that the deductibility of the typical recurring maintenance expenditure, such as lubrication of machinery, painting of property, etc., is seldom litigated.<sup>321</sup> On the other hand, in many cases, the taxpayer has asserted that expenditures were to maintain ordinarily efficient operating condition, but the courts have disagreed, concluding that the expenditure was not made to *keep* the property in ordinarily efficient condition, but instead to *put* it into ordinarily efficient condition.<sup>322</sup> Accordingly, capitalization was required of expenditures to rebuild a building that had not been repaired for so many years that it had become virtually unusable.<sup>323</sup> Capitalization is the typical result where the property has passed beyond efficient operating condition and the expenditures are necessary to restore it

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319. See, e.g., *Difco Laboratories, Inc. v. Commissioner*, 10 T.C. 660, 669 (1948).

320. See, e.g., *Collingwood v. Commissioner*, 20 T.C. 937 (1953); *Gilles Frozen Custard, Inc. v. Commissioner*, 39 T.C.M. 350 (1970).

321. For a rare exception, see *Ticket Office Equipment Co. v. Commissioner*, 20 T.C. 272, 279 (1953), *aff'd per curiam*, 213 F.2d 318 (2d Cir. 1954).

322. See, e.g., *Stoeltzing v. Commissioner*, 266 F.2d 374 (3d Cir. 1959); *Bloomfield S.S. Co. v. Commissioner*, 33 T.C. 75 (1959), *aff'd per curiam*, 285 F.2d 431 (5th Cir. 1961); *Churchill Farms, Inc. v. Commissioner*, 38 T.C.M. 1071 (1969).

323. *Stoeltzing v. Commissioner*, 266 F.2d 374, 377 (3d Cir. 1959).

rather than to keep it in good operating condition.<sup>324</sup> Such a conclusion is not universal; and in some instances where property apparently has been permitted to run down, restoration expenditures have nevertheless been held deductible.<sup>325</sup> These authorities ignore the proper reasoning that where property has fallen into disrepair, substantial expenditures to restore it to its original condition must be capitalized because they are in effect incurred in the acquisition of property suitable to the taxpayer's business.<sup>326</sup> While the put-keep dichotomy falls into place in the entire area of business expense versus capital expenditures, the primary difficulty is that the courts do not universally apply it.<sup>327</sup>

#### F. *Replacement of Recurring Minor Items*

Expenditures for replacement of minor items that do not appreciably prolong the life of property nor result in an increase in its value, but only arrest deterioration by replacing similar minor items (which through the wear and tear of normal usage have become no longer economically feasible or useful) are currently deductible.<sup>328</sup> Other authorities have looked at the temporary nature of expenditures and found them deductible when they are of a recurring nature, such as painting or filling cracks.<sup>329</sup> As the Board of Tax Appeals pointed out in *Libby & Blouin, Ltd. v. Commissioner*,<sup>330</sup> replacing small parts, which in this instance were short-lived and had to be replaced every two or three years, constitutes a deductible expense.

When a building is erected the flooring, nails and other small supplies of course enter into the capital cost of the building, yet when a building is repaired, the cost of replacing planks in the floor, and the cost of nails in making repairs, while it might be a considerable

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324. *Jones v. Commissioner*, 24 T.C. 563 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957).

325. *See, e.g., Farmers Creamery Co. v. Commissioner*, 14 T.C. 879 (1950).

326. *Bloomfield S.S. Co. v. Commissioner*, 33 T.C. 75 (1959), *aff'd per curiam*, 285 F.2d 431 (6th Cir. 1961). *See Stoeitzing v. Commissioner*, 266 F.2d 374 (3d Cir. 1959).

327. *See, e.g., Farmers Creamery Co. v. Commissioner*, 14 T.C. 879 (1950).

328. *Gaddis v. United States*, 330 F. Supp. 741 (S.D. Miss. 1971). *See J.F. Wilcox & Sons v. Commissioner*, 28 B.T.A. 878 (1933).

329. *Ticket Office Equipment Co. v. Commissioner*, 20 T.C. 272 (1953), *aff'd per curiam*, 213 F.2d 318 (2d Cir. 1954).

330. 4 B.T.A. 910 (1926).

item, is entirely different from the ordinary cost of such things when the building is being erected. As in the case of the locomotive involved in this appeal, expenditures to replace certain worn out parts, as worn out tubes, broken parts, wheels, etc., merely keep the machine in operating condition.<sup>331</sup>

### G. Overall Pattern of Rehabilitation

As early as 1930, the Board of Tax Appeals in *I. M. Cowell v. Commissioner*,<sup>332</sup> adopted the principle that the costs of otherwise deductible repairs must be capitalized when they constitute a part of an entire group of items making up a general improvement and reconditioning of property. In some of the early cases, the courts appear to have taken this position largely on the basis that it was impractical to separate the capital items from the ordinary repairs.<sup>333</sup> In *Cowell* the Board stated:

While the characterization of some of the items is such that standing alone or made as periodic repairs they might be deductible as ordinary and necessary expenses, it is impractical from the evidence to make such a detailed classification of the items. Such a classification is not a mere matter of what an item is called, but whether it is a part of the entire capital investment in the improved property. To fix a door or patch plaster might very well be treated as an expense when it is an incidental minor item arising in the use of the property in carrying on business, and yet, as here, be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property.<sup>334</sup>

The majority of early cases, however, did not rely upon a difficulty in separating capital from ordinary expenditures, but rather held (without further reasoning) that where all of the expenditures were pursuant to a general plan of reconditioning and improving and altering the property as a whole, none of the expenditures was deductible.<sup>335</sup> Other cases, while adopting a general plan of recon-

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331. *Id.* at 914.

332. 18 B.T.A. 997 (1930).

333. *See, e.g., Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599, 619 (1931), *rev'd on other grounds*, 64 F.2d 424 (4th Cir. 1933).

334. 18 B.T.A. at 1002 (1930).

335. *Home News Publishing Co. v. Commissioner*, 18 B.T.A. 1008 (1930); *accord*, *First*

ditioning analysis, have still held that the expenditures in question were material replacements or added to the value of the property and, hence, were capital.<sup>336</sup>

The leading plan of rehabilitation case, *United States v. Wehrl*,<sup>337</sup> analyzed the general plan of rehabilitation as a part of a continuing quest by courts in the repair-replacement area for a "formularization," i.e., an automatic category that results in a certain answer:

In the continuing quest for formularization, the courts have superimposed upon the criteria in the repair regulation an overriding precept that an expenditure made for an item which is part of a "general plan" of rehabilitation, modernization, and improvement of the property, must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair. . . . Whether the plan exists, and whether a particular item is part of it, are usually questions of fact to be determined by the fact finder based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done, e.g., whether the work was done to suit the needs of an incoming tenant, or to adapt the property to a different use, or, in any event, whether what was done resulted in an appreciable enhancement of the property's value.<sup>338</sup>

Although commentators have criticized the "general rehabilitation" rule as it is articulated in the above authorities,<sup>339</sup> it appears well entrenched in the case law.<sup>340</sup>

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*American Nat'l Bank of Nashville v. United States*, 327 F. Supp. 675 (M.D. Tenn. 1971), *aff'd*, 467 F.2d 1098 (6th Cir. 1972).

336. See, e.g., *Cox v. Commissioner*, 17 T.C. 1287, 1293 (1952).

337. 400 F.2d 686 (10th Cir. 1968); *accord*, *Mountain Fuel Supply Co. v. United States*, 449 F.2d 816 (10th Cir. 1971), *cert. denied*, 405 U.S. 989 (1972).

338. 400 F.2d at 689-90.

339. See, e.g., *Gunn*, *supra* note 5; Shugarman, *Basic Criteria for Distinguishing Revenue Charges from Capital Expenditures in Income Tax Computations*, 49 MICH. L. REV. 213 (1950).

340. *Mountain Fuel Supply Co. v. United States*, 449 F.2d 816 (10th Cir. 1971), *cert. denied*, 405 U.S. 989 (1972); *Griffin & Co. v. United States*, 389 F.2d 802 (Ct. Cl. 1968); *First American Nat'l Bank of Nashville v. United States*, 327 F. Supp. 675 (M.D. Tenn. 1971), *aff'd*, 467 F.2d 1098 (6th Cir. 1972).

Moreover, several authorities support the general plan of rehabilitation rule by reasoning that is wholly consistent with other areas of the capital expense-ordinary deduction dichotomy. In *California Casket Co. v. Commissioner*,<sup>341</sup> the taxpayer acquired a building with the "express intention and purpose of completely renovating and altering it to conform to the specific requirements of [his] business."<sup>342</sup> Viewed in this perspective, the plan of rehabilitation clearly constituted a plan for acquisition of a new capital asset. In such a case, an expenditure which is part of the acquisition costs must be capitalized even though it would be deductible standing alone or incurred after the process of acquisition is complete.<sup>343</sup> For example, cleaning is generally an ordinary expense; however, if the cleaning is the final touch in the turnkey construction of a building, it constitutes a capital expenditure.<sup>344</sup> This rationale underlying the plan of general rehabilitation rule was explicitly recognized by the Tax Court in *Jones v. Commissioner*.<sup>345</sup>

The expenditures involved . . . were not made for "incidental repairs" but were part of an overall plan for the general rehabilitation, restoration, and improvement of an old building which had lost its commercial usefulness due to extreme deterioration. . . . The useful life of the building had ended and its value had almost disappeared when the process of restoration started. The expenditures materially added to its value and gave the building a new useful life as a rental property. . . . The purpose and effect of the expenditures . . . were

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341. 19 T.C. 32 (1952).

342. *Id.* at 37.

343. The taxpayer in *California Casket Co.* sought to deduct as a repair the cost of restoration of foundation pilings as separate and apart from the overall plan of rehabilitation, citing two cases where such an expenditure received repair treatment, *viz.*, *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950) and *American Bemberg Corp. v. Commissioner*, 10 T.C. 361 (1948). The court distinguished the two cases, stating:

Both cases involved expenses incurred by taxpayers to permit them the continued normal operation of plants which had been used and occupied by them for some years. In neither case was the expenditure involved made to prepare initially a structure for the operation of a particular business. Nor was there present any intention to make such structure suitable for new or additional uses. The present case is different. Contrary to the above, the petitioner, in the instant proceeding, acquired the building in question with the express intention and purpose of completely renovating and altering it to conform to the specific requirements of the petitioner's business.

19 T.C. at 37.

344. *Shainberg v. Commissioner*, 33 T.C. 241, 251 (1959).

345. 24 T.C. 563 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957).

not ordinary maintenance expenses and cannot be separated from the general plan and purpose. They probably contributed as much as, or more than, the conceded capital expenditures to the increased value and new useful life of the building. . . . [A]ll should be capitalized and recovered during the new useful life of the building through deductions for depreciation, which will offset the rental income made possible by the restoration.<sup>346</sup>

#### H. *Distortion of Income*

The criteria discussed for separating repairs from improvements are not in conflict although some are difficult to reconcile with general rules regarding capitalization. For example, almost every replacement, even of a minor item, has a useful life extending quite beyond the current tax year.<sup>347</sup> Similarly, most repair expenditures increase the value of property for the taxpayer's business or as a matter of business judgment he would not make the expenditures.<sup>348</sup> The greater difficulty is that these criteria cannot be used to predict with any accuracy the outcome of a particular repair-improvement controversy in most instances. The cases simply are not reconcilable.<sup>349</sup>

A commentator has suggested that the proper criterion is whether an expenditure for a "repair" is sufficiently substantial in relationship to the taxpayer's entire business so that to deduct it would produce a distortion of his income.<sup>350</sup> If so, it must be capitalized; if not, it may be currently deducted. This approach is not without judicial and other support.<sup>351</sup> For example, regulations

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346. 24 T.C. at 568.

347. *United States v. Wehrli*, 400 F.2d 686, 687 (10th Cir. 1968).

348. *See Stoltz v. Commissioner*, 266 F.2d 374 (3d Cir. 1959).

349. *Compare Oberman Mfg. Co. v. Commissioner*, 47 T.C. 471, 481 (1967), *acq.* 1967-2 C.B. 3 with *Mountain State Steel Foundries, Inc. v. Commissioner*, 18 T.C.M. 306 (1950), *rev'd on other grounds*, 284 F.2d 737 (4th Cir. 1960) and *Southwest Ornamental Iron Co. v. Commissioner*, 12 T.C.M. 521 (1953).

350. *Gunn*, *supra* note 5 at 457-61.

351. The concern for matching income with expense items is illustrated in *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979). There the taxpayer sought to depreciate the cost of an irrigation system acquired with a ranch, and to capitalize and depreciate the maintenance required every 10 years. The court held that the cost of the system could not be depreciated because its useful life could not be determined; however, the court had a much more difficult time with the maintenance costs. The irrigation ditches required "dragging" every 10 years to remove silt and plants which would impair the system's hydraulic

provide that farmers may deduct the cost of small tools<sup>352</sup> and that professionals may deduct the cost of books, furniture, professional instruments and equipment which have a short useful life, albeit in excess of a year.<sup>353</sup> In these instances, although the assets have a useful life beyond the tax year and hence under traditional definition constitute capital assets, allowing a current deduction would not distort the taxpayer's income. Indeed, the Tax Court in *Sharon v. Commissioner*,<sup>354</sup> stated that where the amount of an expenditure is small, the taxpayer would ordinarily be allowed to elect to deduct the full amount of the fee in the year of payment, despite its capital nature. The Court of Claims in *Cincinnati, New Orleans & Texas Pacific Ry. Co. v. United States*,<sup>355</sup> expressly concluded that the capital expenditure and depreciation sections of the Internal Revenue Code were not superior to the method of accounting section of the Code. The fact that an asset has a benefit extending beyond the current tax year is not conclusive; rather, the capitalization and depreciation provisions and the method of accounting provisions are so "inextricably intertwined"<sup>356</sup> that they

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capacity. It was emphasized that the work did not alter the system or expand its capacity, but only restored it to its original condition. However, the cost of "draglining" the ditches was substantial, about the same as the cost of digging a new ditch. The court agonized over what it termed a "conundrum":

To permit a current deduction of such a large expenditure with a beneficial effect lasting on the average of 10 years would surely distort that year's income. Yet to deny even an amortization deduction for an expenditure with a specific demonstrable beneficial life on the grounds that its deductibility is contaminated by its relationship to an asset of indefinite life, i.e., the land, would similarly require an uneven reporting of income.

Since a basic premise of the income tax laws is to relate expenses to the income which they helped earn, a reasonable solution to our conundrum is to hold that the expenses in issue should be written off over their useful life. In short we would subscribe independent status to those expenditures on the basis that they create a free-standing intangible asset with an amortizable 10-year life.

*Id.* at 13.

352. Treas. Reg. § 1.162-12.

353. Treas. Reg. § 1.162-6.

354. 66 T.C. 515 (1976), *aff'd per curiam*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979). The expenditure in question was a \$25 license fee paid to practice law in New York State. The court drew an analogy to the purchase of inexpensive tools, as permitted under § 1.162-12(a). *But see* Snell v. Commissioner, 48 T.C.M. 599 (1979) (taxpayer required to amortize the cost of becoming a member of Lloyds of London over his lifetime; cost was several thousand dollars).

355. 424 F.2d 563 (Ct. Cl. 1970).

356. *Id.* at 569.

must be utilized in conjunction in deciding the ultimate question whether the taxpayer's method of deducting expenditures clearly reflects income. The Court of Claims allowed the taxpayer to currently deduct items which cost less than \$500 even though they had a useful life in excess of one year.

Application of the distortion of income approach by itself would also produce problems since it must be applied on a case by case basis.

One taxpayer might be justified in capitalizing an expenditure for a mattress or a rug, whereas another, operating on a larger scale and with substantially identical recurring expenditures, might be justified in deducting the expenditure as an expense, if it consistently followed such a system of accounting and reporting its income.<sup>357</sup>

Despite case law support for this approach,<sup>358</sup> it is unlikely to be universally adopted by the courts due to the plethora of cases applying the traditional repair-replacement criteria. Moreover, its wide scale judicial application undoubtedly would entail considerable litigation itself in establishing the parameters for when deduction of an item would materially distort the taxpayer's income.

Fortunately, however, the Asset Depreciation Range depreciation provisions<sup>359</sup> in effect make available a distortion of income approach and formularization approach, which should reduce or even eliminate the controversy as to expenditures for repairs versus replacements. If a taxpayer elects the ADR System for the tax year, he may elect a Percentage Repair Allowance (PRA) rule.<sup>360</sup> The PRA rule was designed to reduce the repair-capital expenditure question<sup>361</sup> and by mechanical computation to provide for current deductions of all expenditures for repair, maintenance, rehabilitation or improvement of "repair allowance property" within a class which are not clearly capital expenditures, i.e., "excluded

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357. *Manger Hotel Corp.*, 10 T.C. 520, 522 (1948), *quoted in* 424 F.2d at 569.

358. *Sharon v. Commissioner*, 66 T.C. 515 (1976), *aff'd*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 99 S. Ct. 2883 (1979); *Cincinnati New Orleans & Pac. R.R. v. United States*, 424 F.2d 563 (Ct. Cl. 1970).

359. *Treas. Reg.* § 1.167(a)-1(a)(1).

360. *Id.* § 1.167-11(d)(2)(ii).

361. *Id.* § 1.167-11(d)(2)(i)(a).



additions" to the extent that they do not exceed a repair allowance.<sup>362</sup>

## VII. CONCLUSION

In deciding whether to recover its costs by capitalization or current deduction, a business need only read the rules under sections 162 and 263 to make a simple determination. The rules, obvious on first reading, have led taxpayers, the Service and the courts down a path into a bramble patch of conflicting theories and unpredictable results.

The courts have used a variety of theories to explain section 263 and to standardize its application. An undercurrent in all these theories is an attempt by the courts to prevent distortion of income. Although not articulated by most courts, reliance on the distortion of income rationale is a useful method to reconcile otherwise contradictory court decisions.

In the creation or enhancement of an asset approach, for example, the Tenth Circuit in *Colorado Springs National Bank*,<sup>363</sup> in allowing deduction of start-up costs, feared that the government's approach "[would permit] a distortion of taxpayer's financial situation."<sup>364</sup> In attempting to reconcile cases in which the same type of expense is treated in one case as standing by itself and in another case as part of the creation of a new asset, the cases can be analyzed more readily by focusing on whether a current deduction for the particular taxpayer leads to a distortion of income.

Another theory used by the courts to determine the proper tax treatment of an item is the origin of the claim doctrine. The doctrine generally holds that expenditures which are integrally related to an income or loss item or transaction must possess the same character for tax purposes as that initial item or transaction, although different tax years are involved. Expenditures which stem from a capital transaction are required to be "matched" or equated

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362. *Id.* § 1.167-11(d)(2)(iii)(a). See generally FEINSCHREIBER, TAX DEPRECIATION UNDER THE CLASS LIFE ADR SYSTEM 73 (1975).

363. 505 F.2d 1185 (10th Cir. 1974).

364. *Id.* at 1192.

with gains from the same transaction. This relation back is also necessary to prevent a distortion of taxpayer's income.

The origin of the claim doctrine has also been used in looking forward in time from an expense. For example, courts have used the doctrine to justify allowing a current deduction for advertising and promotional expenses because the expenses will generate ordinary income in the future. Using origin of the claim, courts have required capitalization of costs associated with the issuance of stock, recapitalizations, and redemptions as well as costs incurred subsequent to such capital transactions. More realistically, to have permitted current deduction of such expenditures would have materially distorted the true operating income of an entity since the transactions do not produce recognized gains.

The third formal doctrine discussed was the tax benefit rule. This rule is closely linked to and often used in conjunction with the origin of the claim doctrine. Implicit in the tax benefit rule is the realization that although the annual accounting concept requires each tax year to stand alone, items occurring in different years may be so integrally related that not to treat them similarly would distort taxpayer's income. The tax benefit rule can help reconcile seemingly conflicting decisions related to expenditures incurred in incorporating businesses, changing corporate capital structures, and liquidating corporations.

If the question of capitalization of organizational expenditures, reorganizational expenditures, expenditures in connection with the issuance of corporate stock and with the redemption or transfers of stock were all approached from the tax benefit viewpoint of avoiding distortion of income, many of the complexities in this area disappear. In all of these transactions, the corporation recognizes no gain; accordingly, to allow it a deduction would produce a distortion of its income.

The important connection among the origin of the claim doctrine, the *Arrowsmith* tax benefit rule, and the classic tax benefit doctrine is that two transactions are linked in order to prevent a distortion of taxpayer's income.

The classic shoals for judicially drawn distinctions between sections 162 and 263 occur in the repair/replacement dichotomy. The

criteria established by the courts in this area cannot be used to predict with any accuracy the outcome of a particular repair/replacement controversy. Similar expenses by different taxpayers are treated differently by the courts. To reconcile these cases, the proper criterion should be whether an expenditure for a "repair" is sufficiently substantial in relation to a taxpayer's entire business that to deduct it would distort taxpayer's income. If a distortion would occur, the "repair" expense must be capitalized; if not, it may be expensed.

Predictability in tax matters is important. Definite, set rules enhance predictability. However, distortion of the income of a particular taxpayer should take precedence over predictability in the section 263 area.

As Justice Cardozo said,

[W]hat is ordinary, though there must always be a strain of constancy within it, is nonetheless affected by time and place and circumstance. . . . One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a rule of life. Life in all its fullness must supply the answer to the riddle. . . . To attempt to harmonize [the phases of the problem] would be a futile task.<sup>365</sup>

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365. *Welch v. Helvering*, 290 U.S. 111, 113-16 (1933).