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XII. TAX

A. *Capital Expenditure or Ordinary Expense: A Fourth Circuit Prescription*

The matching of income and expenses determines the taxable income of a business.[1] Congress has provided that a business may deduct from gross income the cost of producing gross income to calculate taxable income.[2] The Internal Revenue Code (Code) defines the costs as "ordinary and necessary business expenses."[3] Not all payments that a business makes during a given year, however, are ordinary and necessary business expenses.[4] Some business payments are "capital ex-

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[1] *See* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT NO. 4, § 121 (1970) (accurate reflection of income depends on current measurement of changes in economic resources and obligations rather than simply on recording receipts and payments of money); *see also* C. HORNGREN, INTRODUCTION TO FINANCIAL ACCOUNTING 63 (1981) (matching is method of relating revenues and expenses to a particular period for which measurement of income is desired). *See generally* Jack's Cookie Co. v. United States, 597 F.2d 395, 402 (4th Cir. 1979) (federal system of income taxation attempts to match income and expenses of the taxable year so as to tax only net income); Richmond Tel. Corp. v. United States, 345 F.2d 901, 907 (4th Cir.) (same), *vacated and remanded on other grounds*, 382 U.S. 68, *on remand*, 354 F.2d 410 (4th Cir. 1965).

[2] I.R.C. § 63 (West 1982). Section 63 defines taxable income as gross income reduced by allowable deductions. *Id.* Section 162 of the Internal Revenue Code (Code) allows a taxpayer to deduct from gross income all the ordinary and necessary business expenses the taxpayer paid or incurred during the taxable year in carrying on the business. *Id.* § 162.

[3] *Id.* § 162. Whether a cost directly relates to a business and whether the cost is ordinary and necessary generally are questions of fact. Commissioner v. Heininger, 320 U.S. 467, 475 (1943). The Supreme Court has construed the term "necessary" as requiring the expense to be appropriate and helpful for the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689 (1966). Although a cost may be necessary without being ordinary, a cost must be both ordinary and necessary to be deductible currently. Deputy v. duPont, 308 U.S. 488, 497 (1940). The function of the term "ordinary" is to clarify the distinction between deductible current expenses and capital expenditures that the taxpayer must amortize over the useful life of the asset. Welch v. Helvering, 290 U.S. 111, 113-16 (1933). The Supreme Court has held that whether a cost is ordinary depends on the kind of transaction out of which the obligation arose and its normalcy in the particular business of the taxpayer. Deputy v. duPont, 308 U.S. at 496. According to the Court, ordinary connotes normal, usual, or customary. *Id.* Ordinary, however, does not mean necessarily that the taxpayer will make the payment often. Welch v. Helvering, 290 U.S. at 114. An expense is ordinary because it is a common or accepted means of conducting business. *Id.* Thus a cost that only occurred once in the taxpayer's lifetime may be ordinary provided the transaction that gave rise to the cost is a common or frequent occurrence in the type of business involved. Deputy v. duPont, 308 U.S. at 495. An ordinary expense is a cost that a reasonable person under the specific circumstances normally and naturally would incur. Hill v. Commissioner, 181 F.2d 906, 908 (4th Cir. 1950). *See generally* Kornhauser v. United States, 276 U.S. 145, 153 (1928) (costs incurred in defending law suit, although not recurring, were ordinary because costs were result of acceptable business response); Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 641 (1950) (that business had not previously made similar payment to protect property did not prevent cost from being ordinary).

[4] *See* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (not all

penditures."[5] As with ordinary and necessary expenses, a business must match capital expenditures with the income that the expenditures produce.[6] To match an expenditure with income, the taxpayer must capitalize the expenditure and deduct it over the period that corresponds with the useful life of the expenditure.[7] A business matches capital expenditures with future income through the process of amortization.[8] Taxpayers often litigate whether a business payment is a

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costs helpful to business are ordinary or expenses for purposes of § 162). The Supreme Court in *Lincoln Savings* held that for a cost to be deductible pursuant to § 162, the taxpayer must have paid or incurred the cost during the taxable year in carrying on a trade or business. *Id.* at 352. Additionally, the cost must have been an ordinary and necessary expense of the business. *Id.* The taxpayer bears the burden of persuasion under § 162 to demonstrate to the court that a particular cost qualifies as a business expense under the elements of *Lincoln Savings*. *Cf.* Woodward v. Commissioner, 419 F.2d 313, 320-21 (8th Cir. 1969) (petitioners have burden to show right to claimed deduction), *aff'd*, 397 U.S. 572 (1970); Iowa S. Utils. Co. v. Commissioner, 333 F.2d 382, 385 (8th Cir.) (taxpayer has burden of showing right to claimed deduction), *cert. denied*, 379 U.S. 946 (1964).

[5] I.R.C. § 263 (West 1982). Section 263 defines a capital expenditure as an outlay of capital that results in the acquisition of property or that permanently improves the property's value. *Id.* § 263(a)(1). The taxpayer must capitalize the cost of renovations or permanent improvements to property and deduct the expenditure over the life of the property. Illinois Merchants Trust Co., 4 B.T.A. 103, 106 (1926). In contrast, a repair is an expenditure for the purpose of keeping property in an ordinarily efficient operating condition. *Id.* The cost of repairs is deductible under § 162. *Id.*

[6] *See* Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966) (when allowed, capital expenditures must be amortized over useful life of assets). A taxpayer may not deduct currently costs incurred in the acquisition, production, or development of capital assets, inventory, and other property used in the trade or business. United States v. Catto, 384 U.S. 102, 109 (1966). The taxpayer must defer the cost until the year of sale of the asset when the taxpayer may set-off the accumulated cost against the proceeds of the sale to reduce taxable gain or increase deductible loss. *Id. But see infra* note 8 (amortization and depreciation of capital assets).

[7] *See* Commissioner v. Idaho Power Co., 418 U.S. 1, 12 (1974) (established tax principles require capitalization of cost of acquiring capital assets); Woodward v. Commissioner, 397 U.S. 572, 575 (1970) (costs incurred in acquisition of capital assets generally are treated as capital expenditures). *See generally* Davis v. Commissioner, 47 T.C.M. (P-H) ¶ 78,012 (1978) (cost of replacing boiler with useful life in excess of one year held to be capital expenditure); F.A. Wilson v. Commissioner, 12 T.C.M. (P-H) ¶ 43,085 (1943) (taxpayer required to capitalize cost of office equipment having useful life of more than one year); W. H. Tompkins Co. v. Commissioner, 47 B.T.A. 292, 294-95 (1942) (taxpayer required to capitalize and depreciate cost of new trucks but allowed to deduct cost of tires having average life of less than one year).

[8] *See* Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966) (when allowed capital expenditures must be amortized over useful life of asset). Amortization describes loss in value due to the passage of time. J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.124 (1980). Depreciation refers to the gradual reduction in value of property because of physical deterioration through use. *Id.* A taxpayer generally amortizes intangible assets and depreciates fixed assets. *Id.* For example, the taxpayer amortizes the cost of prepaid expense payments, such as advance rental payments, over the useful life of the payments. Jack's Cookie Co. v. United States, 597 F.2d 395, 402 n.18 (4th Cir. 1979). In the case of fixed assets, such as property, the taxpayer depreciates the cost over the useful life of the asset. *See* State Highway Comm'n v. Tubbs, 147 Mont. 296, _____, 411 P.2d 739, 744 (1966) (tax-

deductible expense or a capital expenditure that the business must amortize.[9]

Section 162 of the Code allows a business to deduct from gross income all the ordinary and necessary expenses that the business incurs in carrying on the business during the taxable year.[10] Courts interpret the section 162 ordinary and necessary business expense language as referring to the customary operating expenses of a business enterprise.[11] Section 263 of the Code requires a business to capitalize a cost incurred outside the ordinary and necessary course of business and to amortize the expenditure over its useful life.[12] Because a current deduction under section 162 ordinarily is more valuable to a taxpayer than a deferred deduction under section 263,[13] a business frequently will attempt to characterize the payment as ordinary and necessary to deduct currently the amount from the business' gross income.[14] The Internal Revenue Service (Service) generally will argue that the payment in question benefits the business for a period lasting beyond the taxable year and that the business should treat the payment as a capital expenditure under section 263.[15]

The Supreme Court has described the function of section 263 as

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payer depreciates property value). *See generally* D. HERWITZ, ACCOUNTING FOR LAWYERS 254 (1980) (depreciation of fixed assets and amortization of intangible deferred expense assets).

[9] *See, e.g.*, Welch v. Helvering, 290 U.S. 111, 115 (1933) (distinction between capital expenditure and business expense is made by examining facts of each case); Iowa S. Utils. Co. v. Commissioner, 333 F.2d 382, 385 (8th Cir.) (in distinguishing between capital expenditure and business expense, each case requires individual investigation and analysis), *cert. denied*, 379 U.S. 946 (1964); United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957) (difficult to find verbal formula that supplies clear distinction between current expenses and capital outlays), *cert. denied*, 355 U.S. 956 (1958); Boagni v. Commissioner, 59 T.C. 708, 712-13 (1973) (difference between currently deductible expenses and capital expenditures often unclear). *See generally* Lee & Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473 (1981) (distinction between ordinary expense and capital expenditure one of most difficult to determine in entire area of tax law).

[10] I.R.C. § 162 (West 1982).

[11] *See supra* note 4 (ordinary and necessary means expense normal, usual, or customary in operation of business).

[12] I.R.C. § 263 (West 1982).

[13] *Id.* §§ 162, 263. If a cost is an expense, the business must deduct the outlay currently and reduce the taxable income of the current year. *Id.* § 162. *But see id.* § 195 (allowing new businesses to deduct start-up costs ratably over period of years). If the outlay is a capital expenditure, the taxpayer must deduct the expenditure over the period of years that corresponds with the asset's useful life. *Id.* § 263. Because of the time value of money, a deduction from gross income taken currently is generally of greater value to the taxpayer than the same deduction taken over a period of years. *See generally* E. HELFERT, TECHNIQUES OF FINANCIAL ANALYSIS 140-43 (1982); Blum, *An Introduction to the Mathematics of Tax Planning*, 57 TAXES 707 (1979).

[14] *See* Philipps, *Deductibility of Legal Expenses Incurred in Corporate Stock Redemptions, Partial Liquidations, and Separations*, 1976 DUKE L.J. 941, 941 (government will argue for capitalization of cost and taxpayer will argue for current deduction of cost).

[15] *Id.*

reflecting the basic principle that a business may not deduct a capital expenditure from current income.[16] Section 263 prevents a taxpayer from deducting currently an asset more properly amortized over a number of taxable years.[17] To identify a capital expenditure, early cases applied a "one-year rule" and required a business to capitalize a payment whenever the benefits to the business lasted longer than the business' taxable year.[18] The courts defined capital expenditure as a cost that secures an advantage to the taxpayer over more than one year.[19] The courts defined an expense as a cost that secures a benefit to the taxpayer that lasts less than one year.[20] In the last decade, however, some courts have applied a "separate and distinct additional asset test" to distinguish between ordinary and necessary business expenses and capital expenditures.[21] According to courts that apply the newer test, a capital expenditure is a cost that procures for the taxpayer a separate and distinct additional asset.[22] The Fourth Circuit has been active in attempting to develop a single standard for determining whether a payment is a capital expenditure or an ordinary and necessary business ex-

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[16] Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974). The issue in *Idaho Power* was whether a taxpayer who performed his own construction work had to capitalize equipment depreciation allocable to the construction of capital facilities. *Id.* at 10. In ruling against the taxpayer, the Court held that § 263 of the Code denies a deduction for costs that a taxpayer incurs in the construction or permanent improvement of facilities. *Id.* at 16. According to the Court, § 263 of the Code serves to prevent a taxpayer from currently utilizing a deduction properly attributable, through amortization, to later tax years when the capital asset produces income. *Id.*

[17] *Id.* at 16.

[18] *See, e.g.*, Strauss Mkt. v. Commissioner, 2 B.T.A. 1264, 1265 (1925) (cost of replacements to store floor not currently deductible because reasonable expected life greater than one year); Georgia Car & Locomotive Co. v. Commissioner, 2 B.T.A. 986, 990 (1925) (new roof of building had life in excess of one year and therefore was capital expenditure).

[19] *See* United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957) (sums taxpayer farmer paid to acquire title to right of way capital expenditures), *cert. denied*, 355 U.S. 956 (1958); Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950) (costs of furniture and equipment capital expenditures). A cost is a capital outlay if the cost procures an asset having a useful life in excess of one year. 180 F.2d at 312.

[20] *See, e.g.*, Pittsburgh Athletic Co. v. Commissioner, 27 B.T.A. 1074, 1078 (1933) (cost of one year contract allowed as deduction in year acquired), *aff'd*, 72 F.2d 883 (3d Cir. 1934); W. B. Harbeson Lumber Co. v. Commissioner, 24 B.T.A. 542, 550 (1931) (cost of automobiles, which wore out six months after date of purchase, currently allowable deduction from income).

[21] *See, e.g.*, Commissioner v. Lincoln Sav. & Loan Ass'n., 403 U.S. 345, 354 (1971) (payments to reserve account capital expenditures because of creation of separate and distinct additional asset); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1191-92 (10th Cir. 1974) (cost of participation in credit card system ordinary business expense because costs failed to create separate and distinct additional asset); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 782-87 (2d Cir. 1973) (cost of promotional activities ordinary expense because cost did not create separate and distinct additional asset).

[22] *See supra* note 21 (cases applying separate and distinct additional asset test to distinguish capital expenditure from ordinary expense).

pense.[23] In *NCNB Corp. v. United States*,[24] the Fourth Circuit addressed whether costs that a corporation incurred were ordinary and necessary or capital in nature.[25]

The North Carolina National Bank (Bank) formed as the result of a merger of banks in Charlotte and Greensboro, North Carolina and subsequently became the largest bank in North Carolina.[26] As part of the expansion process, the Bank incurred a variety of costs,[27] including payments for constructing and equipping new facilities, conducting various market and feasibility studies, devoting staff time to planning and implementing expansion projects,[28] and applying for permission

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[23] *See* NCNB Corp. v. United States, 651 F.2d 942, 963 (4th Cir. 1981) (expenditures incurred in developing feasibility study capital because benefit extended beyond one year), *rev'd on rehearing en banc*, 684 F.2d 285, 294 (4th Cir. 1982) (expenditures deductible because costs did not create separate and distinct additional asset); Jack's Cookie Co. v. United States, 597 F.2d 395, 406 (4th Cir. 1979) (monthly rentals allocable to reserve fund capital because of length of useful life and because rentals created separate asset); First Nat'l Bank v. United States, 558 F.2d 721, 723 (4th Cir. 1977) (per curiam) (costs incurred in entering credit card program deductible because costs did not create separate and distinct asset); Georator Corp. v. United States, 485 F.2d 283, 285 (4th Cir. 1973) (legal costs incurred resisting cancellation of trademark registration capital expenditure because benefits extended beyond current tax period); Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494, 496 (4th Cir. 1968) (franchise owner's outlays to purchase less costly Coca-Cola syrup capital expenditure because payments produced positive business benefits extending beyond current year); Richmond Tel. Corp. v. United States, 345 F.2d 901, 907 (4th Cir.) (expenditures of television corporation for training programs for prospective employees in anticipation of broadcasting license created capital asset of indefinite duration), *vacated on other grounds*, 382 U.S. 68, *original holding on this issue reaff'd*, 354 F.2d 410 (4th Cir. 1965).

[24] 684 F.2d 285 (4th Cir. 1982) (en banc), *aff'g* North Carolina Nat'l Bank v. United States, 42 A.F.T.R.2d (P-H) ¶ 78-5237 (W.D.N.C. 1978).

[25] 684 F.2d at 287-94.

[26] *Id.* at 285. NCNB Corp. was the parent corporation of North Carolina National Bank (Bank), a national banking association. *See* Appendix at 74-75, 136, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982). Both the Bank and NCNB Corp. filed claims for refunds against the Internal Revenue Service (Service). North Carolina Nat'l Bank v. United States, 42 A.F.T.R.2d (P-H) ¶ 78-5237 (W.D.N.C. 1978). Because the cases involved the same legal issues and facts, the United States District Court for the Western District of North Carolina consolidated the cases. *Id.*

[27] 684 F.2d at 286; *see* Appendix at 44-66, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (expenses incurred by North Carolina National Bank in expansion process).

[28] North Carolina Nat'l Bank v. United States, 42 A.F.T.R.2d (P-H) ¶ 78-5237, 78-5867 (W.D.N.C. 1978). The *North Carolina National Bank* district court found that during the relevant tax periods North Carolina National Bank's planning function had two aspects. *Id.* The first aspect involved long-rang planning to identify geographic areas that would require service in the future and to analyze how North Carolina National Bank could serve the areas. *Id.* The second feature was a short range plan that consisted of more refined feasibility studies that identified possible locations for future expansion throughout the state. *Id.*

As part of its long-range planning, the Bank produced and purchased marketing studies of large metropolitan areas. *Id.* Although some of the studies led to more specific localized studies that induced the Bank to establish new branches, other studies did not result directly in the establishment of any branches. *Id.* With the assistance of outside consultants, the

from the Comptroller of the Currency (Comptroller) to open and relocate various facilities.[29] The Bank deducted the costs of the market and feasibility studies and the Comptroller's fee under section 162 of the Code.[30] The Service assessed a deficiency, arguing that the costs the Bank deducted as current expenses under section 162 were actually capital expenditures under section 263 because the costs related to the production of future income.[31] The Bank paid the deficiency and filed for a refund in district court.[32] The district court applied the separate and distinct additional asset test and concluded that the challenged costs were not capital expenditures but ordinary and necessary business expenses under section 162 of the Code.[33]

On appeal, a Fourth Circuit panel vacated the judgment of the district court and remanded for a determination of what amount of the feasibility studies the Bank used in its current revenue producing operations and what amount the Bank used in planning for and implementing

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Bank drew up more focused feasibility studies for each proposed branch location. *Id.* The cost of these studies was among the disputed items in the suit. *Id.*

[29] *Id.* at 78-5868. Once management approved of a new branch bank, North Carolina National Bank complied with federal banking law and applied to the Comptroller of the Currency for approval. *Id.* at 78-5868; *see* 12 U.S.C. § 36 (1976) (Comptroller's permission to open branch bank required). The Bank's initial application consisted of a brief form, a filing fee, and a resolution of the Board of Directors of the Bank authorizing the filing. 42 A.F.T.R.2d (P-H) at ¶ 78-5868. The deductibility of the filing fee was one of the issues in the suit. *Id.*

[30] 684 F.2d at 286.

[31] *See* Brief for Appellant at 12-13, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) [hereinafter cited as Brief for Appellant]. In *NCNB Corp.*, the Service argued that a taxpayer must capitalize an expenditure even though the expenditure was not for a capital asset. *Id.* The Service maintained that merely because a taxpayer purchases an asset that does not meet the Code § 1221 definition of a capital asset does not mean that the expenditure is an ordinary expense. *Id.*; *see* I.R.C. § 1221 (West 1982) (capital asset defined as property held by the taxpayer). The Service asserted that a taxpayer must capitalize the cost of any asset having a useful life greater than one year. Brief for Appellant, *supra*, at 12. If a taxpayer purchases an asset with a useful life greater than one year, the taxpayer must amortize the cost of the asset over the economic life of the asset to match the income the asset produces with the cost of acquisition. *Id.* The Service also argued that because the Bank's expenditures created a separate and distinct asset, the taxpayer should capitalize the expenditures even under the narrow separate and distinct additional asset test. *Id.*; *see infra* note 33 (*North Carolina National Bank* court held branch banks were not separate and distinct additional assets).

[32] 684 F.2d at 287. NCNB Corp. filed in district court a claim in the amount of $227,652.73 for refund of income taxes plus interest for the years 1965-70. North Carolina Nat'l Bank v. United States, 42 A.F.T.R.2d (P-H) ¶ 78-5237, 78-5867 (W.D.N.C. 1978); *see* Appendix at 142, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (refund claim).

[33] 42 A.F.T.R.2d (P-H) at ¶ 78-5869. In *North Carolina National Bank*, the district court held that the offering of banking services from new locations does not create a separate and distinct asset. *Id.* at 78-5868. Opening a new branch office is a way of adjusting the scope of existing business operations to accommodate changing business conditions and to maintain a competitive position. *Id.* The court held that the costs did not create a separate and distinct additional asset because the costs were business expenses as opposed to capital expenditures. *Id.* at 78-5869.

future revenue producing operations.[34] The Fourth Circuit found that capitalization of an expenditure as an asset is proper to carry the cost forward into an accounting period in which the business properly may match the expenditure with the benefits the expenditure produces.[35] The Fourth Circuit required capitalization of costs that benefit a taxpayer beyond the year of payment even though capitalization might conflict with the method of accounting that the Comptroller requires.[36] A pay-

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[34] NCNB Corp. v. United States, 651 F.2d 942, 947 (4th Cir. 1981), *rev'd on rehearing en banc*, 684 F.2d 285 (4th Cir. 1982). In *NCNB Corp.*, a panel decision, the Fourth Circuit vacated the judgment of the district court and remanded the case for further fact finding. 651 F.2d at 947; *see supra* note 33 (discussing basis for district court's holding). Specifically, the Fourth Circuit directed the district court to make a finding of fact concerning the amount of the marketing study that the Bank used in the Bank's current revenue producing operations and the amount of the study the Bank used in planning for and implementing new facilities for future use in the Bank's revenue producing operations. 651 F.2d at 962. The Fourth Circuit concluded that because the Service conceded that the Bank's expenditures were necessary, the issue was to what extent the expenditures also were ordinary. *Id.* at 948. *See generally supra* note 3 (distinction between ordinary and necessary expenses).

[35] 651 F.2d at 949. In finding that capitalization of an expenditure is proper to carry the cost forward into an accounting period when the taxpayer may match the cost with the benefits the cost produces, the *NCNB Corp.* panel relied on several cases. *Id.* at 950-52; *see* Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974); Kauai Terminal, Ltd. v. Commissioner, 47 B.T.A. 523, 528 (1942); Kauai Terminal, Ltd. v. Commissioner, 36 B.T.A. 893, 899 (1937). In *Kauai Terminal*, the taxpayer contributed funds to the government for the construction of a breakwater that benefitted the taxpayer's lighterage operation as well as his overall business. 47 B.T.A. at 524. Four years after the construction of the breakwater, the government built a wharf that effectively made the taxpayer's lighterage operations obsolete. *Id.* at 525. The court required a rough apportionment of the capital costs of the breakwater between the lighterage operations and the taxpayer's overall business. *Id.* at 528. The court allowed the taxpayer to depreciate ratably during the period between the time of completion of the breakwater and the time of completion of the wharf that portion of the cost of the breakwater allocated to lighterage operations. *Id.* The period covered the time during which the breakwater benefitted the lighterage operations but before the wharf made the lighterage operations obsolete. *Id.* The *Kauai Terminal* court reasoned that in contributing to the cost of the breakwater, the taxpayer was making an investment. *Id.* The investment benefitted not only the taxpayer's lighterage operations, but also the taxpayer's entire business for an indefinite period. *Id.*

The *NCNB Corp.* panel also relied on *Commissioner v. Idaho Power Co.*, 651 F.2d at 951; *see* Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974). In *Idaho Power*, the taxpayer attempted to deduct from gross income the depreciation on equipment that the company used in constructing permanent facilities for the company. *Id.* at 5. The *Idaho Power* Court held that when a taxpayer uses an asset to further his daily business operations, the periods of benefit usually correspond with the production of income. *Id.* at 11. To the extent a taxpayer uses equipment in the business operations, a current depreciation deduction is an appropriate offset to gross income currently produced. *Id.* Referring to Idaho Power's attempt to depreciate the cost of the company's construction equipment, the Court held that different principles apply when the consumption of an asset occurs in the construction of other assets that will produce income in the future. *Id.* In *Idaho Power*, the depreciation of the company's equipment did not match the production of current income but was related to the future in that Idaho Power used the equipment to construct a capital facility for the company. *Id.* The Court required Idaho Power to capitalize the cost of the depreciation as part of the cost of acquiring an income producing asset. *Id.*

[36] 651 F.2d at 955. The *NCNB Corp.* panel repeated the general rule that a taxpayer

ment does not need to be for a capital asset nor does the payment need to relate to a new trade or business before the taxpayer must capitalize the cost.[37] The Fourth Circuit panel held that the one-year rule for distinguishing between capital expenditures and ordinary expenses remained valid despite recent circuit court decisions relying on the

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may compute taxable income under the method of accounting that the taxpayer regularly uses to compute book income. *Id.* at 954; *see* I.R.C. § 446(a) (West 1982) (method of computing taxable income). The consistency rule is particularly appropriate when a regulatory authority prescribes the accounting method. 651 F.2d at 954. *But see* Commissioner v. Idaho Power Co., 418 U.S. 1, 15 (1974) (agency-imposed compulsory accounting practices do not necessarily dictate tax treatment). Despite the rule of consistency, however, the critical determination remains whether the taxpayer's accounting practice clearly reflects income. 651 F.2d at 953-54. The Secretary of the Treasury or his delegate, the Commissioner of Internal Revenue, determines whether an accounting practice clearly reflects income. *Id.*; *see* I.R.C. § 446(b) (opinion of Secretary of Treasury is controlling). *NCNB Corp.* involved a conflict between the method of accounting the Comptroller of the Currency required for accounting purposes and the method of accounting the Commissioner required for tax purposes. 651 F.2d at 954-55. The Comptroller advocated an accounting system in which the bank deducts expenditures immediately. *Id.* at 955. Conservative accounting practices reduced reported net income so much that the report failed to reflect income clearly. *Id.* Although the Comptroller's aim is investor protection, the Commissioner gives primary significance to accurate reflection of income. *Id.* In view of the differing goals of the two accounting systems, the *NCNB Corp.* panel held that the Commissioner did not abuse his discretion in determining that the Bank's regular system of accounting did not clearly reflect income under § 446(b). 651 F.2d at 955; *see* I.R.C. § 446(b). Thus the Bank could not, despite the requirements of the Comptroller of the Currency, understate its income by currently deducting costs properly capitalized for tax purposes. 651 F.2d at 954.

[37] 651 F.2d at 956-57 (citing United States v. Mississippi Chem. Corp., 405 U.S. 298, 310 (1972) and Georator Corp. v. United States, 485 F.2d 283, 285 (4th Cir. 1973), *cert. denied*, 317 U.S. 945 (1974)). In *Georator* the court held that an expenditure does not need to be for a capital asset as described in § 1221 of the Code to be a capital expenditure. *Id.* at 285. The *NCNB Corp.* panel interpreted the Supreme Court's decision in *Mississippi Chemical Corp.* to mean that status as a capital asset under § 1221(2) is sufficient but not necessary to require capitalization. 651 F.2d at 956.

In addressing the Bank's contention that an existing business currently may deduct costs that do not relate to a new trade or line of business, the *NCNB Corp.* panel distinguished *Richmond Tel. Corp. v. United States* as inapposite. *Id.*; *see* Richmond Tel. Corp. v. United States, 345 F.2d 901 (4th Cir.) (capitalization of staff training costs), *vacated on other grounds*, 382 U.S. 68, *original holding on this issue reaff'd*, 354 F.2d 410 (4th Cir. 1965). The Fourth Circuit in *Richmond Television* required a television station to capitalize the costs of training staff during tax years before the station began to receive revenues from broadcasting. 345 F.2d at 904-905. NCNB Corp. relied on *Richmond Television* to show that depending on whether an existing or a new business incurs the cost, the same cost may be an expenditure or an expense. 651 F.2d at 956. According to the *NCNB Corp.* panel, the current or future nature of the matching income, not the age of the business, controlled the capitalization of the cost in *Richmond Television. Id.* at 957.

In rejecting the Bank's argument that an expenditure must create a tangible property interest before the taxpayer must capitalize the expenditure, the *NCNB Corp.* panel relied on several Supreme Court cases. *Id.*, *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (payments to reserve insurance fund capital expenditures); Welch v. Helvering, 290 U.S. 111, 115 (1933) (payments to protect professional reputation capital expenditures). According to the Fourth Circuit, *Lincoln Savings* did not require the acquisi-

separate and distinct additional asset test.[38] On rehearing en banc, the Fourth Circuit vacated the panel decision and affirmed the judgment of the district court.[39] The Fourth Circuit ruled that costs which do not create or enhance separate and distinct additional assets are not capital within the meaning of section 263 of the Code.[40]

In distinguishing on rehearing between capital expenditures and current expenses, the Fourth Circuit relied on the Supreme Court's opinion in *Commissioner v. Lincoln Savings & Loan Association*.[41] In ruling that the payments Lincoln Savings made to a refundable insurance reserve were capital expenditures,[42] the Supreme Court in *Lincoln Savings* found that the presence of a benefit to the taxpayer extending beyond the taxable year was not controlling in determining whether the cost was a capital expenditure or an ordinary and necessary business expense.[43] According to the Court, the controlling factor was that the

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tion of a tangible property interest before the taxpayer must capitalize an expenditure. *NCNB Corp.*, 651 F.2d at 957. The presence of a property interest, however, influenced the *Lincoln Savings* Court's determination that the costs were capital expenditures. *Id.*; *see infra* text accompanying notes 42-44 (payments in *Lincoln Savings* were capital expenditures). The *NCNB Corp.* panel reasoned that the *Lincoln Savings* Court did not hold that costs which do not secure a property interest are ordinary business expenses, rather than capital expenditures. *NCNB Corp.*, 651 F.2d at 957. The *NCNB Corp.* panel held that the association of a cost with a property interest that lasts for more than a year always has been and continues to be a sufficient but not a necessary condition for capitalizing a cost. *Id.* at 958.

The Supreme Court's decision in *Welch v. Helvering* provided further support for the *NCNB Corp.* panel's analysis. *NCNB Corp.*, 651 F.2d at 957; *see* Welch v. Helvering, 290 U.S. 111, 115 (1933). In *Welch v. Helvering*, a former officer of a bankrupt corporation satisfied many of the corporation's debts to protect his professional reputation. 290 U.S. at 112. The Supreme Court held that the payments resembled capital outlays more than current expenses. *Id.* at 115. Accordingly, although the payments did not create a tangible property interest, the Court required the taxpayer to capitalize the costs. *Id.*

[38] 651 F.2d at 958-60; *see, e.g.*, First Nat'l Bank v. United States, 558 F.2d 721, 723 (4th Cir. 1977) (per curiam) (cost of participation in nonprofit association was ordinary expense); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192-93 (10th Cir. 1974) (cost of developing credit card system was ordinary expense); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973) (promotional costs were ordinary expenses).

[39] NCNB Corp. v. United States, 684 F.2d 285, 286 (4th Cir. 1982) (en banc).

[40] *Id.* at 294.

[41] *Id.* at 287-91; Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971).

[42] 403 U.S. at 354. In *Lincoln Savings*, § 404(a) of the National Housing Act (Act) required the taxpayer to pay the Federal Savings and Loan Insurance Corporation (FSLIC) an annual insurance premium. 403 U.S. at 348; *see* 12 U.S.C. § 1727 (1976). FSLIC placed the money into the general reserve fund of the insurance corporation. 403 U.S. at 348. The insured institutions had no property interest in the reserve fund. *Id.* at 349. In September, 1961, Congress amended the Act to require insured institutions to pay FSLIC an additional premium which FSLIC placed into a separate reserve. *See* Pub. L. No. 87-210, 75 Stat. 483 (codified as amended at 12 U.S.C. § 1761c (1976)). Because the insured institutions could receive a refund of their funds in the separate reserve under certain limited and specifically prescribed circumstances, the Banks thereby maintained a property interest in the reserve. 403 U.S. at 350.

[43] 403 U.S. at 354. The *Lincoln Savings* Court held that before a taxpayer can deduct a payment under § 162 of the Code, the taxpayer must incur the cost during the taxable year

payment of the premium created or enhanced an essentially separate and distinct additional asset.[44] The Fourth Circuit in *NCNB Corp.* relied on the *Lincoln Savings* Court's reasoning as authority for rejecting the traditional one-year rule for distinguishing between capital expenditures and ordinary and necessary business expenses.[45]

The *NCNB Corp.* court also relied on the Second Circuit's decision in *Briarcliff Candy Corp. v. Commissioner*[46] in holding that the Bank's costs were ordinary and necessary business expenses.[47] In *Briarcliff*, the Second Circuit interpreted *Lincoln Savings* as shifting emphasis from the one-year rule[48] and held that the costs of promotional activities would be capital only if the costs created or enhanced a separate and distinct additional asset.[49] The *NCNB Corp.* court held that the costs which the Bank

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in a trade or business. *Id.* at 352. Additionally, the cost must be an ordinary and necessary business expense. *Id.*

[44] *Id.* at 354. Lincoln Savings attempted to characterize its payment into a secondary insurance reserve as an ordinary business expense. *Id.*; *see supra* note 42 (National Housing Act required Lincoln Savings to make payments into FSLIC's general and secondary insurance reserves). Lincoln Savings argued that payments to FSLIC's general reserve were not different from payments to the secondary reserve since both payments were premiums for insurance that the law required all similarly situated savings and loan associations to pay. 403 U.S. at 354. Lincoln Savings also argued that the possibility of a future benefit did not make the expenditure capital as opposed to an expense. *Id.*

The Court rejected Lincoln Saving's argument and held that since all similarly insured associations pay the expenditure or that the expenditure serves to fortify FSLIC's insurance purpose and operation is not sufficient to qualify the cost as an expense. *Id.* The presence of a potential benefit does not control the character of the cost. *Id.* Many deductible expenses have prospective effect beyond the taxable year. *Id.* The *Lincoln Savings* Court found controlling the fact that the payment created or enhanced for Lincoln Savings an essentially separate and distinct additional asset. *Id.* Consequently the payment was capital and not an expense deductible under § 162 of the Code. *Id.*

[45] 684 F.2d at 289; *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (presence of benefit with useful life beyond one year not controlling in determining capital expenditures).

[46] 475 F.2d 775 (2d Cir. 1973).

[47] 684 F.2d at 290; *see* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973). *Briarcliff* involved a candy company that engaged in a series of promotional activities. 475 F.2d at 777. The company attempted to deduct the promotional costs under § 162 of the Code. *Id.* at 778. The promotional activities included entering into various franchise contracts with local candy stores. *Id.* at 777. The Service ruled that the promotional expenses were capital because Briarcliff incurred the expenses in obtaining contracts with benefits that extended into future years. *Id.* at 780.

[48] 475 F.2d at 782. Because *Lincoln Savings* seemed to shift emphasis away from the one-year rule, the *Briarcliff* court held that in determining whether a cost is a capital expenditure courts should inquire whether the cost created or enhanced a separate and distinct additional asset. *Id.*; *see* Commissioner v. Lincoln Sav. & Loan, 403 U.S. 345, 354 (1971) (ensuing benefit does not control capitalization issue); *supra* text accompanying notes 41-44 (*Lincoln Savings*).

[49] 475 F.2d at 782. The *Briarcliff* court held that in the absence of a statutory definition of "capital asset," courts must interpret the term in the usual or customary business sense as an item of ownership of a permanent or fixed nature that is convertible into cash. *Id.* at 786. The *Briarcliff* court reasoned that since the franchise contracts Briarcliff negotiated

incurred in exploring the possibility of expansion were analogous to the costs of Briarcliff's promotional activities because the costs in both cases did not create a separate and distinct additional asset.[50] The Fourth Circuit found particularly relevant the Second Circuit's rejection of the Service's argument that under the one-year rule the possible long-term benefits of the promotional activities required capitalization of the costs.[51]

The Fourth Circuit also found analogous to *NCNB Corp.* several circuit court cases involving banks deducting the cost of developing credit card systems.[52] In *Colorado Springs National Bank v. United States*,[53] for example, the Tenth Circuit held that credit card system start-up costs were ordinary and necessary business expenses.[54] The *Colorado Springs* court described the credit card system as a more efficient method of conducting an old business.[55] The *NCNB Corp.* court reasoned that the persuasive factual similarity between the credit card cases and *NCNB Corp.* was that costs incurred in expanding a business are not capital expenditures unless the costs meet the *Lincoln Savings* separate and distinct additional asset test.[56] Although the *NCNB Corp.* court warned that courts should not ignore the long-term benefits of costs,[57] the court also held that the *Lincoln Savings* test applies whether or not the costs secure benefits extending beyond the current taxation period.[58]

In addition, the Fourth Circuit noted that the Senate Report which accompanied section 195 of the Code supported the *NCNB Corp.* holding.[59] Section 195 allows a new business to treat previously nondeductible start-up costs as deferred expenses and provides that a new business may deduct the deferred expenses ratably over a period of

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were not convertible into cash, the contracts were not capital assets. *Id.* Thus the costs Briarcliff incurred in obtaining the contracts were not capital expenditures. *Id.*

[50] 684 F.2d at 290-91; *see* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973) (promotional costs that did not procure separate and distinct additional asset were ordinary business expenses).

[51] 684 F.2d at 290-91; *see* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 786 (2d Cir. 1973) (presence of ensuing benefit no longer controls characterization of cost).

[52] 684 F.2d at 291; *see, e.g.*, First Sec. Bank v. Commissioner, 592 F.2d 1050, 1052 (9th Cir. 1979) (costs incurred in adoption of credit card plan ordinary expenses); Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433, 436 (8th Cir. 1979) (credit investigation costs ordinary expenses); First Nat'l Bank v. United States, 558 F.2d 721, 723 (4th Cir. 1977) (costs of participation in credit card association ordinary expense); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) (start-up costs for developing credit card system ordinary expense).

[53] 505 F.2d 1185 (10th Cir. 1974).

[54] *Id.* at 1192-93.

[55] *Id.* at 1192.

[56] 684 F.2d at 291.

[57] *Id.* at 289.

[58] *Id.* at 291.

[59] *Id.*; *see* S. REP. No. 1036, 96th Cong., 2d Sess. 11, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7293, 7301 (amortization of business start-up costs) [hereinafter cited as SENATE REPORT].

years.[60] Section 195 limits the deferable costs of a new business to start-up expenses that an existing business could deduct.[61] The *NCNB Corp.* court interpreted the eligible expenditures listed in the Senate Report accompanying section 195 as referring to the allowable deductions of an existing business.[62] Because the examples of allowable deductions in the Senate Report included the cost of feasibility studies, the Fourth Circuit reasoned that Congress believed that an existing business could deduct currently the cost of feasibility studies.[63]

To support the holding that costs which the Bank incurred in applying for permission from the Comptroller of the Currency to open branch banks were current expenses,[64] the Fourth Circuit distinguished *NCNB Corp.* from several cases in which courts held that license costs were capital expenditures.[65] The *NCNB Corp.* court rejected the holding of any case that relied on the one-year rule.[66] The Fourth Circuit also distinguished *NCNB Corp.* from cases that involved licenses for permission to expand into new business ventures, in contrast to the expansion of an established part of the regular business operation.[67] The *NCNB*

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[60] I.R.C. § 195 (West 1982).

[61] *Id.*

[62] 684 F.2d at 291. The Senate Report stated that Congress enacted § 195 to allow the amortization of investigatory costs that a taxpayer incurs in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. Senate Report, *supra* note 59, at 11, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7293, 7301. Among the allowable start-up costs the Senate Report lists is the expense a taxpayer incurs in the analysis or survey of potential markets. *Id.* The *NCNB Corp.* court interpreted the cost of a market survey as referring to a cost that an existing business, as opposed to a new business, could deduct. 684 F.2d at 291. The court concluded that Congress believed that the cost of market studies was an allowable deduction for an existing business. *Id.*; *see infra* note 79 (dissent's interpretation of market study costs as referring to the amortizable costs of a new business).

[63] 684 F.2d at 291; *see supra* note 62 (Fourth Circuit interpretation of § 195 market survey costs as referring to the deductible costs of existing business).

[64] 684 F.2d at 292; *see supra* text accompanying notes 27-30 (expenses Bank incurred during expansion process).

[65] 684 F.2d at 292; *see* Chandler Trailer Convoy, Inc. v. Commissioner, 42 T.C.M. (P-H) ¶ 73,285, 1322-23 (1973) (costs incurred in securing operating license, which had useful life in excess of one year, nondeductible business expenses); WHEC, Inc. v. Commissioner, 37 T.C. 821, 826 (1962) (attorney's fees incurred in connection with securing right to broadcast from FCC nondeductible business expenses); Radio Station WBIR, Inc. v. Commissioner, 31 T.C. 803, 816 (1959) (legal, engineering, and travel costs incurred in obtaining operating permit, which had useful life in excess of one year, nondeductible business expense).

[66] 684 F.2d at 292; *see* Chandler Trailer Convoy, Inc. v. Commissioner, 42 T.C.M. (P-H) ¶ 73,285, 1322-23 (1973) (costs incurred in securing operating license, which had useful life in excess of one year, nondeductible business expense); Radio Station WBIR, Inc. v. Commissioner, 31 T.C. 803, 816 (1959) (legal, engineering, and travel costs incurred in obtaining operating permit, which had useful life in excess of one year, nondeductible business expense).

[67] 684 F.2d at 292; *see* Chandler Trailer Convoy, Inc. v. Commissioner, 42 T.C.M. (P-H)

Corp. court held that the Comptroller's permission to open a branch bank differs factually from other government licenses because the Comptroller's permission is not an exclusive territorial franchise nor is the permission transferable.[68]

In addition, the Fourth Circuit reasoned that the Comptroller's accounting requirements supported treating the Bank's expansion costs as current expenses under section 162 of the Code.[69] The *NCNB Corp.* court noted that the policy of the Office of the Comptroller is to require national banks to charge all costs relating to the development or expansion of banking services to current operations.[70] According to the Fourth Circuit, the Comptroller's accounting method presumptively controls the characterization of a cost so long as the method accurately reflects income.[71]

In the dissenting opinion to *NCNB Corp.*, Judge Murnaghan construed the Supreme Court's statement in *Lincoln Savings* that the one-year rule did not control as dicta.[72] According to the dissent, the acquisition of a benefit with a useful life of more than one year remains a predominant characteristic of a capital expenditure even though factors other than the duration of the benefit may prove controlling in some circumstances.[73] The dissent also criticized the majority's reliance on section 195 of the Code to justify the deduction of the Bank's expansion

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¶ 73,285, 1322 (1973) (not expansion of existing business for local truck line to seek nationwide routes); WHEC, Inc. v. Commissioner, 37 T.C. 821, 826 (1962) (not expansion of existing business for radio broadcasting company to seek television license).

[68] 684 F.2d at 292.

[69] *Id.*

[70] *Id.* The *NCNB Corp.* court recognized that the accounting policy of the Office of the Comptroller requires conservative accounting procedures. *Id.* The reason for requiring national banks to charge all expenditures to current operations is the Comptroller's responsibility to assure the solvency and liquidity of national banks and the concurrent protection of depositors and shareholders. *Id.*; *see* Letter from Comptroller of the Currency to Assistant Secretary for Tax Policy, U.S. Treasury Department (August 21, 1972) (explaining Comptroller's conservative accounting policy), *reprinted in part in* NCNB Corp. v. United States, 684 F.2d 285, 292 (4th Cir. 1982).

[71] 684 F.2d at 292-93; *see* Commissioner v. Idaho Power Co., 418 U.S. 1, 15 (1974) (federal income tax consequences of compulsory accounting methods). In *Idaho Power* the Supreme Court ruled that when a regulatory agency compels a taxpayer to use a particular method of accounting and that method clearly reflects income, the agency's requirements presumptively control federal tax consequences. 418 U.S. at 15. The court in *NCNB Corp.* followed the Supreme Court's holding in *Idaho Power* that the Comptroller's policy of charging all expenditures to current operations controls the tax consequences of expenditures. 684 F.2d at 293.

[72] 684 F.2d at 294 (Murnaghan, J., dissenting).

[73] *Id.* In *NCNB Corp.*, Judge Murnaghan reiterated the position he had taken in the *NCNB Corp.* panel decision that whether the costs North Carolina National Bank incurred were capital expenditures or ordinary expenses was not a question the court had to answer on an all or nothing basis. *Id.*; *see* NCNB Corp. v. United States, 651 F.2d 942, 962 (4th Cir.

costs under section 162.[74] According to Judge Murnaghan, the legislative intent of section 195 is to allow taxpayers to amortize the start-up costs the taxpayer incurs before a new business actually begins operation.[75] Normally, a taxpayer may not deduct currently costs incurred prior to the establishment of a business because the taxpayer does not incur the costs in carrying on a trade or business within the meaning of section 162 of the Code.[76] Section 195 enables a new business to amortize the start-up costs that an existing business may deduct.[77] The dissent disagreed with the majority's conclusion that section 195 implies that an existing business may deduct all start-up costs.[78] The dissent argued that the explicit language of section 195, which limits the section's applicability to the investigatory costs that an existing business may deduct,

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1981) (allocate cost of Bank's feasibility study among accounting periods during which study was economically valuable to taxpayer), *rev'd on rehearing en banc*, 684 F.2d 285 (4th Cir. 1982).

[74] 684 F.2d at 295 (Murnaghan, J., dissenting).

[75] *Id.* In *NCNB Corp.*, Judge Murnaghan stressed that Congress enacted I.R.C. § 195 to benefit taxpayers by permitting them to elect to amortize, over a five-year period, costs that they otherwise could deduct currently. *Id.*; see I.R.C. § 195 (West 1982) (amortization of business start-up costs); Senate Report, *supra* note 59, at 11 (purpose for enacting I.R.C. § 195), *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7293, 7301. According to the dissent, Congress enacted § 195 in response to concern that a new business might lose the tax benefits of start-up losses if the business did not have profits against which to apply losses. 684 F.2d at 296 (Murnaghan, J., dissenting). Section 195 extended to new businesses an election to amortize start-up expenses to preserve the deduction for use in later more profitable years. *Id.*

[76] *See* I.R.C. § 162 (West 1982) (allowable deductions for costs incurred in carrying on a trade or business); Senate Report, *supra* note 59, at 10 (nondeductibility of business start-up costs), *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7293, 7300; *supra* text accompanying notes 10-11 (I.R.C. § 162).

[77] *See* I.R.C. § 195 (West 1982) (election to amortize start-up costs); Senate Report, *supra* note 59, at 11 (amortization of business start-up costs), *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7293, 7301. In *NCNB Corp.*, Judge Murnaghan explained that the focus of I.R.C. § 195 is on broadening the category of capital expenditure, not on expanding the expense category. 684 F.2d at 295 (Murnaghan, J., dissenting). Judge Murnaghan referred to the recommendation he made in the *NCNB Corp.* panel decision that the district court determine the portion of the Bank's costs that did not qualify for an immediate deduction and the time of the expected benefit of the remaining costs. *Id.*; *see* NCNB Corp. v. United States, 651 F.2d 942, 962 (4th Cir. 1981) (remanding to district court for findings regarding disputed allocations of costs), *rev'd on rehearing en banc*, 684 F.2d 285 (4th Cir. 1982). Items an existing business could not deduct under law when Congress enacted § 195 were neither the subject of nor affected by § 195. 684 F.2d at 295 (Murnaghan, J., dissenting).

[78] 684 F.2d at 295 (Murnaghan, J., dissenting). Judge Murnaghan argued that no justification exists for interpreting the legislative history of I.R.C. § 195 as broadening the category of deductible start-up expenses of an existing business. *Id.* To the extent start-up costs have the character of ordinary and necessary expenses of limited duration, the costs remain deductible for an existing business but become amortizable for a new business under § 195. *Id.* at 295-96. To the extent that expansion costs of an existing business have characteristics of longer life, the existing business must capitalize the cost. *Id.* at 296.

means that other investigatory costs exist that businesses may not deduct and instead must capitalize.[79]

The Fourth Circuit's decision in *NCNB Corp.* is the most recent in a series of Fourth Circuit opinions that postdate the Supreme Court's decision in *Lincoln Savings* and that have considered whether a cost was a capital expenditure or an ordinary and necessary business expense.[80] After *Lincoln Savings*,[81] the Fourth Circuit first addressed whether a cost was a capital expenditure or an ordinary and necessary business expense in *Georator Corp. v. United States*.[82] In *Georator*, the Fourth Circuit considered whether fees that a business incurred while resisting a petition to cancel registration of a trademark were deductible from gross income as ordinary and necessary business expenses or whether the fees were capital expenditures.[83] The *Georator* court applied the traditional one-year rule in deciding the case against the taxpayer.[84]

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[79] *Id.* at 295. In *NCNB Corp.*, Judge Murnaghan interpreted the allowable costs listed in the Senate Report as referring to the allowable start-up costs of a new business. *Id.*; *see* Senate Report, *supra* note 59, at 11 (allowable start-up costs), *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 7293, 7301; *see also supra* text accompanying notes 59-63 (majority interpreted list of allowable start-up costs in Senate Report as enumerating deductible costs of existing businesses). Judge Murnaghan concluded that § 195 permits a new business to amortize any of the allowable costs listed in the Senate Report provided an existing business can deduct the same costs. 684 F.2d at 295 (Murnaghan, J., dissenting). Whether an existing business can deduct the same costs currently, according to Judge Murnaghan, depends on the duration of the costs' benefit to the existing business. *Id.* at 295-96.

[80] *See, e.g.*, Jack's Cookie Co. v. United States, 597 F.2d 395, 401 (4th Cir. 1979) (portion of monthly rentals allocable to reserve fund that guaranteed payment of bonds was capital expenditure); First Nat'l Bank v. United States, 558 F.2d 721, 723 (4th Cir. 1977) (costs relating to participation in non-profit association were currently deductible expenses); Georator Corp. v. United States, 485 F.2d 283, 285 (4th Cir. 1973) (fees incurred in resisting cancellation of trademark registration were capital expenditures), *cert. denied*, 417 U.S. 945 (1974).

[81] *See* 403 U.S. 345, 354 (1971) (presence of ensuing benefit that may have some future aspect not controlling); *supra* text accompanying notes 41-45 (Supreme court's holding in *Lincoln Savings*).

[82] 485 F.2d 283 (4th Cir. 1973), *cert. denied*, 417 U.S. 945 (1974).

[83] 485 F.2d at 284. In reasoning that a taxpayer must capitalize the legal costs incurred in resisting cancellation of a trademark registration, the *Georator* court relied on *Duesenberg, Inc. v. Commissioner*. *Id.* at 285 (citing Duesenberg, Inc. v. Commissioner, 31 B.T.A. 922 (1934), *aff'd on other grounds*, 84 F.2d 921 (7th Cir. 1936). In *Duesenberg*, the Board of Tax Appeals held that because the benefits of trademark registration are likely to extend over several tax periods, the costs of registration are capital expenditures. 31 B.T.A. at 925. The *Georator* court found that successful opposition to a cancellation proceeding secures benefits similar to the benefits the original registration of the trademark secures. 485 F.2d at 285.

[84] 485 F.2d at 285. The *Georator* court held that I.R.C. § 162 reflects the principle that a taxpayer may deduct costs that secure benefits which the taxpayer realizes or exhausts in the same tax period. *Id.* Conversely, a taxpyer must capitalize costs that secure benefits beyond the taxable year. *Id.* The *Georator* court relied on previous Fourth Circuit decisions

Since the benefits of successful opposition to the cancellation petition were likely to extend beyond the tax period in which Georator incurred the fees, the Fourth Circuit reasoned that the fees were capital expenditures.[85] The *Georator* court did not discuss whether Georator expended the fees to expand an existing trade or business or to create an essentially separate and distinct additional asset.[86] The court found the one-year rule controlling despite the prior *Lincoln Savings* decision.[87]

After *Georator*, the Fourth Circuit next considered whether a cost was an ordinary and necessary business expense or a capital expenditure in *First National Bank v. United States*.[88] In *First National*, which appeared to abrogate the one-year rule, the Fourth Circuit relied exclusively on the separate and distinct additional asset test in ruling for the taxpayer.[89] The *First National* court did not mention the one-year rule even as a factor for consideration,[90] despite the fact that the cost at issue benefitted the bank in subsequent years.[91] The Fourth Circuit relied on the Supreme Court's decision in *Lincoln Savings*[92] as inter-

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to apply the one-year rule. *Id.*; *see, e.g.*, Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494, 496 (4th Cir.) (amounts spent to purchase soft drink syrup contracts capital expenditures), *cert. denied*, 393 U.S. 962 (1968); Richmond Tel. Corp. v. United States, 345 F.2d 901, 907 (4th Cir.) (training costs of prospective employees in anticipation of broadcasting license were capital expenditures), *vacated on other grounds*, 382 U.S. 68, *original holding on this issue reaff'd*, 354 F.2d 410 (4th Cir. 1965).

[85] 485 F.2d at 285.

[86] *See id.* The *Georator* court cited *Lincoln Savings* not for the separate and distinct additional asset test but for the Supreme Court's proposition that I.R.C. § 263 does not provide a complete or exhaustive list of nondeductible expenditures. *Id.*; *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 358 (1971) (§ 263 does not provide a complete list of nondeductible expenditures); I.R.C. § 263 (West 1982) (no deductions for expenditures that increase value of property).

[87] 485 F.2d at 285; *see supra* text accompanying note 84 (*Georator* court's reliance on one-year rule); *see also* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (creation of separate and distinct additional asset controls taxability of cost); *supra* text accompanying notes 41-45 (*Lincoln Savings* Court's reliance on separate and distinct additional asset test).

[88] 558 F.2d 721 (4th Cir. 1977) (per curiam).

[89] *Id.* at 723. In *First National*, the First National Bank of South Carolina attempted to deduct costs relating to its participation in a banking association. *Id.* at 722-23. Member banks sought to avoid duplication of costs in the acquisition of computer services essential to credit card operations. *Id.* The Service disallowed the deduction on the ground that the payment was a membership fee that required capitalization. *Id.* at 722. On appeal, the Fourth Circuit affirmed the district court's grant of summary judgment to the taxpayer. *Id.* at 724; *see* 413 F. Supp. 1107, 1113 (D.S.C. 1976) (district court's holding in *First National*).

[90] *See infra* note 94 (*Colorado Springs National Bank* court's characterization of one-year rule as mere factor for consideration).

[91] *See* Jack's Cookie Co. v. United States, 597 F.2d 395, 404 (4th Cir. 1979) (bank's contribution in *First National* helped to launch association that rendered cost saving service to bank in subsequent years).

[92] 558 F.2d at 723; *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (presence of benefit with useful life beyond one year not controlling in determining capital expenditure); *supra* text accompanying notes 41-45 (*Lincoln Savings* Court's reliance on separate and distinct additional asset test).

preted by the Second[93] and Tenth Circuits[94] to support the *First National* holding.[95]

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[93] *See* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973) (promotional costs designed to bolster sales were ordinary expenses because costs did not procure separate and distinct additional asset); *supra* text accompanying notes 48-49 (*Briarcliff* court's reliance on separate and distinct additional asset test). In *Briarcliff*, the Second Circuit interpreted the Supreme Court's statement in *Lincoln Savings* that the one-year rule was not controlling as shifting emphasis from the traditional one-year rule to whether the cost created or enhanced an essentially separate and distinct additional asset. 475 F.2d at 782; *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (presence of benefit with useful life beyond one year not controlling in determining capital expenditures). The issue in *Briarcliff* was whether Briarcliff's promotional activities, which included entering into franchise contracts, created or enhanced separate and distinct additional assets. 475 F.2d at 785-86. The Second Circuit found that the cost in *Briarcliff* protected the existence and income of an existing trade or business. *Id.* at 787. Although Briarcliff contemplated an additional division and entered into franchise contracts, the Second Circuit found that the corporation only was attempting to stem a downward sales trend. *Id.* The *Briarcliff* court held that by soliciting franchises, the corporation made its candy available in the suburbs to a class of customers who had moved there from the cities where they previously had been purchasers of the candy. *Id.* at 782-83. The Second Circuit reasoned that because Briarcliff was selling to former customers the same product the company had sold for decades, the promotional costs did not create a separate and distinct additional asset for the corporation. *Id.* at 787. The *Briarcliff* court reasoned that costs which preserve an existing income or business are ordinary and necessary expenses within the meaning of Code § 162 and are not capital in nature. *Id.* Since the *Briarcliff* court focused on the lack of a separate and distinct additional asset, the court treated as irrelevant the Service's argument that the costs procured benefits which Briarcliff enjoyed beyond the taxable year. *Id.* at 785-86.

[94] *See* Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) (costs of developing new sales territory deductible under I.R.C. § 162); *supra* text accompanying notes 52-56 (*Colorado Springs National Bank* court's reliance on separate and distinct additional asset test). In *Colorado Springs National Bank*, a bank attempted to deduct currently the cost of participation in a credit card system. 505 F.2d at 1187. The government claimed that a bank's credit cards were a new area or line of business designed to return a future profit. *Id.* at 1190. The Tenth Circuit recognized that Colorado Springs National Bank participated in the credit card system to return a future benefit, but reasoned that since banks always have been involved in extending credit, the credit card system merely enabled the bank to carry on an old business in a new way. *Id.* The court reasoned that a new method of doing business is distinguishable from a new business. *Id.* Relying on *Briarcliff*, the *Colorado Springs National Bank* court reasoned that a going concern may deduct the cost of developing a new sales territory under § 162 of the Code. *Id.* at 1190-91; *see* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973) (promotional costs designed to bolster sales were ordinary expenses because costs did not create separate and distinct additional asset); I.R.C. § 162 (West 1982) (deduction for all ordinary and necessary business expenses). The *Colorado Springs National Bank* court cited both *Lincoln Savings* and *Briarcliff* as support for the court's holding and concluded that the one-year rule was only a factor for consideration in determining a capital expenditure. 505 F.2d at 1190-93; *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (presence of benefit with useful life beyond one year not controlling in determining capital expenditures); *supra* text accompanying notes 41-44 (*Lincoln Savings* Court's reliance on separate and distinct additional asset test); *see also* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973) (promotional costs designed to bolster sales were ordinary expenses because costs did not procure separate and distinct additional asset); *supra* text accompanying notes 48-49 (*Briarcliff* court's reliance on separate and distinct additional asset test); *supra* note 93 (same).

[95] 558 F.2d at 723.

The Fourth Circuit reconsidered the validity of the one-year rule, however, in *Jack's Cookie Co. v. United States.*[96] In an attempt to reconcile the one-year rule and the separate and distinct additional asset test, the *Jack's Cookie* court held that *First National* did not abrogate the one-year rule although the *First National* court never mentioned the rule.[97] According to the *Jack's Cookie* court, *First National* merely refined and made more explicit certain limitations that always had been inherent in the rule's application.[98] The Fourth Circuit stated that the one-year rule was useful since the rule identified costs that could not be capital because of their temporary benefit to the taxpayer.[99] The Fourth Circuit held that the *Lincoln Savings* separate and distinct additional asset test necessarily incorporated the one-year rule since an integral characteristic of a separate and distinct additional asset is that the asset will benefit the taxpayer in subsequent years.[100]

Jack's Cookie established a two-part capitalization test that incorporated the one-year rule and the separate and distinct additional asset test.[101] Under *Jack's Cookie*, the one-year rule alone identifies costs

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[96] 597 F.2d 395 (4th Cir. 1979). The *Jack's Cookie* court addressed whether a portion of monthly rentals allocable to a reserve fund that guaranteed the payment of bonds was a capital expenditure or current expense. *Id.* at 401. The *Jack's Cookie* court used both the one-year rule and the separate and distinct additional asset test in its analysis. *Id.* at 405-406. The Fourth Circuit found that the disbursements secured benefits having a useful life that extended beyond the close of the year. *Id.* at 405. The court also held that the disbursements created a separate and distinct additional asset. *Id.* at 405-406.

[97] *Id.* at 403; *see* First Nat'l Bank v. United States, 558 F.2d 721, 723 (4th Cir. 1977) (separate and distinct additional asset test not met); *supra* text accompanying notes 89-95 (*First National* court's exclusive reliance on separate and distinct additional asset test). The taxpayer in *Jack's Cookie* argued that the *First National* court replaced the one-year rule with the separate and distinct additional asset test. 597 F.2d at 403. The Service argued that the decision in *First National* established only an alternative test that a court does not need to apply in every case. *Id.* The *Jack's Cookie* court explained the Fourth Circuit's failure to mention the one-year rule in *First National* by holding that although *First National* did not explicitly mention the one-year rule, the *First National* court implicitly referred to the rule when the court found *First National* to be indistinguishable from *Colorado Springs National Bank. Id.* at 404; *see* First Nat'l Bank v. United States, 558 F.2d 721, 723 (4th Cir. 1977) (*First National* indistinguishable from *Colorado Springs National Bank*); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) (one-year rule mere guidepost, not absolute rule).

[98] 597 F.2d at 403.

[99] *Id.* at 405. The *Jack's Cookie* court held that the one-year rule was useful in identifying as an ordinary expense a cost that secures a benefit to the taxpayer lasting less than one year. *Id.* The court, however, also found that failure to satisfy the one-year rule did not mean that the cost at issue was a capital expenditure. *Id.* For a cost to be a capital expenditure the cost must create for the taxpayer a separate and distinct additional asset. *Id.* The *Jack's Cookie* court incorporated the one-year rule into the test for a capital expenditure by holding that a separate and distinct additional asset by definition will serve the taxpayer in subsequent years. *Id.*

[100] *Id.*

[101] *Id.*; *see supra* text accompanying notes 96-100 (*Jack's Cookie* court's reconciliation of one-year rule with separate and distinct additional asset test).

lasting less than one-year as ordinary business expenses.[102] Courts must apply both the one-year rule and the separate and distinct additional asset test, however, to identify costs that secure benefits lasting beyond a year as capital expenditures.[103] Applying the *Jack's Cookie* court's definition of a capital expenditure to the facts of *NCNB Corp.*, the Fourth Circuit determined that the Bank incurred the cost of the feasibility studies to expand an existing business rather than to create a separate and distinct additional asset.[104] Because no separate and distinct additional asset existed, the *NCNB Corp.* court did not address whether the benefit of the cost extended beyond the tax year in issue.[105]

NCNB Corp. is the latest of the series of cases since *Lincoln Savings* in which the Fourth Circuit has attempted to fashion a test to determine whether a cost is a capital expenditure or a business expense.[106] In an effort to formulate a concise rule of law to distinguish expenses from capital expenditures, the Fourth Circuit in *Jack's Cookie* adopted the separate and distinct additional asset test in conjunction with the once disregarded one-year rule.[107] Although the *NCNB Corp.* court warned that it would not ignore the long-term characteristics of costs in deciding whether the costs were capital expenditures or current expenses,[108] the *NCNB Corp.* court also stated that the separate and distinct additional asset test applies whether or not the costs extend benefits beyond the current taxation period.[109] The *NCNB Corp.* court's emphasis on the separate and distinct additional asset test, coupled with the court's refusal to consider the long term benefits of the Bank's feasibility studies, is more consistent with the Second Circuit's consideration of a capital expenditure in *Briarcliff*[110] than the Fourth Circuit's two-part

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[102] 597 F.2d at 405; *see supra* text accompanying note 99 (*Jack's Cookie* court's use of one-year rule to identify ordinary business expenses).

[103] 597 F.2d at 405; *see supra* text accompanying notes 100-101 (*Jack's Cookie* court's combined use of one-year rule and separate and distinct additional asset test to identify capital expenditure); *supra* note 99 (same).

[104] NCNB Corp. v. United States, 684 F.2d 285, 294 (4th Cir. 1982) (en banc).

[105] *Id.* at 286-94.

[106] *Id.*; *see supra* text accompanying notes 80-100 (cases decided since *Lincoln Savings* dealing with distinction between ordinary expense and capital expenditure).

[107] Jack's Cookie Co. v. United States, 597 F.2d 395, 405 (4th Cir. 1979); *see supra* text accompanying notes 100-101 (*Jack's Cookie* court's reliance on both one-year rule and separate and distinct additional asset test to identify capital expenditures); *supra* note 99 (same).

[108] 684 F.2d at 289; *see supra* text accompanying note 57 (courts faced with the issue of expense versus expenditure should not ignore long term benefits of cost).

[109] 684 F.2d at 289; *see supra* text accompanying note 58 (separate and distinct additional asset test applies whether or not cost extends benefits beyond taxable year).

[110] *See* Briarcliff Candy Corp. v. United States, 475 F.2d 775, 787 (2d Cir. 1973) (*Lincoln Savings* shifted emphasis away from one-year rule); *supra* text accompanying notes 46-51 (*Briarcliff* court's sole reliance on separate and distinct additional asset test); *supra* note 93 (same).

definition of a capital expenditure announced in *Jack's Cookie*.[111] Although the ultimate holding in *NCNB Corp.* comports with the Fourth Circuit's definition of a capital expenditure in *Jack's Cookie*,[112] the language of the *NCNB Corp.* opinion provides a narrower description than does *Jack's Cookie* of what costs the Fourth Circuit will treat as capital expenditures.[113]

The Fourth Circuit's decision in *NCNB Corp.* is consistent with the court's definition of a capital expenditure in *Jack's Cookie*.[114] Whether *NCNB Corp.* is consistent with *Lincoln Savings*, however, is uncertain. The meaning of the Supreme Court's statement in *Lincoln Savings* that the creation of a separate and distinct additional asset and not the duration of an ensuing benefit controls the determination of a capital expenditure remains unclear.[115] The Fourth Circuit's[116] and the Supreme Court's[117] application of the one-year rule subsequent to *Lincoln Savings*

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[111] 597 F.2d at 405; *see supra* text accompanying notes 101-103 (*Jack's Cookie* court's reconciliation of one-year rule with separate and distinct additional asset test); *supra* note 99 (same).

[112] 597 F.2d at 405; *see supra* note 99 (capital expenditure is separate and distinct additional asset that benefits taxpayer in subsequent years).

[113] *Compare NCNB Corp.*, 684 F.2d at 289 (courts should not ignore long-term benefits of costs but separate and distinct additional asset test applies regardless of duration of costs' benefit) *with Jack's Cookie*, 597 F.2d at 405 (capital expenditure defined as separate and distinct additional asset that benefits taxpayer in subsequent years).

[114] *Compare NCNB Corp.*, 684 F.2d at 294 (costs that do not create or enhance separate and identifiable assets are properly considered ordinary and necessary) *with Jack's Cookie*, 597 F.2d at 405 (creation of separate and distinct additional asset essential feature of capital expenditure).

[115] *See* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (presence of benefit with useful life extending beyond one year not controlling in determining capital expenditure); *supra* text accompanying notes 41-45 (*Lincoln Savings* Court's reliance on separate and distinct additional asset test).

[116] *See* Georator Corp. v. United States, 485 F.2d 283, 285 (4th Cir. 1973); *supra* text accompanying notes 82-87 (*Georator* court's use of one-year rule). *Georator* provides authority that the Supreme Court limited the *Lincoln Savings* holding to the facts. 485 F.2d at 285; *see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (benefit extending beyond taxable year not controlling in determining capital expenditure). In *Georator*, the Fourth Circuit applied the one-year rule even though the court decided the case two years after *Lincoln Savings*. *See* 485 F.2d at 285 (likelihood of benefits extending beyond taxable year controls character of costs). The Fourth Circuit applied the separate and distinct additional asset test only after the Second Circuit's decision in *Briarcliff*. *See* First Nat'l Bank v. United States, 558 F.2d 721, 724 (4th Cir. 1977) (per curiam) (Fourth Circuit first applies separate and distinct additional asset test). Whether the Fourth Circuit would have applied the *Lincoln Savings* separate and distinct additional asset test in *First National*, *Jack's Cookie*, and *NCNB Corp.* if the *Briarcliff* court had not recognized a "radical shift" in emphasis is uncertain. *See* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 782 (1973) (describing *Lincoln Savings* as effecting a "radical shift" in emphasis away from one-year rule).

[117] *See* United States v. Mississippi Chem. Corp., 405 U.S. 298, 310 (1972) (use of one-year rule). In *Mississippi Chem. Corp.*, cooperatives participating in a federal agricultural program had to purchase regional bank capital stock in amounts measured by interest paid

to distinguish a capital expenditure from a current expense supports dissenting Judge Murnaghan's argument in *NCNB Corp.* that *Lincoln Savings* did not effect a shift in emphasis away from the one-year rule.[118]

The *NCNB Corp.* court differentiated capital expenditures from current expenses by narrowly defining capital expenditure as a payment creating a separate and distinct additional asset.[119] While noting that courts should not ignore the long-term benefits of costs,[120] the *NCNB Corp.* court departed from the traditional one-year rule and employed the separate and distinct additional asset test.[121] The *NCNB Corp.* decision provides that costs which a business incurs in planning the expansion of business operations are deductible currently because the costs do not create a separate and distinct additional asset but merely assure the continuation of an existing line of business.[122] Although the Fourth Circuit relied exclusively on the separate and distinct additional asset test to determine whether a business must capitalize a cost,[123] whether the

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on their borrowings. *Id.* at 299-300. Although the Supreme Court decided *Mississippi Chem. Corp.* nearly nine months after *Lincoln Savings*, the Court relied on the one-year rule in holding that the purchase of the stock represented a capital expenditure rather than a deductible business expense. *Id.* at 310. While the Court could have ruled that the cost of the stock was a capital expenditure because the purchased stock represented a separate and distinct additional asset, the Court instead reasoned that the cost was a capital expenditure because the stock provided a benefit to the taxpayer beyond the taxable year. *Id. Mississippi Chem. Corp.* provides authority for Judge Murnaghan's dissenting opinion in *NCNB Corp.* that life in excess of one year remains a predominant characteristic of a capital item, even though factors other than duration of existence may prove controlling in some circumstances. *See id.* at 310 (Supreme Court applied one-year rule subsequent to *Lincoln Savings*); NCNB Corp. v. United States, 684 F.2d 285, 294-95 (4th Cir. 1982) (Murnaghan, J., dissenting) (duration of benefit beyond taxable year remains characteristic of capital expenditure); *supra* text accompanying notes 72-73 (describing *Lincoln Savings* statement that one-year rule does not control character of cost as dicta).

[118] *See* NCNB Corp. v. United States, 684 F.2d 285, 294-95 (4th Cir. 1982) (Murnaghan, J., dissenting) (duration of benefit beyond taxable year remains characteristic of capital expenditure); *supra* text accompanying notes 72-73 (describing as dicta *Lincoln Savings* statement that one-year rule does not control tax consequences of cost).

[119] *See* 684 F.2d at 294 (costs that do not create or enhance separate and distinct additional asset are ordinary business expenses); *supra* text accompanying notes 41-58 (*NCNB Corp.* court's reliance on separate and distinct additional asset test to identify capital expenditure).

[120] *See* 684 F.2d at 289 (courts should not ignore long term benefits of costs, but separate and distinct additional asset test applies whether or not cost extends benefits beyond taxable year); *supra* text accompanying notes 108-109 (same).

[121] *See* 684 F.2d at 294 (ordinary business expenses are costs that do not relate to creation of separate and distinct additional asset); *supra* text accompanying notes 41-58 (*NCNB Corp.* court's reliance on separate and distinct additional asset test to distinguish capital expenditure from ordinary expense).

[122] *See* 684 F.2d at 290 (costs expended in continuation of existing business are ordinary expenses); *supra* text accompanying note 50 (costs NCNB Corp. incurred in exploring possibility of expansion were ordinary business expenses).

[123] *See* 684 F.2d at 294 (costs that do not create or enhance separate and distinct additional asset are ordinary business expenses); *supra* text accompanying notes 41-58 (*NCNB*

cost actually procures a separate and distinct additional asset remains a question of fact for which, according to the dissent, duration of benefit to the business in excess of one year provides at least a partial answer.[124]

DANIEL E. RILEY

B. *Estate Tax Determination Qualifies Under Mitigation Provisions*

The Internal Revenue Code (Code) of 1954 limits the time period within which the Revenue Service can assess and collect taxes[1] and within which the taxpayer can claim a refund for overpayment.[2] The limitation period generally is three years.[3] In specified circumstances, however, sections 1311 through 1314 of the Code mitigate the effect of the statute of limitations to prevent an inequitable taxation or tax avoidance in a closed tax year.[4] Application of section 1311 through 1314

Corp. court's reliance on separate and distinct additional asset test to identify capital expenditure).

[124] *See* 684 F.2d at 294 (Murnaghan, J., dissenting) (life in excess of one year remains a primary characteristic of capital item); *supra* text accompanying note 73 (same).

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[1] I.R.C. § 6501 (1976 & Supp. V 1981). The Revenue Service must assess or collect taxes within three years after the taxpayer files the tax return. *Id.* § 6501(a) (1976). The limitations period begins to run on the day after the filing of a return, whether the taxpayer files on or after the prescribed date. *See* Burnet v. Willingham Loan & Trust Co., 282 U.S. 437, 439 (1931) (day of filing does not count in determining time of filing); I.R.C. § 6501(a) (1976). The Internal Revenue Code treats an early return as filed on the filing deadline. I.R.C. § 6501(b)(1) (1976). The date of the postmark determines the date the taxpayer filed the return. *See* Hotel Equities Corp. v. Commissioner, 546 F.2d 725, 727-28 (7th Cir. 1976) (term "filed" in statute means time taxpayer mails return). The statute of limitations remains open in the case of the filing of a false or fraudulent return or a failure to file a return. I.R.C. § 6501(c) (1976). The IRC extends the three-year limitation period to six years if the taxpayer omits from gross income an amount in excess of 25% of the gross income shown on his return. *Id.* § 6501(e)(1)(A); Treas. Reg. § 301.6501(e)-1 (1972). The taxpayer and the Revenue Service can extend the statute of limitations by agreement in writing before the expiration of the time otherwise applicable. I.R.C. § 6501(c)(4) (1976). *See generally* 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 113.1-.9 (1981); TAX MGMT. (BNA) 28-4th (1982).

[2] I.R.C. § 6511 (1976 & Supp. V 1981). The taxpayer must file a claim for a refund or credit within three years from the time of filing or two years from the time of payment, whichever expires later. *Id.* § 6511(a) (1976); Treas. Reg. § 301.6511(b)-1(a) (1961). The IRC extends the limitation period to seven years for claims based on bad debts and worthless security losses and resulting carryovers. I.R.C. § 6511(d)(1) (1976); Treas. Reg. § 301.6511(d)-1 (1960). *See generally* 4 B. BITTKER, *supra* note 1, 113.1-.9; TAX MGMT. (BNA) 124-3d, § A, 3 (1982).

[3] I.R.C. § 6511 (1976 & Supp. V 1981); *see supra* note 2.

[4] I.R.C. §§ 1311-1314 (1976). Sections 1311-1314 of the Internal Revenue Code grant relief to both taxpayers and the Revenue Service from the inequitable results that occur when one party adopts a tax position inconsistent with his erroneous treatment of an item

initially requires a determination with regard to the closed tax year.[5] The determination must establish that the taxpayer or the Revenue Service took an erroneous position in a tax year closed by the statute of limitations.[6] The determination must fall within one of the circumstances of adjustment[7] specified in section 1312.[8] In addition, the party who

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in a closed tax year. *See id.*; *infra* text accompanying notes 5-10. *See generally* 4 B. BITTKER, *supra* note 1, ¶ 113.9; 2 J. MERTENS, LAW OF FEDERAL TAXATION § 14 (1982); TAX MGMT. (BNA) 110-2d (1978); Coleman, *Mitigation of the Statute of Limitations*, 31 INST. ON FED. TAX'N 1575 (1973); Scheifly, *Internal Revenue Code Sections 1311-1314: Resurrection of the Tax Year*, 11 GONZ. L. REV. 457 (1976). Although the mitigation provisions apply to the statute of limitations, the mitigation statutes also can apply to bars such as estoppel, quasi-estoppel, recoupment, and set-off. Treas. Reg. § 1.1311(a)-2 (1960). *See generally* TAX MGMT. (BNA) 110-2d § A, 1 (1977). Meeting the threshold requirements of the mitigation provisions does not create automatically a favorable judgment, but only presents a method of proceeding on the merits of the case. *See* 2 J. MERTENS, *supra*, § 14. If the case warrants corrective adjustment under §§ 1311-1314, the taxpayer must claim a refund or the Revenue Service assess a deficiency within one year from the date of the determination. I.R.C. § 1314(b) (1976); *see* Treas. Reg. § 1.1314(b)-1(b) (1974).

[5] I.R.C. § 1313(a)(1) (1976). A determination is a final decision by the Tax Court or other court of competent jurisdiction. *Id.* A Tax Court decision becomes final 90 days after the decision, or if a party files an appeal, when the order of the appellate court becomes final. *Id.* § 7481. A closing agreement made under § 7121 of the IRC qualifies as a final determination. *Id.* § 1313(a)(2) (1976); Treas. Reg. § 1.1313(a)-2 (1956); *see* I.R.C. § 7121 (1976). A closing agreement is an agreement between the Revenue Service and the taxpayer by which the parties establish the liability of the taxpayer conclusively except upon a showing of fraud, malfeasance, or misrepresentation of a material fact. I.R.C. § 7121 (1976); *see* 4 B. BITTKER, *supra* note 1, ¶ 112.1.5. A closing agreement becomes final on the date the Revenue Service approves the agreement. I.R.C. § 1313(a)(2) (1976). A final determination also results when a final disposition of a claim for refund exists. *Id.* § 1313(a)(3). The time when a determination of a refund claim becomes final depends upon what action the Revenue Service takes and whether the Revenue Service allows the refund claim. Treas. Reg. § 1.1313(a)-3(b)(1) (1956). An agreement pursuant to § 1.1313(a)(4) becomes final when the tax liability for the year involved becomes final. Treas. Reg. § 1.1313(a)-4(d) (1956). *See generally* 4 B. BITTKER, *supra* note 1, ¶ 113.9.4; TAX MGMT. (BNA) 110-2d § A, 3-6 (1978).

[6] I.R.C. § 1311(b)(2) (1976); *see supra* notes 1-2.

[7] I.R.C. § 1312 (1976). Section 1312 provides for a corrective adjustment under the prescribed situations when the taxpayer or the Revenue Service takes a position inconsistent with an erroneous position in a closed tax year. *See id.* Section 1312(1) describes the double inclusion of an item of gross income. *Id.* § 1312(1); Treas. Reg. § 1.1312-1 (1956). Section 1312(2) provides for a corrective adjustment if the determination allows a double allowance of a deduction or credit. I.R.C. § 1312(2) (1976); *see* Treas. Reg. § 1.1312-2 (1956). Section 1312(3) describes the double exclusion of an item of gross income. I.R.C. § 1312(3) (1976); *see* Treas. Reg. 1.1312-3 (1956). Section 1312(4) deals with the double disallowance of a deduction or credit. I.R.C. § 1312(4) (1976); *see* Treas. Reg. § 1.1312-4 (1956). Section 1312(5) involves correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs. I.R.C. § 1312(5) (1976); *see* Treas. Reg. 1.1312-5 (1956). Section 1312(6) describes correlative deductions and credits for certain related corporations. I.R.C. § 1312(6) (1976); *see* Treas. Reg. 1.1312-6 (1962). Section 1312(7) provides for a corrective adjustment if the determination establishes the basis of property and an error occurred in a transaction on which such basis depends. I.R.C. § 1312(7) (1976); *see* Treas. Reg. § 1.1312-7 (1962); *see infra* note 31 (listing requirements for § 1312(7) to apply). *See generally* 4 B. BITTKER, *supra* note 1, ¶ 113.9; TAX MGMT. (BNA) 110-2d § A, 19-20 (1978).

[8] I.R.C. § 1312 (1976); *see supra* note 7.

prevailed in the determination must have maintained a position inconsistent[9] with the erroneous treatment.[10] In *Chertkof v. United States*,[11] the Fourth Circuit considered whether a determination of estate tax deficiency that altered income tax liability for a prior year was a determination within the meaning of the mitigation provisions.[12]

Subsequent to the deaths of David and Annie Chertkof,[13] their executors established the fair market value[14] for securities in the

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[9] I.R.C. § 1311(b)(1) (1976). The inconsistent position must be adopted in the determination. *Id.* § 1311(b)(1)(a) (1976); Treas. Reg. § 1.1311(b)-1(a) (1962). A split among the courts exists over whether an inconsistent position requires active or passive inconsistency. *Compare* Commissioner v. Estate of Weinreich, 316 F.2d 97, 105 (9th Cir. 1963) (active inconsistency required to satisfy § 1311(b)(1)) *and* Heineman v. United States, 391 F.2d 648, 652-53 (Ct. Cl. 1968) (inconsistent position requires active inconsistency) *with* Yagoda v. Commissioner, 331 F.2d 485, 490 (2d Cir.) (passive inconsistency satisfies § 1311(b)), *cert. denied*, 379 U.S. 842 (1964) *and* Albert W. Priest Trust v. Commissioner, 6 T.C. 221, 226 (1946) (same). The legislative history of the mitigation provisions discusses the distinction between active and passive inconsistency. *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 48 (1938). The Senate report states that Congress intended to preserve the bar of the statute of limitations except when one party has justified a modification of the limitations statute by active inconsistency. *Id.* This language has led the Court of Claims and the Ninth Circuit to require that a taxpayer actively exploit the statute of limitations before the courts will allow any mitigation adjustment. *See Weinreich*, 316 F.2d at 105; *Heineman*, 391 F.2d at 652-53. The Second Circuit and the Tax Court hold that the mitigation provisions only require that the position adopted in the determination be inconsistent with the erroneous treatment in the closed year. *See Yagoda*, 331 F.2d at 490; *Priest Trust*, 6 T.C. at 226. *See generally* TAX MGMT. (BNA) 110-2d § A, 8-12 (1978). The Fourth Circuit recently has dealt with the active and passive inconsistency issue in *Chertkof v. Commissioner*, 649 F.2d 264 (4th Cir. 1981) (rejecting taxpayers' contention that § 1311(b) required active inconsistency). *See generally* Note, *Mitigation of Limitations*, 39 WASH. & LEE L. REV. 808 (1982).

[10] I.R.C. § 1311(b)(1) (1976). If the taxpayer or the Revenue Service meet the conditions of the mitigation provisions, § 1314 permits correction of the error by attributing income or deductions to the right year or by establishing the correct basis of property. *Id.* § 1314.

[11] 676 F.2d 984 (4th Cir. 1982).

[12] *Id.* at 985-95; *see infra* text accompanying notes 36-46.

[13] 676 F.2d at 985. David Chertkof died on September 17, 1968. *Id.* His widow, Annie Chertkof, died on September 13, 1969. *Id.*

[14] *Id.* The executors established the fair market value of the securities in order to determine the basis of the securities. *Id.* Basis is ordinarily the cost of the property. *See generally* 2 B. BITTKER, *supra* note 1, ¶ 41.1. In some situations, however, such as when the taxpayer obtains the property by gift or bequest, the taxpayer determines his basis in the property according to a special statutory, administrative, or judicial rule. *Id.* The basis of property acquired from a decedent is its fair market value on the date of the decedent's death. I.R.C. § 1014 (Supp. V 1981). This rule also applies to securities received by the decedent's estate from the decedent. *See* TAX MGMT. (BNA) 143-2d § A, 12 (1977). Although local or temporary market conditions in the amount traded may cause some distortion, generally the quoted exchange price reflects the opinion of willing buyers and sellers. *See id.*; *cf.* Treas. Reg. § 1.170A-1(c)(2) (1982) (fair market value is price between willing buyer and willing seller). In the case of inactive or closely held stock, however, market quotations are frequently unreliable or altogether lacking. *See* TAX MGMT. (BNA) 132-2d § A, 5 (1977). To determine the value of such stock, the Revenue Service recommends consideration of the nature and history of the business, the economic outlook, the book value of the stock, the earning and dividend paying capacity of the company, goodwill, and sales of both the stock

decedents' estates.[15] The executors used these values when they filed federal estate tax returns.[16] During the 1971 tax year, however, the estates received liquidating distributions from some of the securities in the decedents' estates.[17] On their income tax return for 1971, the estates used the values reported on the estate tax returns as the basis for computing gain or loss for the liquidated securities.[18] The Revenue Service did not accept the estate tax valuations and issued a notice of deficiency[19] to both estates.[20] The Revenue Service and the executors reached an agreement under which the taxpayers agreed to adjust upward the valuation of certain securities in the estate tax returns.[21] This upward

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in question and the stock of companies similarly situated. *See* Treas. Reg. §§ 20.2031-2(e), 25.2512-2(e) (1976); Rev. Rul. 59-60, 1959 I.R.B. 237-42.

[15] 676 F.2d at 985.

[16] *Id.*

[17] *Id.* at 986.

[18] *Id.* The amount of gain realized on a sale or other disposition of property is the difference between the amount realized and the adjusted basis of the property. I.R.C. § 1001 (1976 & Supp. V 1981). The amount realized is the sum of any money plus the value of any other property received from the sale or disposition. *See* Treas. Reg. § 1.1001-1 (1971). The basis of property acquired from a decedent is generally the property's fair market value at the date of the decedent's death. I.R.C. § 1014(a) (Supp. V 1981); *see supra* note 14. In *Chertkof,* when the executors adjusted the basis of the securities upward, a corresponding reduction in the amount of gain resulted. *See* 676 F.2d at 986.

The executors filed the income tax returns for the estate on June 15, 1971. 676 F.2d at 986. The Revenue Service issued the notices of deficiency on November 14, 1972 for David Chertkof's estate and November 8, 1973 for Annie Chertkof's estate. *Id.* The statute of limitations began to run with the filing of the return. I.R.C. § 6501(a) (1976); *see supra* note 1 (limitations period begins to run with filing of tax return).

[19] I.R.C. § 6213(a) (Supp. V 1981). A notice of deficiency is the formal notice of the determination of a deficiency in tax issued by the Revenue Service. *See id.* Upon the receipt of this notice, if the taxpayer is able to pay the proposed deficiency, he has the option either to pay the tax and sue for a refund in federal district court or the Court of Claims or to litigate the issues in the Tax Court before paying the tax. *Id.*; *see* 28 U.S.C. § 1491 (1976 & Supp. V 1981) (Court of Claims jurisdictional grant); 28 U.S.C. § 1346(a)(1) (Supp. V 1981) (district court jurisdictional grant). *See generally* Worthy, *The Tax Litigation Structure,* 5 GA. L. REV. 248 (1971). If the taxpayer chooses to proceed in the Tax Court, he has 90 days to file a petition for a redetermination of the asserted deficiency. I.R.C. § 6213(a) (1976 & Supp. V 1981). In the alternative, the taxpayer may choose to forego review by the Tax Court, pay the tax, and file a claim for refund in the Court of Claims or the federal district court. *Id.* § 6213; *cf.* Flora v. United States, 357 U.S. 63, 68 (1958) (taxpayer must pay deficiency in full before refund suit allowed in district court). *See generally* TAX MGMT. (BNA) 124-3d § A, 2 (1982). The statute of limitations on the assessment and collection of any deficiency does not run during the 90-day period. I.R.C. § 6213(a) (Supp. V 1981); *see* Phoenix Elec., Inc. v. United States, 164 F. Supp. 614, 615 (D. Mass. 1958) (statute of limitations suspended during the 90-day period). During the initial period of litigation, the limitation period does not run if the taxpayer files the petition in the Tax Court. I.R.C. § 6214(a) (1976).

For factors to consider in selecting the forum in which to litigate, see TAX MGMT. (BNA) 152-4th § A, 12-16 (1980); Alexander, *Choosing the Proper Court Increasingly Important as Settlement Prospects Decline,* 8 TAX'N FOR LAW. 18 (July-August 1979).

[20] 676 F.2d at 985.

[21] *Id.* at 985-86. The Revenue Service and the executors of the Chertkof estates

adjustment gave rise to an estate tax deficiency for both estates.[22] Based on the settlement agreement, the Tax Court entered a decision in November 1974 which reflected the final estate tax liability.[23]

The increased valuation of the securities for estate tax purposes was inconsistent with the valuation the executors used to compute the gain or loss for the securities in the 1971 income tax returns.[24] The lower valuation used in the income tax returns resulted in a larger gain from the liquidated securities than the estate would have realized under the valuations established by the settlement agreement.[25] As a result, the amount of income tax paid in 1971 on the gain from the securities was too high and the executors sued for a refund of the overpayment.[26] The Revenue Service and the executors agreed on the amount of overpayment.[27] The Revenue Service, however, contended that the statute of limitations barred the refund action.[28] The executors argued that the mitigation provisions of sections 1311 through 1314 allowed the reopening of the 1971 tax year to permit the refund suit.[29]

The United States District Court for the District of Maryland found that although the mitigation provisions applied to estate tax determinations,[30] the determination by the Tax Court did not fall within any of the

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entered into a collateral agreement under which the executors agreed to use the increased values giving rise to the estate tax deficiency as their bases for future transactions involving those assets. *Id.* at 986 n.4.

[22] *Id.* at 986. The increase in estate tax liability was not at issue in *Chertkof. Id.*

[23] *Id.* at 985-86.

[24] *Id.* at 986; *see supra* note 18.

[25] 676 F.2d at 986; *see supra* note 18.

[26] 676 F.2d at 986.

[27] *Id.* at 986-87.

[28] *Id.* at 986-87 n.8. Since the three-year statute of limitations expired on June 15, 1974, the executors would had to have filed nearly five months before the Tax Court determination. *Id.* at 986 n.6.

[29] *Id.* at 986.

[30] *See* Chertkof v. United States, 47 A.F.T.R. 2d (P-H) 81-1347 (D. Md. 1981). The district court held that the Tax Court decisions regarding the Chertkofs' estate tax liability were valid judgments by a court of competent jurisdiction and qualified as determinations under the language of § 1313(a)(1). 47 A.F.T.R. 2d (P-H) at 81-1349; *see* I.R.C. § 1313(a)(1) (1981). The court rejected the Revenue Service's contention that the mitigation provisions applied solely to income tax determinations. 47 A.F.T.R. 2d (P-H) at 81-1349. The district court noted that existing statutory language did not support the Revenue Service's proposed limitation that every § 1312 circumstance of adjustment must relate to an income tax determination. *Id.* at 81-1350; *see* I.R.C. § 1312 (1976). In addition, the district court observed that § 1314(e) of the IRC would be unnecessary if the provisions applied solely to income tax determinations. 47 A.F.T.R. 2d (P-H) at 81-1349; I.R.C. § 1314(e) (1976). The district court also noted that the legislative history of the mitigation provisions revealed that Congress was concerned with providing an equitable solution to numerous tax problems that could go unredressed due to the limitations bar. 47 A.F.T.R. 2d (P-H) at 81-1349. The court held that the legislative history and language of the current provisions demonstrated that Congress did not intend to restrict the mitigation provisions to income tax determinations. *Id.*

circumstances of adjustment specified in section 1312.[31] The district court, therefore, held that the mitigation provisions did not apply and the statute of limitations barred the taxpayers' refund action.[32] The taxpayers appealed the district court's decision to the Fourth Circuit.[33]

On appeal, the taxpayers contended that the Revenue Service had adopted an inconsistent position which required the taxpayers to use the original estate tax valuation for the basis of their stock on the 1971 income tax returns and a higher valuation of the securities for estate tax purposes.[34] This inconsistent position, the taxpayers argued, entitled them to relief under the mitigation provisions.[35] The Revenue Service argued that the mitigation statutes concerned only income tax adjustments and that the Tax Court determination of estate tax liability did not satisfy the requirements of section 1311.[36]

The Fourth Circuit rejected the Revenue Service's contention and held that the mitigation provisions of sections 1311 through 1314 applied to determinations of estate tax deficiencies.[37] The *Chertkof* court noted that although the Tax Court decision concerned liability for estate taxes, the decision also constituted grounds for determining income tax

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[31] 676 F.2d at 986-87; *see* I.R.C. § 1312(7) (1976). Section 1312(7) allows certain taxpayers to open a closed tax year if a determination establishes both the basis of the property and that one of three specified errors occurred in any transaction on which basis depends. I.R.C. § 1312(7) (1976). The three specified errors are an erroneous inclusion in or omission from gross income, an erroneous recognition or nonrecognition of gain or loss, and an erroneous deduction of an item properly chargeable to the capital account of an item properly deductible. *Id.* Section 1312(7) thus deals with situations in which basis depends on the proper treatment of a transaction and either the taxpayer or the Revenue Service has asserted a position in the proceeding that is inconsistent with an earlier and erroneous treatment of the transaction. *See id.* The specified taxpayer for whom the erroneous treatment occurred must be the taxpayer who received the determination, a taxpayer who acquired title to the property in the transaction and from whom the taxpayer receiving the determination received title to the property, or a taxpayer who had title to the property at the time of the transaction and subsequently gives the property to the taxpayer for whom the determination was made. *Id.*; *see* Treas. Reg. § 1.1312-7 (1972). *See generally* TAX MGMT. (BNA) 110-2d (1978); Burford, *Basis of Property After Erroneous Treatment of a Prior Transaction*, 12 TAX L. REV. 365 (1957); Knickerbocker, *Mysteries of Mitigation: The Opening of Barred Years in Income Tax Cases*, 30 FORDHAM L. REV. 225 (1961).

The district court found that the taxpayers failed to demonstrate that a transaction existed on which basis depended. 47 A.F.T.R. 2d (P-H) 81-1347, 81-1352. The court noted that since the bases of the securities were not dependent upon sales, but rather upon the death of the decedent, the taxpayers could satisfy the statute only if they could establish that death is a transaction within the meaning of § 1312(7). *Id.* The district court held that death is not a transaction as Congress intended in § 1312(7). *Id.*

[32] 47 A.F.T.R. 2d (P-H) at 81-1353.

[33] 676 F.2d at 987.

[34] Brief for Appellant at 22, Chertkof v. United States, 676 F.2d 984 (4th Cir. 1982).

[35] *Id.*

[36] 676 F.2d at 987.

[37] *Id.* at 990; *see infra* text accompanying notes 38-50.

liability.[38] The application of the mitigation provisions to a situation involving both income tax and estate tax considerations, the court stated, did not contradict the congressional objectives behind the mitigation statutes.[39] In addition, the *Chertkof* court found that death is a transaction on which basis depends, therefore qualifying the transaction for mitigation under section 1312(7).[40] The Fourth Circuit concluded that the mitigation statutes applied to the taxpayers and that the statute of limitations did not bar the taxpayers' action.[41]

In holding that the taxpayers qualified for relief under section 1311, the Fourth Circuit noted that the predecessor to sections 1311 through 1314 in the 1939 Code[42] specifically limited the mitigation provisions to determinations under the income tax laws.[43] Congress, however, removed the limitation to income tax deteminations when Congress enacted the

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[38] 676 F.2d at 989.

[39] *Id.* at 991.

[40] *Id.* at 993. The Revenue Service contended that the taxpayers failed to demonstrate that a transaction existed on which the basis of the property depended. *Id.* at 992; *see* I.R.C. § 1312(7)(A) (1976); *supra* note 31. The Revenue Service relied on *Gardiner v. United States*. 676 F.2d at 992; *see* Gardiner v. United States, 391 F. Supp. 1202 (D. Utah 1975), *aff'd*, 536 F.2d 903 (10th Cir. 1976). In *Gardiner*, the Tenth Circuit restricted the interpretation of "transaction on which basis depends." 391 F. Supp. at 1206. The taxpayer in *Gardiner* had failed to claim depreciation deductions that the Revenue Service would allow. *Id.* at 1205. When she sold the property, the Revenue Service reduced the basis by the amount of allowable deductions. *Id.* at 1200-04. The *Gardiner* court held that the failure to take depreciation deductions did not constitute a transaction within the meaning of § 1312(7)(A). *Id.* at 1208; *see* I.R.C. § 1312(7)(A) (1976). The court found that a transaction required a business transaction in the ordinary sense, such as a sale, purchase, acquisition, or exchange. *Id.* at 1206.

In *Chertkof*, the taxpayers contended that the *Gardiner* definition was too restrictive and that the acquisition of property from the decedents as a result of the decedents' death fulfilled the requirement of § 1312(7)(A). Brief for Appellant at 17, Chertkof v. United States, 676 F.2d 984 (4th Cir. 1982); *see* I.R.C. § 1312(7)(A) (1976). The Fourth Circuit held that death constituted a transaction for purposes of § 1312(7)(A). 676 F.2d at 992. The Fourth Circuit reasoned that death, like a transfer by deed, involved the disposition of the property by one person and acquisition by another. *Id.* Since death initiates the transfer of the property, death is the transaction on which basis depends. *Id.* at 993.

[41] 676 F.2d at 993. The Fourth Circuit held that the Revenue Service adopted an inconsistent position satisfying § 1311(b)(1). *Id.*; *see* I.R.C. § 1311(b)(1) (1976). The Fourth Circuit reasoned that the Revenue Service's acceptance of an income tax return showing an increased gain on the sale of some of the securities was inconsistent with the values the Revenue Service advocated for estate tax purposes. *Id.* at 993-94.

[42] Revenue Act of 1938, ch. 289 § 820, 52 Stat. 581 (current version at I.R.C. §§ 1311-1314 (1976)). Congress originally enacted the mitigation provisions as § 820 of the Revenue Act of 1938 and adopted them into the Code as § 3801. *See generally* Knickerbocker, *supra* note 31; Maguire, Surrey & Traynor, *Section 820 of the Revenue Act of 1938*, 48 YALE L. J. 509, 509-15 (1939).

[43] 676 F.2d at 987. Section 820(b) of the 1939 Code expressly limited the circumstances under which the mitigation provisions would apply to matters involving determinations under the income tax laws. *See* Revenue Act of 1938, ch. 289 § 820(b), 52 Stat. 581 (current version at I.R.C. §§ 1311-1314 (1976)).

present version of the Code in 1954.[44] The Fourth Circuit observed that Congress' deletion of the express limitation from the statute strongly suggested that Congress intended a broader construction.[45] The *Chertkof* court chose not to defer to a Treasury Regulation[46] because the regulation did not reflect the changes made under the 1954 Code.[47] In addition, the Fourth Circuit noted that section 1314(e), which expressly makes the mitigation provisions inapplicable to employment taxes, would be unnecessary if the mitigation provisions applied solely to income tax determinations.[48] The *Chertkof* court found that the failure to exclude estate taxes in the same manner as employment taxes demonstrated congressional intent that the mitigation statutes apply to estate tax determinations.[49] The Fourth Circuit concluded, therefore, that the prior estate tax determination was subject to the mitigation provisions.[50]

The *Chertkof* court distinguished two cases relied on by the Government that held that the mitigation provisions do not apply to inconsistencies between estate tax and income tax results.[51] In *Evans Trust v. United States*,[52] taxpayers sued for a refund of federal income tax erroneously paid and collected as a result of a prior inconsistent estate tax determination.[53] The taxpayers filed more than three years after the due

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[44] *See* 676 F.2d at 987. The 1954 statute, which is the current Code, contains no limitation to income tax determinations. *See* I.R.C. § 1311(a) (1976). Section 1311(a) of the current act simply provides that the determination at issue must be one described in one or more of the seven circumstances of adjustment set out in § 1312. I.R.C. § 1311(a) (1976); *see supra* note 7 (situations in which adjustment permissible under § 1312).

[45] 676 F.2d at 987-88.

[46] Treas. Reg. § 1.1311(a)-2(b) (1960).

[47] 676 F.2d at 988; *see infra* text accompanying notes 71-74.

[48] 676 F.2d at 990; *see* I.R.C. § 1314(e) (1976).

[50] *Id.* The Fourth Circuit rejected the Revenue Service's legislative history arguments, which relied entirely on the concerns of Congress when adopting § 3801 of the 1939 Internal Revenue Code. *See* 676 F.2d at 987-88; Brief for Appellee at 19-23, Chertkof v. United States, 676 F.2d 984 (4th Cir. 1982). The Fourth Circuit noted that the objectives that Congress designed the tax statute to achieve should be determinative of what the statute's language intended to convey. 676 F.2d at 990; *cf.* Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 301 (1946) (limitations statute protects taxpayer from litigation after memories faded, witnesses disappeared, and documents lost). The Fourth Circuit found that Congress intended the mitigation statutes to provide relief in situations of inequitable taxation in which the statute of limitations operated to bar the taxpayer's claim. 676 F.2d at 990-91. The Fourth Circuit noted that the taxpayer's refund claims were perfectly valid and that the application of the mitigation provisions would not contradict the purposes of the statute of limitations. *Id.*

[51] *See infra* text accompanying notes 52-65.

[52] 462 F.2d 521 (Ct. Cl. 1972).

[53] *Id.* at 522-23. In *Evans Trust v. United States*, the plaintiff had paid capital gains tax on receipt of installments on certain notes in the years 1961, 1962, and 1963. *Id.* at 523. The plaintiff trust failed to claim deductions for the estate tax attributable to such gains because the notes were not part of the estate in those years and no such deduction was available. *Id.* A 1967 Tax Court determination included a portion of the notes in the estate for estate tax

dates of the returns and more than two years after the taxpayers paid the tax.[54] The taxpayers asserted sections 1311 through 1314 of the Code to overcome the bar of the statute of limitations.[55] The Court of Claims in *Evans* held that a decision in an estate tax matter could not satisfy the mitigation provisions.[56] The *Evans* court relied upon section 1.1311(a)-2(b) of the Treasury Regulations, which limits the application of the mitigation provisions to circumstances arising out of income tax determinations.[57] Since the overpayment in *Evans* resulted from a prior inconsistent estate tax determination, the Court of Claims found that the mitigation provisions did not apply to reopen the closed tax year.[58]

In *Provident National Bank v. United States*,[59] a federal district court considered Treasury Regulation 1.1311(a)-2(b) and the legislative history of the mitigation provisions in adopting the position of the *Evans* court.[60] In *Provident*, the statute of limitations barred the taxpayer's re-

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purposes. *Id.* The plaintiff trust filed for refund of income taxes for 1961, 1962, and 1963, relying on §§ 1311-1314 to overcome the statute of limitations. *Id.*; *see supra* note 4 (explaining §§ 1311-1314). The *Evans* court rejected the plaintiff's argument, citing Treasury Regulation § 1.1311(a)-(2)(b). *Id.* at 524-25. The court held that a decision in an estate tax matter could not satisfy the mitigation provisions. *Id.* at 524.

The Fourth Circuit in *Chertkof* distinguished *Evans* by noting that in *Evans* the question was whether an estate tax decision satisfied the provisions of § 1312(5) and not § 1312(7). 676 F.2d at 988. In addition, the Fourth Circuit noted that the *Evans* court relied upon a Treasury Regulation which did not reflect the changes made under the 1954 Code. *Id.* at 987; *see infra* text accompanying notes 78-82.

[54] *See* 462 F.2d at 523; *supra* note 2 (taxpayer must file refund claim within three years from filing date or two years from payment).

[55] 462 F.2d at 523; *see supra* note 4.

[56] *Id.* at 524; *see supra* note 53.

[57] 462 F.2d at 524-25; *see* Treas. Reg. § 1.1311(a)-2(b) (1960).

[58] 462 F.2d at 524; *see supra* note 53.

[59] 507 F. Supp. 1197 (E.D. Pa. 1981).

[60] *Id.* at 1202; *see* Treas. Reg. § 1.1311(a)-2(b) (1960). In *Provident*, the grantor's estate entered into a settlement agreement with the Revenue Service. 507 F. Supp. at 1199. The agreement provided that the estate include one-half the value of the securities transferred to certain trusts in 1971 in the gross estate for purposes of computing estate tax. *Id.* In addition to the settlement, the executors of the grantor's estate entered into a collateral agreement with the trustees. *Id.* The basis of the 1971 trust securities provided for in the collateral agreement set forth a higher basis that the trusts used in determining the gain reported from the sale of certain securities in 1972. *Id.* In 1977, the trusts filed claims for a refund of income tax using the basis of the stock as set forth in the collateral agreement for determining gain from the sale of stock in 1972. *Id.* The district court rejected the trusts' argument that §§ 1311-1314 applied to mitigate the effect of the statute of limitations. *Id.* at 1202. The court held that the trusts could not use the mitigation provisions because the Tax Court determination was a determination of estate taxes and, as shown in the legislative history, applicable regulations, and prior case law, the mitigation provisions apply specifically to income tax determinations. *Id.*

The Fourth Circuit distinguished *Provident* by noting that the *Provident* opinion failed to consider the changes between the 1939 Code and the 1954 Code and therefore misinterpreted the legislative history of the mitigation provisions. 676 F.2d at 989; *see infra* text accompanying notes 77-78 (*Provident* court failed to consider substantial changes in mitigation provisions in 1954 Code).

fund of excess capital gains taxes paid on a sale of securities.[61] The overpayment resulted from an agreement between the taxpayer and the Revenue Service in which the taxpayer agreed to a higher basis of the stock in the taxable estate.[62] The taxpayer argued that the mitigation provisions applied to allow relief from the overpayment of the tax.[63] The *Provident* court held that Congress designed the mitigation provisions to alleviate income tax inequities, not estate tax inequities.[64] The *Provident* court reasoned that the legislative history, Treasury Regulation 1.1311(a)-2(b), and the *Evans* decision demonstrated that the mitigation provisions did not apply to determinations involving estate taxes.[65]

The Fourth Circuit in *Chertkof* correctly held that the mitigation provisions apply to determinations of estate tax liability as well as income tax liability.[66] The Fourth Circuit's holding is consistent with the legislative history and statutory language of the mitigation provisions.[67] Neither the legislative history nor the statutory language of the mitigation statutes precludes an estate tax determination from satisfying the requirements of the mitigation provisions.[68] Congress intended that sections 1311 through 1314 of the Code mitigate the unfairness which prevents equitable adjustment of various income tax hardships.[69] The Senate Finance Committee report reveals that Congress was concerned about providing an equitable solution to cases in which one party would obtain an unfair benefit by assuming an inconsistent position from the party's position in a closed tax year, and then taking shelter behind the statute of limitations.[70] The 1939 Code expressly limited the circumstances under which the mitigation statutes would apply to matters involving determinations under the income tax laws.[71] The 1954 statute,

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[61] 507 F. Supp. at 1199-1200, *cf. supra* note 2 (taxpayer must file refund claim within three years from filing date or two years from time of payment).

[62] 507 F. Supp. at 1199; *see supra* note 60.

[63] 507 F. Supp. at 1200.

[64] *Id.* at 1202.

[65] *Id.* The district court in *Provident* relied on the legislative history of the 1939 Code to argue that the mitigation statutes applied to only income tax determinations. *Id.* at 1200-02; *see* H.R. REP. NO. 79, 75th Cong. 3d Sess. 48 (1938); H.R. REP. NO. 2330, 75th Cong., 3d Sess. 56 (1938).

[66] *See infra* text accompanying notes 67-88.

[67] *Id.*

[68] *See* 676 F.2d at 989. Section 1311(a) simply recites that one or more of the seven paragraphs set out in § 1312 must describe the determination at issue. *See* I.R.C. § 1311(a) (1976).

[69] *See* H.R. REP. NO. 2330, 75th Cong., 3d Sess. 56 (1938) (mitigation statutes will lessen inequities under income tax laws which now prevent equitable adjustments of various income tax hardships).

[70] *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 49 (1938) (mitigation provisions protect against individual assuming inconsistent position and taking shelter behind statute of limitations).

[71] *See* Revenue Act of 1938, ch. 289 § 289 § 820(b), 52 Stat. 581 (current version at I.R.C. §§ 1311-1314 (1976)) (mitigation provisions limited to "determinations under the income tax laws").

which is the current Code, contains no such express limitation.[72] Congress' deletion of the limitation to income tax determinations demonstrates the congressional intention to expand the application of the mitigation provisions from the statutes' original scope under the 1939 Code.[73] The legislative history of the mitigation provisions, therefore, clearly suggests that sections 1311 through 1314 of the Code apply to determinations of both estate tax and income tax liability.[74]

The *Chertkof* court considered the deletion of the limiting language significant and correctly chose not to defer to the applicable Treasury Regulation or the reasoning in *Provident* and *Evans*.[75] The district court in *Provident* relied upon congressional statements made with respect to the 1939 mitigation provisions when the Code contained an express limitation of the mitigation statutes to income tax determinations.[76] The *Provident* court failed to consider the substantial change of the mitigation provisions in the 1954 Code.[77] In *Evans*, the Court of Claims relied upon a Treasury Regulation that also failed to reflect the legislative changes made under the 1954 Code.[78] The deference due a regulation does not extend to an interpretation contrary to the statutes' origin and purpose.[79] The regulation must conform to the law as the statutes express the law.[80] The legislative history of the mitigation provisions makes it plain that the regulation is not a reasonable statutory interpretation.[81] The Fourth Circuit's decision in *Chertkof* is consistent with the broad equitable policy that led Congress to adopt the mitigation provisions.[82]

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[72] *See* I.R.C. §§ 1311-1314 (1976).

[73] *See* 676 F.2d at 987-88; *infra* note 74.

[74] *See* 676 F.2d at 989. The legislative history of the mitigation provisions demonstrates that Congress was concerned with providing an equitable solution to certain classes of income tax problems. *See* S. REP. No. 1567, 75th Cong., 3d Sess. 48-49 (1938). As the *Chertkof* court noted, the problem in *Chertkof* has two aspects, both income tax and estate tax in nature. *See* 676 F.2d at 989. The deletion of the limiting language with the adoption of the 1954 Code compels the conclusion that Congress intended to make the mitigation provisions more comprehensive. *See* 676 F.2d at 987-88.

[75] 676 F.2d at 988. The Fourth Circuit noted that Treasury Regulations must conform to the statutory language in the Internal Revenue Code. 676 F.2d at 988. The *Chertkof* court noted that § 1.1311(a)-2(b) of the Treasury Regulations did not reflect the changes from the 1939 Code. 676 F.2d at 988.

[76] *See* 507 F. Supp. at 1200-02; *supra* note 43.

[77] *See* 676 F.2d at 989.

[78] 462 F.2d at 524-25; *see* Treas. Reg. § 1.1311(a)-2(b) (1960).

[79] *See* Vogel Fertilizer Co. v. United States, 634 F.2d 497, 512 (Ct. Cl. 1980) (deference due regulation does not extend to application contrary to perceptible and perceived intent), *cert. granted*, 450 U.S. 994 (1981).

[80] *Id.*

[81] *See* 676 F.2d at 989; *supra* note 74.

[82] *See* H.R. REP. NO. 2330, 75th Cong., 3d Sess. 56 (1938) (mitigation provisions avoid inequities). The Senate Finance Committee, in the report accompanying the Revenue Bill of 1938, stated that disputes over the correct year to include income should not result in double taxation. *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 48, 49-50 (1938).

Section 1314(e) of the current Code, furthermore, specifically provides that the mitigation provisions do not apply to tax determinations involving employment taxes.[83] Such a provision would have been unnecessary if the mitigation statutes applied solely to income tax determinations.[84] Congress' inclusion of section 1314(e) demonstrates that estate taxes fall within the limits that Congress intended for the mitigation statutes.[85]

In reversing the district court, the Fourth Circuit in *Chertkof* also determined that death is a transaction upon which basis depends.[86] The Fourth Circuit correctly found that upon the decedents' deaths, a transaction existed with the same effect as if a taxpayer has passed title by bill or sale.[87] The same consequences flow from death as from the other transactions, namely disposition by one person and acquisition by another.[88] Because the transaction determined the basis of the property, the taxpayers fulfilled that requirement of section 1312 (7).[89]

Application of the mitigation statutes in *Chertkof* serves the objectives of Congress in providing an equitable solution for certain income tax hardships while maintaining the integrity of the statutes of limitation.[90] The *Chertkof* decision is consistent with the legislative history

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[83] *See* I.R.C. § 1314(e) (1976).

[84] *See* 676 F.2d at 990. Section 1314(e) of the current Code specifically provides that §§ 1311-1314 do not apply to tax determinations involving employment taxes. I.R.C. § 1314(e) (1976). Such a provision would be redundant if Congress intended the mitigation provisions to apply only to income tax determinations. *See* 676 F.2d at 990.

[85] *See* 676 F.2d at 990. As the Fourth Circuit noted in *Chertkof*, precisely because no mitigation statutes exist for estate taxes, the reasons are strong for allowing the application of §§ 1311-1314 when a prevailing inconsistent position regarding estate taxes leads to an excessive imposition of income tax. *See* 676 F.2d at 990; I.R.C. §§ 1311-1314 (1976). Congress' decision not to exclude estate taxes in the same manner that Congress excluded employment taxes demonstrates that Congress did not intend that the mitigation provisions apply only to income tax determinations. 676 F.2d at 990.

[86] 676 F.2d at 993; *see supra* note 40.

[87] 676 F.2d at 992; *see supra* note 40.

[88] *See supra* note 40.

[89] *See* I.R.C. § 1312(7) (1976); *see supra* note 31.

[90] *See supra* note 69. One of the concerns of Congress in promulgating the mitigation statutes was to preserve unimpaired the essential function of the statute of limitations. *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 48, 49 (1938) (mitigation provisions shall not impair essential function of limitation statutes except under certain strictly defined circumstances); *id.* (purpose of statute of limitations to prevent litigation of stale claims fully recognized and appreciated). Some courts have construed the mitigation provisions strictly and literally because the mitigation provisions are in derogation of the basic period of limitations. *See* MacDonald v. Commissioner, 17 T.C. 934, 939-40 (1951) (tolling of bar of limitations statute dealt with strictly); Central Hanover Bank & Trust Co. v. United States, 163 F.2d 60, 64 (2d Cir. 1947) (same). These courts rely on a statement in a Senate report suggesting that Congress designed the predecessor to §§ 1311-1314 to effect a forfeiture of the protection of the bar of the statute for parties who adopted an inconsistent position. *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 48, 49 (1938). Several courts, however, have viewed the mitigation provisions as relief statutes which deserve a liberal interpretation to carry out fully the purpose Congress intended. *See* First Nat'l Bank v. United States, 565 F.2d 507, 516 (8th Cir. 1977) (courts should interpret mitigation provisions as consistent with equitable principles