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THE TAX BENEFIT RULE AFTER *HILLSBORO*

In both its original and most recent form, the tax benefit rule has been a popular subject of praise, criticism and debate. This Note, however, which focuses on the latest version of the rule, provides a unique and insightful analysis of the Supreme Court's opinions in the companion cases Hillsboro National Bank *and* Bliss Dairy *which were decided in 1984. Unlike the traditional formulation of the rule which required the realization of income only upon the actual recovery of a previously taken deduction, the Court's new rule depends on the occurrence of a "fundamentally inconsistent event." This author finds difficulties with the application of this new tax benefit rule to both the facts in* Hillsboro National Bank *and* Bliss Dairy *as well as to fact situations which are likely to arise in the future. He concludes that a narrowing of the rule is necessary in order to ensure consistent treatment of taxpayers and consistent results.*

INTRODUCTION

THE TAX BENEFIT RULE is a judicially-created[1] attempt to redress certain inequities which would arise in a tax system which strictly adheres to an annual accounting method.[2] First recognized in 1929,[3] the rule has gone through periods of acceptance, rejection, and modification.[4] Basically, the tax benefit rule requires a taxpayer to recognize income in the year in which an event occurs which is fundamentally inconsistent with the taking of a deduction in a prior year. The Supreme Court formulated this latest version of the rule in the companion cases *Hillsboro National Bank v. Commissioner* and *Bliss Dairy, Inc. v. Commissioner*.[5] The *Hillsboro* ver-

1. Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265, 267 (1978).

2. Comment, *An Asset-Based Approach to the Tax Benefit Rule*, 72 CALIF. L. REV. 1257, 1257 (1984).

3. Excelsior Printing v. Commissioner, 16 B.T.A. 886 (1929). The rule was first discussed by the Supreme Court in Dobson v. Commissioner, 320 U.S. 489 (1943). Although the Court declined to adopt "any rule of tax benefits," *Dobson*, 320 U.S. at 509, the decision was the first to recognize the inequity of treating the recovery of a prior loss as taxable income when that prior loss conferred no tax benefit upon the taxpayer. *Dobson*, 320 U.S. at 506.

4. For a discussion of the history of the tax benefit rule, see Bittker & Kanner, *supra* note 1, at 265-67; Note, *The Tax Benefit Rule, Claim of Right Restorations and Annual Accounting: A Cure For the Inconsistencies*, 21 VAND. L. REV. 995, 999-1010 (1968). For detailed discussions of the rule's early development, see Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 130-34 (1943); Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX. L. REV. 329, 329-30 (1948). *See also* Elliott, *The Tax Benefit Rule: A Common Law of Recapture*, 39 SW. L.J. 845 (1985); Nichols, *The Tax Benefit Rule: Clarification or Confusion after* Hillsboro National Bank *and* Bliss Dairy, 30 U. CALIF. SCH. L. TAX INST. 12 (1984).

5. 460 U.S. 370 (1983). Both cases are cited under the *Hillsboro* title. For purposes of

sion of the tax benefit rule[6] represents the Supreme Court's acceptance of a significant change in the formulation of the rule. Prior to *Hillsboro*, the traditional and most common formulation of the rule was that when there was recovery by a taxpayer of an item he deducted in an earlier year, the taxpayer must recognize income to the extent that the prior deduction gave him a tax benefit.[7]

In addition to this "inclusionary" aspect of the rule, the tax benefit rule also has an "exclusionary" side, from which it derives its name.[8] According to the exclusionary tax benefit rule, income is only recognized upon the happening of a fundamentally inconsistent event (or a recovery) to the extent that the taxpayer received a tax benefit from the earlier deduction.[9] For example, suppose a taxpayer pays state taxes but cannot deduct them on his federal tax return because he takes the zero bracket amount deduction. Any subsequent refund of the state tax to the taxpayer is therefore not taxable income because no tax benefit was derived from the earlier deduction.[10] While this Note will focus primarily on the inclusionary aspect of the tax benefit rule, exploration of the rule's underlying rationales require an appreciation of its exclusionary side as well.

The purpose of this Note is to shed some light on the application of the tax benefit rule after *Hillsboro*. To do this, the Note will examine the evolution of the tax benefit rule, noting how the test

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this Note, the opinion of the case will hereinafter be referred to as *Hillsboro*. When discussing the facts of each particular case, however, *Bliss* and *Hillsboro* will be used accordingly.

6. Justice O'Connor, who wrote for the majority, stated: "[T]he tax benefit rule will 'cancel out' an earlier deduction [i.e., require income to be recognized in the current tax year] only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based." *Hillsboro*, 460 U.S. at 383.

7. The most notable case upholding this "recovery" theory was a Ninth Circuit opinion. *See* Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963). *See also* Note, *Formulation and Application of the Tax Benefit Rule*: Hillsboro National Bank v. Commissioner, 37 Sw. L.J. 1009, 1013-15 (1984); Comment, *supra* note 2, at 1261-64. *See infra* notes 18-23 and accompanying text.

8. Congress codified the exclusionary component of the tax benefit rule in section 111 of the Internal Revenue Code (the Code). I.R.C. § 111(a) (1980) provides: "Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce income subject to tax." Subsequently issued Treasury Regulations and court decisions have noted its inclusionary aspect as well. *See* Treas. Reg. § 1.111-1; Dobson v. Commissioner, 320 U.S. 489, 505-06 (1943). *See* Note, *The Tax Benefit Rule — A Judicially Broadened Tool For Transactional Tax Equity*, 37 VAND. L. REV. 1351, 1353 (1984); Note, *supra* note 7, at 1012. *See also* Bittker & Kanner, *supra* note 1, at 272-81.

9. Bittker & Kanner, *supra* note 1, at 276-81.

10. *Id.*

has developed to its present formulation.[11] A brief discussion of the rationales underlying the tax benefit rule and how they apply to the various formulations of the rule will follow.[12] The Note will then analyze and critique the Supreme Court's application of its new test to the *Hillsboro* and *Bliss* facts.[13] Next, the Note will apply the new test to fact patterns in which the tax benefit problem may arise in the future.[14] Finally, this Note concludes that some narrowing of the tax benefit rule is necessary to ensure its consistent application and suggests how that narrowing should take place.

I. EVOLUTION OF THE TAX BENEFIT RULE

The specific history of the tax benefit rule has been exhaustively explored elsewhere.[15] This discussion will therefore only generally trace that evolution. Throughout its history, the most difficult task associated with the tax benefit rule has been to determine what type of occurrence triggers the rule. Indeed, it was this issue that sparked the intense disagreement between Justice O'Connor and Justice Stevens in *Hillsboro*.[16]

A. *The Recovery Requirement*

Throughout its first fifty or so years the tax benefit rule forced taxpayers to recognize income on the recovery of an earlier year's deduction.[17] For instance, assume a taxpayer wrote off a bad debt in year One and made an appropriate deduction of the amount.[18] That deduction provides him with a tax benefit, i.e., it reduces his taxable income. In year Two (or any subsequent year),[19] if the debtor pays off the debt, the taxpayer would have "recovered" the

11. *See infra* notes 15-47 and accompanying text.

12. *See infra* notes 48-74 and accompanying text.

13. *See infra* notes 99-117 and accompanying text.

14. *See infra* notes 118-43 and accompanying text.

15. *See, e.g.*, Bittker & Kanner, *supra* note 1; Plumb, *supra* note 4; Comment, *supra* note 2, at 1258-61.

16. For a critical discussion of the propriety of the argumentative opinions of Justices O'Connor and Stevens, see Blum, *The Role of the Supreme Court in Federal Tax Controversies*—Hillsboro National Bank *and* Bliss Dairy, Inc., 61 TAXES 363 (1983); Note, *supra* note 7, at 1020-21.

17. Bittker & Kanner, *supra* note 1, at 265.

18. Section 166 of the Code allows for the deduction of bad debts.

19. The statute of limitations is no bar to the application of the tax benefit rule. It is this aspect of the rule that is particularly troublesome to Justice Stevens under the majority's formulation of the rule in *Hillsboro*: "[The new formulation] will enlarge the tax gatherer's discretionary power" to reexamine past transactions. *Hillsboro*, 460 U.S. at 416 (Stevens, J., concurring in part and dissenting in part).

previous deduction and as such would have to recognize income to the extent of the lesser of 1) the amount of the recovery or 2) the amount by which the previous deduction reduced his taxable income.[20]

This example is a simple case in which there is no doubt that a recovery has occurred. The taxpayer has in fact not lost something (the amount of the debt) that he had previously told the government he had lost. Note that normally the repayment of a debt is not an income realization event.[21] In the context of a previous deduction, however, at least intuitively it seems fair that the taxpayer should have to make amends for his previous error. Several rationales support this intuition.[22] It can be noted now that the recovery requirement rests somewhat on the notion that the taxpayer's recovery is, in and of itself, a realization event, i.e., it is no longer a return of capital but rather it represents an increase in the taxpayer's income.

B. *The Inconsistent Events Theory*

Although the inconsistent events theory first appeared in *Estate of Block v. Commissioner,*[23] the more complete exposition of the theory is found in *Tennessee-Carolina Transportation, Inc. v. Commissioner.*[24] While paying lip service to the recovery requirement, the *Tennessee-Carolina* court adopted the view that "[t]he rule should apply whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction."[25] In January, 1967, the taxpayer, Tennessee-Carolina Transportation, Inc., (Tennessee-Carolina) pur-

20. The tax benefit rule does not account for differences in marginal tax rates between the years in question. Therefore, the amount of tax saved in the year of deduction will probably differ from the amount of the tax increase in the year of the inconsistent event and income recognition. *See, e.g.*, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967) (previous deductions recovered as income were taxed at the tax rate in effect during the year of realization rather than at the tax rate during the year of deduction).

21. Normally the repayment of capital, e.g., repayment of loan principal, is not income to the recipient. Similarly, in Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918), the Court held that proceeds received from a conversion of capital assets were not to be regarded as income. *Id.* at 184.

22. *See* Bittker & Kanner, *supra* note 1, at 267-72.

23. 39 B.T.A. 338 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940).

24. 582 F.2d 378 (6th Cir. 1978).

25. *Id.* at 382. The court undercut its argument, however, noting that even if recovery was required, a fictional recovery could be found by virtue of the fact that the tires and tubes, supposedly used up, existed at liquidation. The "reappearance" of the tires and tubes was therefore sufficient recovery to invoke the rule. *Id.*

chased all of the capital stock of Service Lines, Inc. (Service). Both companies were engaged in the trucking industry. On March 1, 1967, Service was liquidated and merged into Tennessee-Carolina, at which time Service transferred all of its assets to Tennessee-Carolina in exchange for Service's own stock, which was then retired.[26]

One of the assets transferred to Tennessee-Carolina was an inventory of truck tires and tubes which Service had properly expensed. Pursuant to section 334(b)(2) of the 1954 Code,[27] Tennessee-Carolina allocated a portion of the purchase price of the Service stock to this inventory thereby acquiring a stepped-up basis in the inventory. Tennessee-Carolina then deducted this basis as a business expense on the consolidated tax return it filed for itself and Service in 1967.[28]

The Commissioner argued that under the tax benefit rule, Service should be required to recognize as income on its 1967 return an amount equal to the previously expensed but unused tires and tubes.[29] Service argued that the rule should not apply since Service itself had never recovered the previous deduction.[30]

The Sixth Circuit held that a recovery requirement "asserts a wooden interpretation of the tax benefit rule which we find inappropriate."[31] Instead, the court endorsed the inconsistent events test stating that the tax benefit rule "should apply whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction."[32] The court concluded that "the transfer to [Tennessee-Carolina] with a stepped-up basis . . . of the tires and tubes which had a substantial useful life remaining was inconsistent with the prior expensing of them."[33] This inconsistency was sufficient for the Sixth Circuit to invoke the tax benefit rule.[34]

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26. *Id.* at 379-80.

27. Section 334(b)(2) of the 1954 Code was amended by § 224(b) of the Tax Equity and Fiscal Responsibility Act of 1982. Its step-up basis principle, however, remains intact in § 338 of the present Code.

28. *Tennessee-Carolina*, 582 F.2d at 380.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.* at 382.

33. *Id.*

34. *Id.* The Sixth Circuit was joined by the Seventh Circuit in endorsing the inconsistent events approach. *See* First Trust and Savings Bank of Taylorville v. United States, 614 F.2d 1142, 1146 (7th Cir. 1980) (although the Seventh Circuit noted that a recovery test would also have been met under the facts).

C. *The Fundamentally Inconsistent Events Test*

Certiorari was granted in the *Hillsboro* cases to settle the conflict among the circuits as to which test to apply under the tax benefit rule.[35] Interestingly though, the Supreme Court did not adhere to any of the previous formulations of the rule nor to any theory argued by the parties.[36] Instead, it created the fundamentally inconsistent events test.[37] Justice O'Connor wrote for the majority and formulated the new test based on the premise that the tax benefit rule should "allay some of the inflexibilities of the annual accounting system."[38] To achieve this purpose, the Court rejected the recovery requirement as being too narrow since there existed situations in which the tax benefit rule should apply where there was no actual recovery.[39] Justice O'Connor stated that a recovery requirement "would introduce an undesirable formalism into the application of the tax benefit rule [and] . . . would, in many cases, simply require the Government to cast its argument in different and unnatural terminology, without adding anything to the analysis."[40] Instead of expanding the meaning of recovery to cover cases like *Tennessee-Carolina*, the Court chose to formulate a new test.[41]

The Court did not, however, endorse the inconsistent events test of *Tennessee-Carolina*. Justice O'Connor thought this test was too broad in that it triggered the tax benefit rule in situations where the rule should not apply. She argued that "[n]ot every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction."[42] Thus, Justice O'Connor sought to distinguish the merely inconsistent from the fundamentally inconsistent stating that the tax benefit rule would apply only upon the occurrence of an event which is "fundamentally inconsistent with the premise on which the [prior] deduction was initially based."[43]

Of course, essential to Justice O'Connor's analysis is a method to determine what constitutes a fundamentally inconsistent event.

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35. 457 U.S. 1103 (1982).

36. *Hillsboro*, 460 U.S. at 381. Justice Stevens found that "[the new test] obviously differs from both the Government's 'inconsistent event' theory and the familiar 'recovery' theory . . . ." *Id.* at 418. *See also* Note, *supra* note 8, at 1380.

37. *Hillsboro*, 460 U.S. at 381.

38. *Id.* at 377; *see also* Bittker & Kanner, *supra* note 1, at 284; Note, *supra* note 8, at 1380.

39. *Hillsboro*, 460 U.S. at 381.

40. *Id.* at 382-83.

41. *Id.* at 382.

42. *Id.* at 383.

43. *Id.*

She tried to provide some help by stating that "only if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction can the Commissioner require a compensating recognition of income when the event occurs in the later year."[44] The usefulness of this attempted definition for fundamentally inconsistent events is limited, however, since it may raise as many questions as it solves.[45]

After her discussion of what triggers the tax benefit rule, Justice O'Connor adds a second tier to the analysis to cover those situations in which the later event occurs in the context of a nonrecognition provision.[46] When application of the tax benefit rule conflicts with some rule of nonrecognition, this second analytical tier compels the Court (and presumably taxpayers) to balance the policy underlying the nonrecognition provision against the policy supporting the tax benefit rule in order to determine whether the nonrecognition provision prevents the application of the tax benefit rule.[47] Since the focus of this Note is on the determination of what type of event signals application of the tax benefit rule, the nonrecognition portion of the analysis will not be examined further.

II. Rationales Behind the Different Formulations of the Tax Benefit Rule

The divergence of views on the proper formulation of the tax benefit rule is not simply a matter of persons disagreeing on how to best reach a common goal.[48] An example of this divergence is amply reflected in *Hillsboro*. Justice O'Connor wrote for a five-justice majority which voted to reverse both cases based on the new fundamentally inconsistent events test.[49] Justice Brennan concurred in

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44. *Id.* at 388-89.

45. For a discussion of the vagueness of this aspect of Justice O'Connor's test, see Comment, *supra* note 2, at 1270-76 (unclear whether the definition is an exclusive one or merely an example). The *Hillsboro* opinion itself manifests the ambiguity of this analysis since Justice O'Connor's approach is not expressly used in either the *Hillsboro* or the *Bliss* fact patterns. White, *An Essay on the Conceptual Foundations of the Tax Benefit Rule*, 82 MICH. L. REV. 486, 493 (1983).

46. *Hillsboro*, 460 U.S. at 397. This analysis differs from the *Tennessee-Carolina* analysis which treated the § 336 liquidation itself as the inconsistent event. *Tennessee-Carolina*, 582 F.2d at 380-83.

47. *Hillsboro*, 460 U.S. at 397-98. Justice O'Connor concluded that the policy underlying § 336 was "to prevent recognition of market appreciation that has not been realized by an arm's-length transfer . . . [and not] to shield all types of income that might arise from the disposition of an asset." *Id.* at 398.

48. The differences of opinion focused on the original purpose underlying the rule. Consequently, this disagreement produced different formulations of the rule.

49. *Id.* at 372-403.

applying the new test but thought the majority applied it incorrectly.[50] Justices Stevens and Marshall rejected the fundamentally inconsistent events test and applied a recovery test.[51] The recovery test yielded a concurrence with the result from its application to the *Hillsboro* facts and a dissent with respect to the facts in *Bliss*.[52] Justice Blackmun dissented in both cases.[53] He disagreed that any tax benefit rule should apply, arguing instead that at least in cases in which the statute of limitations had not run, it makes far more sense to amend the prior return.[54] Alternatively, Justice Blackmun found that if a fundamentally inconsistent events rule is applied, the majority's application of the rule was erroneous under the *Hillsboro* facts.[55]

This disparity of opinion generates the question of whether all the members of the Court have the same rule in mind. The answer is that they do not. Since each of three Justices attacks the tax benefit rule with a different goal in mind, each disagrees on the solutions to the cases.[56] Justice Blackmun's argument suggests that returns should be amendable at any time prior to the running of the statute of limitations.[57] In essence, he is suggesting a multi-annual accounting period. It is questionable whether Justice Blackmun would suggest an overturning of the *Sanford & Brooks* doctrine,[58] that doctrine having been engrained into the present tax system.[59] But Justice Blackmun at least suggests that the annual accounting requirement should be significantly relaxed: "I am troubled, however, by the tendency to carry out the second concern (the integrity of the annual return) to unnecessary and undesirable limits. The

50. *Id.* at 403.

51. *Id.* at 403-22.

52. *Id.*

53. *Id.* at 422-27.

54. *Id.*

55. *Id.* at 422.

56. These differences can be traced to the respective deference (or lack thereof) that the Justices pay to the notion that transactional accounting is a more equitable arrangement than annual accounting and, therefore, that annual accounting should give way wherever practicable.

57. The statute of limitations for amending a federal tax return is three years. I.R.C. § 6511(a) (1954).

58. Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931). The Supreme Court endorsed the annual accounting system for tax purposes on the grounds of practical and administrative necessity.

59. Section 441(a) of the present Code, entitled "Period for Computation of Taxable Income," provides that "[t]axable income shall be computed on the basis of the taxpayer's taxable year." I.R.C. § 441(a) (West Supp. 1986).

rule is not that sacrosanct."[60]

Justice O'Connor takes the middle ground on this continuum of deference to transactional accounting. Rather than completely dispensing with annual accounting, as Justice Blackmun would in many cases,[61] she would use the tax benefit rule to maintain the integrity of the annual accounting system while correcting what she sees as one of its major deficiencies.[62] Justice O'Connor saw an unfairness in allowing a taxpayer to reap a tax benefit that, if all facts had been known at the time of the earlier deduction, should have been disallowed. The unfairness derives from the fact that other similarly situated taxpayers, for whom the "deduction" and the inconsistent event occurred in the *same* year, would be forced to pay more in taxes than a taxpayer whose deduction and inconsistent event straddled two years. This fact pattern from a comment on the tax benefit rule may be instructive.[63] Assume taxpayer *A* writes off and deducts a bad debt as a loss in year One. Assume also that in year Two the debtor pays off the debt. Without the tax benefit rule, *A* would have received the benefit of the deduction and could keep it, since it was valid at the time. In year Two no income would be recognized since returns of capital are not income producing events.[64] However, taxpayer *B*, who writes off a bad debt in year One and subsequently but unexpectedly receives repayment in year One, is precluded from taking any deduction. All other factors being equal, taxpayer *A* pays less tax than taxpayer *B*.[65] It is from this concern that Justice O'Connor apparently derives her same year test for fundamental inconsistency: "if the event had occurred within the same taxable year, it would have foreclosed the deduction."[66]

Justice Stevens' position is at the other end of the spectrum, opposite that of Justice Blackmun.[67] Justice Stevens acknowledges the annual accounting requirement as fundamental to the tax system and totally rejects the notion that the purpose of the tax benefit rule

60. *Hillsboro*, 460 U.S. at 424.

61. Justice Blackmun does not say at what point he would choose a tax benefit rule over opening up a previous year's return. He argues, however, that at least in fact patterns like those found in *Hillsboro* and *Bliss*, where the inconsistent event occurs shortly after the close of the tax year, common sense would counsel amendment. *Id.* at 427.

62. *Id.* at 403-22.

63. Comment, *supra* note 2, at 1259-61.

64. *See supra* note 21 and accompanying text.

65. *Hillsboro*, 460 U.S. at 377.

66. *Id.* at 383-84.

67. *Id.* at 403-04 (Stevens, J., concurring in part and dissenting in part).

is to effect transactional accounting.[68] He believes the purpose of the rule is "to determine the character of a current wealth-enhancing event, when viewed in light of past deductions . . . ."[69] To Justice Stevens, the majority's new formulation "constitutes an extremely significant enlargement of the tax collector's powers,"[70] because it allows the government to determine the propriety of an earlier deduction in light of events in subsequent years. The taxpayer, on the other hand, has no power to amend returns beyond the three year statute of limitations.[71] According to Stevens, the majority's formulation of the rule is a grant of power to the Internal Revenue Service (IRS) without any corresponding grant to the taxpayer.[72] Note that in virtually all situations in which the tax benefit rule can be invoked, it is the government which will reap the benefits.[73]

The principle on which Stevens' position on the tax benefit rule is based, namely, that income is to be taxed in the year it is received, is a pervasive one in the area of taxation. For Justice Stevens, the tax benefit rule makes sense only when it works to tax income received and not to disqualify an earlier deduction. This, in turn, requires that there be a recovery in order to recognize income—a recovery which entails some increase to the net worth of the taxpayer in the present tax year. In contrast, O'Connor's approach is aimed at recognizing in the *present* tax year income that should have been recognized in an earlier tax year.[74]

III. Application of the Fundamentally Inconsistent Events Test to *Hillsboro* and *Bliss*

Building upon the previous discussion of the evolution and rationales of the tax benefit rule, a critical examination of the Supreme Court's application of the rule in the *Hillsboro* and *Bliss* cases follows. Such an examination is necessary to understand the

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68. *Id.*

69. *Id.* at 404.

70. *Id.* Previously the tax collector's powers to determine a deduction were limited to performance of an audit of that year's return. Justice Stevens objected to the government being able to scrutinize deductions with the aid of hindsight. *Id.* at n.2.

71. I.R.C. § 6511(a) (1954).

72. *Hillsboro,* 460 U.S. at 404.

73. The only situation where this will not be so is where the previous deduction did not decrease the taxpayer's taxable income. This is the exclusionary side of the rule. *See supra* notes 8-10 and accompanying text.

74. For an analytical discussion of the concept of recognizing a prior year's income in the present tax year, see White, *supra* note 45.

cases' precedential value, and provides the basis for predicting the rule's future applications.

A. *The Facts of* Hillsboro

In *Hillsboro*, the taxpayer, Hillsboro National Bank (the Bank) was an incorporated bank operating in Illinois.[75] Until 1970, Illinois imposed a property tax on shares of stock held in such banks.[76] The banks customarily paid these taxes for their shareholders.[77] The banks were allowed a deduction for the taxes paid under section 164(e) of the Code, and the shareholders were not allowed any deduction for these taxes.[78] In 1970, Illinois amended its constitution to prohibit ad valorem[79] taxation on personal property.[80] While the constitutionality of the amendment was being litigated in the state courts and the Supreme Court, the Bank paid the disputed taxes for 1972 into a state escrow account.[81] When the Supreme Court upheld the constitutionality of the state amendment,[82] the state treasury refunded the taxes directly to the shareholders in 1973 (with accrued interest). The Bank recognized no income from this sequence of events on its 1973 federal income tax return. The Commissioner charged the Bank with a deficiency in the amount of the payments made from the escrow to its shareholders.[83] The Tax Court upheld the Commissioner's determination,[84] and the Seventh Circuit affirmed the Tax Court's decision.[85]

B. *The Facts of* Bliss

In *Bliss*, the taxpayer, Bliss Dairy, Inc., (the Dairy), was a

75. *Hillsboro*, 460 U.S. at 372.
76. *Id.*
77. *Id.* at 372-73.
78. Section 164(e) of the Code provides that a corporation may deduct, and a shareholder may not deduct, state taxes "[w]here a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation . . . ." I.R.C. § 164(e) (1982).
79. Ad valorem taxation is taxation imposed by states on the value of property. BLACK'S LAW DICTIONARY 48 (5th ed. 1979).
80. *Hillsboro*, 460 U.S. at 373. *See* ILL. REV. STAT. ch. 120 §§ 557-58 (1971) (repealed 1981, eff. Dec. 31, 1982).
81. *Hillsboro*, 460 U.S. at 373.
82. Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356 (1973).
83. *Hillsboro*, 460 U.S. at 373-74.
84. The Tax Court ruled that the refund of taxes to the Bank's shareholders triggered the tax benefit rule. However, payments to the shareholders of the accrued interest on the refunds did not. Therefore, the Bank had to recognize income only to the extent of the refunds, not the interest. Hillsboro Nat'l Bank v. Commissioner, 73 T.C. 61, 67-68 (1979).
85. Hillsboro Nat'l Bank v. Commissioner, 641 F.2d 519 (7th Cir. 1981).

closely held corporation engaged in the dairy business.[86] As a cash basis taxpayer, it deducted the cost of certain cattle feed it purchased during its tax year ending June 30, 1973.[87] The deduction was proper under section 162 of the Code as an ordinary and necessary business expense.[88] On the second day of its next tax year, the Dairy adopted a plan of liquidation under which the Dairy distributed its assets, including a significant amount of the cattle feed, to its shareholders.[89] Relying on section 336, the Dairy recognized no income on the liquidation.[90] The shareholders continued to operate the business in noncorporate form and filed an election under section 333[91] to limit the gain recognized by them and calculated their basis in the assets received (including the feed) according to section 334(c).[92] Under this section the shareholders had a positive basis in the unused cattle feed and deducted that basis as a section 162 business expense for the next fiscal year.[93]

The Commissioner charged that the Dairy should have recognized income in the year of liquidation in the amount of the value of the unused cattle feed.[94] The Dairy paid the resulting tax and sued for a refund in the District Court for the District of Arizona.[95] The district court held in favor of the Dairy[96] and the Ninth Circuit affirmed.[97] Both courts held that since the Dairy did not recover its previous deduction it need not recognize income on this sequence of

86. *Hillsboro*, 460 U.S. at 374.

87. *Id.*

88. Section 162(a) of the 1982 Code provides for the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162(a) (1982).

89. *Hillsboro*, 460 U.S. at 374.

90. *Id.* at 374-75. Section 336(a) of the 1976 Code provided that "no gain or loss shall be recognized to a corporation on the distribution of property in complete or partial liquidation." I.R.C. § 336(a) (1976).

91. Section 333 of the 1954 Code provided certain elections with respect to gain recognition in liquidations. It stated the conditions under which shareholders would recognize gain and the nature of that gain in pursuance of plans of complete one-month liquidations. I.R.C. § 333 (1954).

92. Section 334(c) of the 1954 Code states that the basis of property received in exchange for stock in such a liquidation equals the shareholder's basis in the stock less any cash or securities received plus any gain recognized on the liquidation. This basis is then allocated among the assets received. I.R.C. § 334(c) (1954). *See also* Treas. Reg. § 1.334-2 (1982).

93. *Hillsboro*, 460 U.S. at 376.

94. *Id.*

95. *Id.*

96. *Id.*

97. Bliss Dairy, Inc. v. United States, 645 F.2d 19 (9th Cir. 1981). The court relied on its formulation of the tax benefit rule in the case of South Lake Farms, Inc. v. Commissioner, 324 F.2d 837 (9th Cir. 1963). *See supra* note 7.

events.[98]

C. *Application of the New Test to* Hillsboro

Under the facts of *Hillsboro*, the majority applied its new test and found that no fundamentally inconsistent event had occurred and therefore the tax benefit rule was not triggered.[99] The methodology in applying the new rule was, however, strained and confusing. It was strained because the majority went to unreasonable lengths to find no inconsistency based on its "premise" test; it was confusing because the majority did not apply its alternative statement of the test, the same year test, at all.

In applying its premise test, the majority approached the *Hillsboro* facts by focusing on section 164(e) of the Code which permitted the initial deduction for payments of the shareholders' tax liability by the Bank.[100] In essence, the majority noted, this provision permitted the Bank to make a deductible dividend[101] by paying taxes actually owed by its shareholders.[102] The majority found that Congress intended to provide relief for corporations making such payments by permitting the deduction,[103] and that Congress was unconcerned whether the payment to the state treasury was used in any way inconsistent with the payment of a tax.[104] In this way, the majority found that the refund to the shareholders was not fundamentally inconsistent with the taking of the deduction. Thus, Congress' intent to provide relief for corporations making such payments on behalf of its shareholders was fulfilled.

In reaching its conclusion, the majority emphasized a brief portion of legislative history.[105] The majority cited remarks made by a Senator during hearings on the then-proposed section 164(e) to support its reasoning that Congress did not care how the state ulti-

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98. *Bliss Dairy*, 645 F.2d at 20.

99. *Hillsboro*, 460 U.S. at 393-95.

100. Section 164(e)(1) of the Code permits the deduction allowed in subsection (1) (relating to the deduction of certain taxes) to be taken by a corporation where that corporation pays a tax "imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation." I.R.C. § 164(e) (1982). *See supra* note 78 and accompanying text.

101. Even though "the general structure of the corporate tax provisions does not permit deduction of dividends . . . ." *Hillsboro*, 460 U.S. at 391.

102. Section 164(e) of the 1982 Code also denies the deduction of the state tax to the shareholders. I.R.C. § 164(e)(2) (1982). Therefore, the provision merely reallocates the benefit of the deduction and does not create a new deduction.

103. *Hillsboro*, 460 U.S. at 394.

104. *Id.*

105. *Id. See* Blum, *supra* note 16, at 364.

mately used the funds.[106] The majority thus reached its result by determining that the premise for the initial deduction was a payment to the state treasury rather than a payment of a tax.[107] Therefore, *Hillsboro* may stand for the proposition that the premise on which a deduction is based is not necessarily to be garnered from the plain words of a statute. Rather, a thorough examination of the legislative history is the key to finding the premise of the deduction.

The majority's fundamentally inconsistent events test is troubling in at least two respects. First, the test provides no guidance as to when the plain words of the statute must be overlooked in order to permit the legislative history to determine the premise on which the deduction is based. Second, even if it is agreed that legislative history should decide the issue in a particular case, taxpayers, tax planners, and tax collectors will be unable to agree on a consistent interpretation of any legislative history. Consequently, the courts will have to decide these matters. To demonstrate the difficulties inherent in the test, one need only point to the opinions of Justices Blackmun and Brennan who agree (at least arguendo in Justice Blackmun's case) that the fundamentally inconsistent events test is appropriate, but who disagree with the majority on the result that the test yields.[108]

Given the problems with the majority's application of the rule, a more appropriate application of the new test, at least as it is worded by the majority, would have been that of Justice Blackmun. Justice Blackmun discounts the finding of the majority concerning the legislative history and focuses on a much more intuitive notion, derived from the statute itself, that the deduction was meant for the payment of a tax, and there being no tax imposed, the tax benefit rule should apply.[109] Such an application would have the advan-

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106. " 'I have been a director in a bank . . . for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank . . . . I know nothing about it. I do not take 1 cent of credit for deductions, and the banks are entitled to it. *They pay it out.*' " *Hillsboro*, 460 U.S. at 394 (quoting *Hearings on H.R. 8245 Before the Comm. on Finance*, 67th Cong., 1st Sess. 251 (1921) (remarks of Sen. Smoot)) (emphasis added by the Court).

107. *Id.* This interpretation of the statute has been severely criticized. Professor Blum states: "I have yet to discover a connection between the Senator's musings and the majority's conclusion." Blum, *supra* note 16, at 364. Blum further contends that "the majority discovered Congressional intention by reading a strained meaning into an off-handed expression by a single Senator directed to a point not involved in the issues under adjudication by the Court." *Id.* This Note tries to explain why the Court strained in its interpretation of this statute.

108. *See supra* notes 50, 53-60 and accompanying text.

109. *Hillsboro*, 460 U.S. at 422 (Blackmun, J., dissenting).

tage of predictability, a valuable commodity in tax law but one with which the majority apparently was unconcerned.

The majority never applies its alternative statement of the rule, the "same year" test, to the *Hillsboro* facts perhaps because application of this test to those facts is circular and inconclusive. Application of the premise test under the majority's analysis would require that had all the events occurred in the same year, the deduction would have been allowed. Application of the premise test under Justice Blackmun's approach would have disallowed the deduction if all events had occurred in the same year. Therefore, the "same year" inquiry adds nothing to the analysis independent of the basic premise test.

D. *Application of the New Test to* Bliss

Under the *Bliss* facts, the majority again avoids the direct use of its new test.[110] It sets out what it believes to be the basic premise for the deduction of the feed, stating that "[t]he deduction is predicated on the consumption of the asset in the trade or business."[111] The majority does not state explicitly, however, that the liquidation with expensed feed on hand is fundamentally inconsistent with this premise. Instead, it focuses on the distinction between section 162, which allows deductions for ordinary and necessary business expenses and which permitted the initial deduction in *Bliss*, and section 262 which denies deductions for personal expenses.[112] The majority then broadly states that distribution to shareholders in liquidation is analogous to personal consumption[113] and that, therefore, the tax benefit rule requires the Dairy to take into account as income the amount of the earlier deduction attributable to the distributed and unconsumed feed.[114]

A proper application of the majority's test would be to decide directly whether liquidation and distribution were fundamentally inconsistent with "consumption" as used in defining the basic premise for the deduction.[115] All that is then required is to find an ap-

110. Comment, *supra* note 2, at 1271.

111. *Hillsboro*, 460 U.S. at 395.

112. *Id.* at 395-96.

113. *Id.* at 396.

114. *Id.* at 403. The Court remanded the case for a determination of the proper amount of the increase in taxable income. *Id.*

115. It may be worth noting that the principle in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that a corporation does not recognize income upon distribution to its shareholders of assets which have appreciated, is eliminated in the 1986 Tax Code. Hence, gains will be recognized whether the distribution is through a liquidation or not.

propriate definition of "consumption." The Court cites a regulation which defines "consumption" to mean "used in operation."[116] Clearly, distribution to shareholders could not be construed as a *use in the operation* of the business; therefore the two notions are fundamentally inconsistent. This straightforward analysis leads to the same conclusion as the majority but has the advantages of: (1) using the fundamentally inconsistent events test as stated, and (2) avoiding the possible theoretical problems of analogizing to personal consumption before deciding whether a fundamental inconsistency exists.[117]

IV. Future Application of the Tax Benefit Rule

The result of *Hillsboro* is that taxpayers are left to deal with the fundamentally inconsistent events test in the wide variety of cases where the tax benefit rule may apply. As discussed above,[118] the rule set forth in and applied to the *Hillsboro* and *Bliss* facts does not provide clear guidelines for future application. Considering that *Hillsboro* represents only the third time the Supreme Court has considered a tax benefit problem,[119] it is unlikely that any further clarifications will be handed down in the near future. Thus, this part of the Note will apply the new test to various fact patterns that have arisen in the past and to some that may arise in the future.

A. *Significant Considerations Arising From* Hillsboro *and* Bliss

Before applications of the new test to both present and future situations are made, it is necessary to take note of some of the factors that may be considered by a court mandated to follow the fundamentally inconsistent events test.

Obviously, examinations of pertinent legislative history will play an important role in the future of the tax benefit rule. Whether these inquiries will be fruitful or theoretically necessary is questionable. One suspects that in many cases (like *Hillsboro*) the legislative history can be read either for or against invoking the tax benefit rule. Therefore, it will be necessary for courts to look to other persuasive factors. The *Hillsboro* and *Bliss* fact patterns are a good starting point because the tax benefit rule was not applied in *Hills-*

116. Treas. Reg. § 1.162-3 (1958).

117. *See, e.g.*, Comment, *supra* note 2, at 1271-73 (arguing that "it is not at all clear that the distribution in a liquidation is akin to personal consumption"). *Id.* at 1271.

118. *See supra* notes 99-117 and accompanying text.

119. The other two cases are Dobson v. Commissioner, 320 U.S. 489 (1943), and Nash v. United States, 398 U.S. 1 (1970).

boro, while it was applied in *Bliss*. An examination of other significant differences between those two cases may be helpful.[120]

At least two distinguishing factors between the *Hillsboro* and *Bliss* cases may account for their different outcomes. First, at the time invocation of the tax benefit rule was sought, the Dairy possessed an asset, the cattle feed, which under tax law no longer existed because it was expensed when purchased. On the other hand, the Bank possessed no such asset.[121] Second, the Dairy had deducted the cattle feed under the broad provisions of section 162 as an ordinary and necessary business expense. The Bank, however, deducted its payments to the state under section 164, a much more specific provision designed to govern a particular set of facts.[122]

The former distinction suggests that the fundamentally inconsistent events test is not as far removed from the recovery analysis as the antagonistic opinions of Justices O'Connor and Stevens might suggest.[123] This distinction is also in concert with Justice O'Connor's desire to create a new test that is broader than recovery analysis but narrow enough to exclude many merely inconsistent events. This distinction also coincides with Justice O'Connor's notion that the tax benefit rule should not be limited to taxing current wealth-enhancing events but should tax income based on transactional accounting. As applied to the Dairy, then, transactional accounting, measuring income at the close of all transactions, would have permitted the Dairy to expense only the feed it actually consumed. Application of the tax benefit rule, in this instance, goes beyond making the Dairy pay tax on recovery of an expense, by requiring it to recognize income to the extent that it had never actually incurred the expense involved.[124] In this way, the tax benefit

120. It is important to remember that Justice O'Connor sought to formulate a test for the application of the tax benefit rule which was broader than recovery analysis but narrower than the inconsistent events test of *Tennessee-Carolina*. *Hillsboro*, 460 U.S. at 382-83. *See supra* notes 41-48 and accompanying text. Furthermore, Justice O'Connor's test taxes income based on transactional accounting and does not look for current wealth-enhancing events to invoke the rule. *Hillsboro*, 460 U.S. at 381. With Justice O'Connor's framework in mind, a comparative examination of the two fact patterns is in order.

121. The shareholders possessed and had complete control over the refunds in *Hillsboro*. 460 U.S. at 373. *Cf.* First Trust and Savings Bank of Taylorville v. United States, 614 F.2d 1142 (7th Cir. 1980) (where refund checks were made payable jointly to bank and shareholders).

122. *See supra* note 78.

123. Both theories would seem to require possession of some asset for the tax benefit rule to apply.

124. One commentator argues that the essence of the tax benefit rule is that it recognizes untaxed income from an earlier year. What is needed in the current year is only a reconciliation event, not a realization event. White, *supra* note 45, at 504-05.

rule reconciles the results under annual accounting to those under transactional accounting, which was Justice O'Connor's goal.

The second distinction, namely the difference in specificity of the statutes on which the *Hillsboro* and *Bliss* deductions were based, may be more helpful to identify when a court can narrowly define the premise for a deduction than to identify when to apply the tax benefit rule. In and of itself, the specificity by which a statute defines a deduction should have no bearing on the applicability of the tax benefit rule. But *Hillsboro* provides a good example of how a court can interpret a specific statute to deny applicability of the tax benefit rule to fact patterns in which the taxpayer has not recovered or retained in its possession any of the previous deduction.

Where a Code provision, like section 164(e), sets out a specific fact pattern in which a deduction is permitted, then the court has an opportunity to construe the statute as providing relief to the taxpayer upon payment of the item without regard to the ultimate disposition of the money. It is not suggested that every specific Code provision can or should be interpreted in this way. It is suggested, however, that certain Code sections lend themselves to this kind of analysis. The common thread among these provisions is that they seek to promote some kind of activity—for example, the deductions for charitable contributions[125] and research and experimental expenditures.[126] In contrast, other provisions of the Code seek to determine true income,[127] as in the provision for the deductions for bad debts.[128]

Distinguishing between Code provisions that allow a deduction to promote a certain activity and those that allow a deduction in order to measure true income is appropriate within Justice O'Connor's framework. Since Justice O'Connor's purpose was to approximate the results of transactional accounting, it follows that her test should be more limited, i.e., the tax benefit rule should apply less often, in cases where the deduction involved is not itself concerned with the measurement of income. Therefore, in cases concerning deductions that promote congressional policies, only direct recovery, such as the refund to the Bank (as opposed to the shareholders under the *Hillsboro* facts), should trigger the tax benefit rule.

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125. I.R.C. § 170 (1954).

126. I.R.C. § 174 (1954).

127. True income is defined for these purposes as revenues less the costs of producing that revenue.

128. I.R.C. § 166 (1954).

B. *Application of the Fundamentally Inconsistent Events Test to Other Fact Patterns*

At this point it is appropriate to take the analysis from the *Hillsboro* and *Bliss* cases and apply it to other fact patterns that may arise in the future. The first situation raises the issue of whether recovery analysis retains any relevancy with respect to the tax benefit rule. The second raises the issue of how the test can be sufficiently narrowed in order to apply it in the future.

1. *Recoupment of Research and Experimentation Expenses*

The following fact pattern is posed in a post-*Hillsboro* Revenue Ruling[129] promulgated by the IRS. The fact pattern is instructive because it includes elements of recovery analysis. The facts state that the taxpayer's principal business is the manufacture and sale of consumer products. For many years the taxpayer has engaged in substantial research leading to the development of patented and unpatented technology. The taxpayer has properly deducted all research expenses under section 174(a) of the Code and derived a tax benefit for the entire amount.[130] In the current year, the taxpayer decides to drop a product line and so sells certain patented and unpatented technology that had been obtained through the previous expenses.[131] This situation poses the problem of whether facts which clearly indicate that a recovery has occurred can nonetheless fail to be fundamentally inconsistent.[132] The Revenue Ruling answers that question affirmatively.[133]

In interpreting the fundamentally inconsistent events test, the IRS gave far too much deference to the fulfillment of what it saw as the legislative purpose behind section 174 and not enough deference to the purpose of the tax benefit rule. The IRS stated that section 174 had two purposes: (1) to encourage research activities, and (2) to eliminate uncertainty as to the tax treatment of such expenditures.[134] The IRS then stated that the legislative purposes were

129. Rev. Rul. 85-186, 1985-2 C.B. 84.

130. It is important to note that in this situation the exact amount of research and development expenses devoted to any particular product line cannot be determined.

131. Rev. Rul. 85-186, 1985-2 C.B. 84.

132. In a pre-*Hillsboro* Revenue Ruling under similar facts, the IRS stated that the recovery invoked the tax benefit rule. Rev. Rul. 72-528, 1972-2 C.B. 481 (overruled by Rev. Rul. 85-186).

133. The ultimate difference to the taxpayer is that the sale can be treated as the sale of a capital asset with a zero basis as opposed to a recoupment of ordinary income under the tax benefit rule.

134. Rev. Rul. 85-186, 1985-2 C.B. 84.

served in the year of deduction and as such the subsequent sale had "independent significance and was not fundamentally inconsistent."[135]

The Ruling indicates the problem with the new test—it is itself subject to too much interpretation. By concentrating on one aspect of the new rule (the legislative purpose behind the specific statute granting a deduction),[136] the IRS completely ignores the rationales behind the tax benefit rule itself. If, as the Ruling implies, the tax benefit rule will not apply when the legislative purposes behind the initial deduction are achieved in the year of deduction, then the rule can never be applied. In all tax benefit cases the initial deduction is a proper one and one that supports the legislative purpose behind the rule.

A proper application of the fundamentally inconsistent events test would require application of the tax benefit rule under these facts. Justice O'Connor's purpose in drafting the new rule was to broaden its application, not narrow it. In this case, the fundamentally inconsistent event is that after all relevant transactions have been completed, the taxpayer did not actually spend the money it claimed as a research and experimentation deduction. There can be no more inconsistent event than a recovery of the expense. This outcome is entirely in accord with the purpose of the fundamentally inconsistent events test— namely, to achieve the results that would be achieved under transactional rather than annual accounting. The inquiry into legislative history should be secondary to the goal of attaining a transactional accounting result. Only in fact patterns like *Hillsboro*, where there was no actual recovery, is it proper to look to legislative history to determine the issue of fundamental inconsistency.

2. *Expenses that Increase Going-Concern Value Without Creating an Asset*

Justice Stevens recognizes a potential problem with the fundamentally inconsistent events test by pointing out that the new test, as stated, would require application of the tax benefit in a broad range of cases where it has never applied before. The common thread among these cases is that the expense incurred and deducted increased the going-concern value of the business without creating a

135. *Id.*

136. *See supra* notes 107-08 and accompanying text.

tangible asset.[137]

Taking one of Stevens' examples, assume the facts of *Bliss* with one addition. The corporation had engaged in an advertising campaign in the year just prior to liquidation. This campaign was to benefit the corporation in the following year, but the corporation was liquidated. Does the fundamentally inconsistent events test require the corporation to recognize income to the extent that it still retains the future benefits of the advertising expenses?

The issue arises because it seems that the taxpayer is still in possession of some asset, albeit intangible, at the time of liquidation, much like the cattle feed in *Bliss*. However, upon closer examination an important difference can be seen. With respect to the cattle feed, the Dairy had never spent the money in the manner the statute contemplates.[138] In the case of advertising,[139] the taxpayer has spent the money in accordance with the requirements of the deduction. Nothing has happened to subvert the premise of the deduction, i.e., that the taxpayer has spent money to promote the business. The fact that the business is now worth more because of the advertising is not at all inconsistent with the taking of a deduction. Indeed, many deductible expenses are incurred for that very reason.[140]

The fundamentally inconsistent events test can and should be

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137. "It is not clear, however, how the Court would react to other expenses that provide an enduring benefit. I find no limiting principle in the Court's opinion that distinguishes cattle feed . . . from prepaid rent, prepaid insurance, accruals of employee vacation time, advertising, management training, or any other expense that will have made the going concern more valuable . . . ." *Hillsboro*, 460 U.S. at 419.

138. The deduction of cattle feed as an ordinary and necessary business expense of a dairy clearly contemplates the consumption of the feed. White, *supra* note 45, at 503. The fact that the feed is deductible in the period bought as opposed to the period consumed is merely a matter of ease of administration.

139. Note that advertising expenses are currently deductible under § 162 of the Code as an ordinary and necessary business expense. Treas. Reg. § 1.162-1 (West Supp. 1986).

140. An argument can be made that the goodwill associated with the advertising expenses can be distributed if, after liquidation, the business is continued in non-corporate form. This would seem to equate the "unconsumed" advertising with the unconsumed cattle feed discussed above, therefore calling for application of the tax benefit rule.

The critical point is, however, that the advertising expenses have been incurred consistent with the premise for their deductibility, i.e., it is a deductible business expense to promote a business by advertising. It is irrelevant to the question of deductibility whether the advertising expenses will benefit future periods. Therefore, distribution of the goodwill generated by the advertising should not invoke the tax benefit rule. *See* White, *supra* note 45, at 503-04.

To draw an analogy to the cattle feed situation, if the feed had been consumed, then the premise of the deductibility of the feed would have been upheld. Therefore, any future distribution of the benefits of incurring the expense, i.e., the benefits of fatter, healthier cattle, should also not invoke the tax benefit rule.

interpreted to reach this result. The basic premise of ordinary and necessary business expenses should be construed as the incurring of the expense to create revenues. In the cattle feed case, the taxpayer has an asset it could turn around and sell. Thus, the Dairy has not incurred the expense with finality.[141] In the advertising case, the taxpayer has finally incurred the expense in question.

Construing the basic premise test narrowly, as this example suggests, supports Justice O'Connor's goal of defining "fundamentally inconsistent" more narrowly than merely "inconsistent."[142] It also supports the goal of promoting transactional accounting because at the end of all the transactions in question, the taxpayer is still in the position of having spent money in the manner contemplated by the deduction.[143]

V. CONCLUSION

The Supreme Court's formulation of the fundamentally inconsistent events test in *Hillsboro* invites some controversy because of the broad language used by the majority. Therefore, taxpayers, tax planners, and tax collectors will need to analyze the cases closely to apply the test consistently in the future. While the test should be construed more broadly than a recovery theory, it must retain some features of the recovery analysis. Furthermore, the premises on which deductions are based should be construed narrowly, with the key inquiry being whether the taxpayer has actually spent the funds in accordance with the statute. In this way, the rule can stay within the framework of the new test while becoming sufficiently narrow for future application.

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141. *See* White, *supra* note 45, at 502. White notes that finality is a key concept in applying the tax benefit rule appropriately. Finality is also important in Justice O'Connor's opinion since transactional accounting is a goal of the new test.

142. *See supra* note 120 and accompanying text.

143. This fact is only known, however, once the basic premise of the deduction is defined as having spent the money in question in promotion of some congressional policy; e.g., charitable deductions, or in an effort to increase net income; e.g., ordinary and necessary business expenses.