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TAXATION

I. *STARKER II:* NONRECOGNITION OF LIKE-KIND EXCHANGES IS STRETCHED TO NEW LIMITS

A. INTRODUCTION

In *Starker v. United States (Starker II)*,[1] the Ninth Circuit Court of Appeals addressed a myriad of significant issues relating to nonrecognition treatment under section 1031 of the Internal Revenue Code (the Code).[2] Of primary importance to the tax practitioner, the court approved delayed three-corner exchanges.[3] The court also held that a contract right to land is a like-kind exchange for real property regardless of the possibility that cash might be received by the taxpaper.[4]

B. FACTUAL BACKGROUND

On April 1, 1967, along with his son and daughter-in-law, Bruce and Elizabeth Starker, T. J. Starker entered into a land exchange agreement with Crown Zellerbach (Crown). Pursuant to the agreement, the Starkers agreed to convey to Crown all their interests in 1,843 acres of timberland in Columbia County, Oregon. In consideration for this timberland, Crown agreed to buy and transfer to the Starkers other real property in Oregon and Washington. According to the agreement, Crown was to provide the Starkers with acceptable real property within five years or pay the outstanding balance in cash. Crown further agreed to credit a six percent annual "growth factor" to the Starkers' exchange balance. This "growth factor" was based on the exchange balance remaining on Crown's books at the end of each year.

1. 602 F.2d 1341 (9th Cir. Aug., 1979)(per Goodwin, J.; the other panel members were Anderson, J. and Jameson, D.J.).

2. I.R.C. §§ 1031(a) (1954) provides as follows:

> (a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

3. 602 F.2d at 1353, 1354.

4. *Id.* at 1355.

The Starkers deeded their timberland to Crown on May 31, 1967, at which time Crown entered an "exchange value" credit in its books of $1,502,500 for T. J. Starker and $73,500 for Bruce and Elizabeth Starker. Within four months, Elizabeth and Bruce Starker found three suitable parcels of land which were promptly acquired and conveyed to them by Crown. Since the value of the transferred property equalled the Starkers' exchange balance of $73,500, no cash was paid to them. Likewise, no "growth factor" was added because a year had not expired since the timberland was deeded to Crown.

Between July, 1967, and May, 1969, T. J. Starker selected twelve parcels of land. Crown purchased nine of these parcels from third parties and then transferred them to taxpayer. After Crown obtained them, two of the remaining parcels, the Timian and Bi-Mart properties, were conveyed at taxpayers' directions to his daughter, Jean Roth. The twelfth parcel, the Booth property, involved a third party's contract to purchase. Crown purchased that contract right and reassigned it to T. J. Starker.

In their income tax returns for 1967, all three Starkers treated the transfers to Crown as nonrecognition transactions under section 1031 of the Code. The Internal Revenue Service ruled that the transactions were not tax exempt and assessed $300,930.31 plus interest against T. J. Starker and $35,248.41 against Elizabeth and Bruce Starker. Taxpayers paid the deficiencies and filed claims for refunds. When the refunds were denied, they filed two actions for refunds in the district court.

In the first action, *Starker v. United States*[5] (*Starker I*), the court granted Bruce and Elizabeth Starker their refund, thereby entitling the transaction to nonrecognition treatment. The Government chose not to pursue their appeal, and the appeal was voluntarily dismissed. The judgment became final.

In *Starker v. United States*[6] (*Starker II*), however, the Government vigorously argued that taxpayer was not entitled to nonrecognition treatment under section 1031. Despite the fact that this case was heard before the same district judge as in *Starker I*, the court implicitly held that its prior decision in favor

5. 751 U.S.T.C. 87,142 (D. Or. 1975)(per Solomon, J.).

6. 432 F. Supp. 864 (D. Or. 1977)(per Solomon, J.).

of the taxpayer in *Starker I* did not collaterally estop the government from relitigating the applicability of section 1031.[7] The court found that taxpayer had exchanged his property for a promise to convey like-kind property in the future, and therefore, the transfer to Crown did not qualify for nonrecognition treatment under section 1031.[8] It further found the six percent "growth factor" added to taxpayer's exchange value credit was taxable as ordinary income.[9]

In reaching its decision, the district court reconsidered the statutory purpose of section 1031 and its application and interpretation of *Alderson v. Commissioner*.[10] As to the purpose of section 1031, the court concluded that section 1031 was enacted to defer recognition on an exchange of property[11] which does not change the nature of the investment.[12] Stating that section 1031 is to be strictly construed,[13] the court found that taxpayer "must bring himself squarely within the explicit provisions of the exception to qualify for nonrecognition treatment."[14]

As to the application of *Alderson v. Commissioner*,[15] the district court stated that it had misread *Alderson*, and therefore reversed itself on the application of *Alderson*.[16] The court felt that its previous interpretation would be contrary to the purpose of section 1031 and would encourage tax avoidance. In *Alderson*,

7. *Id.* at 868. *See* note 19 *supra* and accompanying text.

8. *Id.*

9. *Id.* at 869.

10. 317 F.2d 790 (9th Cir. 1963).

11. *See* Woodbury v. Commissioner, 49 T.C. 180 (1967).

12. *See* Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940).

13. 432 F. Supp. at 867. It is an exception to the general rule that the entire gain or loss realized on disposition of property is recognized. *See* Treas. Reg. § 1.1002-1(b) (1962).

14. 432 F. Supp. at 867, *citing* Coleman v. Commissioner, 180 F.2d 758, 760 (8th Cir. 1950).

15. 317 F.2d 790 (9th Cir. 1963).

16. In *Starker I*, the court believed that the reasoning in *Alderson* required the finding that taxpayers were entitled to nonrecognition treatment under section 1031. In the instant case, the court realized that *Alderson* was not directly on point. In the opinion of Judge Solomon, who wrote the opinion in *Starker I*:

> I have considered my opinion in *Starker I*. I now conclude that I was mistaken in my holding as well as in my earlier reading of *Alderson*. Even if *Alderson* can be interpreted as contended by plaintiff, I think that to do so would be improper. It would merely sanction a tax avoidance scheme and not carry out the purposes of § 1031.

432 F Supp. 867-68.

taxpayer agreed to sell his property. Before the sale was consummated, taxpayer located a second parcel which he wanted to exchange for his property. The escrow agreement was amended, and ultimately, the parties exchanged deeds. A reciprocal, simultaneous exchange of like-kind property was the result,[17] entitling taxpayer to nonrecognition treatment under section 1031.

The district court also attacked T. J. Starker's motives in *Starker II* by noting that the "exchange" in question, *i.e.*, the transfer of all taxpayers' rights in the timberland in return for a promise to transfer future like-kind property, was an attempt to unduly expand the definition of "exchange."[18] In so doing, taxpayer sought to disguise a sale as an exchange thereby ignoring the relevant statutory distinctions.

In departing from its application of *Alderson* followed in *Starker I*, the district court implicitly decided that the Government was not collaterally estopped from litigating *Starker II*.[19] Additionally, the court noted that the six percent growth factor on the exchange balance which was to be paid to Starker at the time of the last off-setting charge. Believing that the growth factor was really used to conceal the true nature of the transaction,[20] the court found that "it was really interest and should be taxed as ordinary income."[21] The district court, in finding for the

17. Unlike *Anderson*, T. J. Starker did not enter into either a reciprocal nor a simultaneous exchange. Although the court noted that there may be cases where there must be a simutaneous exchange to qualify for non-recognition treatment under § 1031, this was not one of them. *Id.* at 868 n.3.

18. *Id.* at 868.

19. *Id.* at 867. While it recognized that many of the transfers of the instant case were identical to those in *Starker I*, the court noted issues which were not raised in the former case. Unlike *Starker I*, Crown transferred property to a third person, taxpayer's daughter. *Id.* The court also made a distinction between the arguments set forth by the Government in *Starker I*, with those made in *Starker II*. For example, in *Starker I*, the Government claimed that there was no exchange because there was no simultaneous transfer of property between Crown and the Starkers. In *Starker II*, the Government also argued that there was no like-kind exchange, on the ground that taxpayer transferred his property for a promise which was the equivalent of cash. *Id.*

20. *Id.* at 869.

21. *Id.* Taxpayer claimed that even if the "growth factor" was found to be interest, it was taxable in 1969 because that was the year Crown reported it as interest and, because the 6% was added to taxpayer's exchange balance at the last offsetting charge in 1969. The court concluded, however, that the parties themselves treated these payments as having been received in 1967. Crown calculated the "growth factor" daily and kept a running total in its books under the heading of "interest." Upon acquiring property for taxpayer, Crown first subtracted the price of the parcel from the accrued interest. Thus,

Government, dismissed T. J. Starker's action.[22]

On appeal, the Ninth Circuit held that the Government is collaterally estopped from relitigating the applicability of section 1031 to nine of the twelve properties in *Starker II*.[23] With respect to the remaining Bi-Mart, Timian and Booth properties, collateral estoppel did not apply. For these properties the court examined whether T. J. Starker qualified for nonrecognition treatment under section 1031.[24] The court found that taxpayer never received an interest in the Timian and Bi-Mart properties,[25] be-

the principle balance was reduced only to the extent that the interest did not cover the cost of the parcel. Such an arrangement allowed taxpayer to obtain additional interest.

22. *Id.*

23. 602 F.2d at 1350. The Ninth Circuit outlined its analysis for a collateral estoppel claim. In order for collateral estoppel to apply, the court must find that the two cases, *Starker I & II*, present similar legal question, facts and parties.

1. *Legal Question Presented.* For collateral estoppel to apply, the issue in the second litigation must have been litigated and decided in the first case. *Id.* at 1344. The first problem the court faced was that of defining the legal issue for purposes of applying collateral estoppel. Stated broadly, the legal issue decided in *Starker I* was whether nonrecognition treatment under section 1031 applied to the transfers pursuant to the Starker-Crown contract. Except for a change in verbal formula, the argument advanced by the Government was substantially the same as that in *Starker I*. The Government made the same appeals to the legislative history and purpose of section 1031, and therefore, the Ninth Circuit was unconvinced that the legal issues presented by the Government were different.

2. *Facts.* With the exception of Bi-Mart, Timian and Booth, in nine of the twelve parcels of property received by T. J. Starker, the Ninth Circuit found no consequentional differences in facts from *Starker I*, citing Montana v. United States, 440 U.S. 147 (1979), and Commissioner v. Sunnen, 333 U.S. 591 (1948). 602 F.2d at 1345-48. The recent Supreme Court holding in *Montana* controlled the Ninth Circuit's finding which applies collateral estoppel in a second case even though some facts differ provided that the differing facts were not "essential to the judgment" or "of controlling significance" in the first case. 440 U.S. at 158. Although no longer followed on the issue of similarity of facts, the Ninth Circuit discussed *Sunnen* at length and noted that it may have led the court to reach the same results as it did under *Montana*. 602 F.2d at 1345-47.

3. *Parties.* Even though T. J. Starker was not a party in *Starker I*, nor was that suit in any way financed or controlled by him, (*see*, Montana v. United States, 440 U.S. 147 (1979)), and therefore could not have been bound by an unfavorable judgment in *Starker I*, T. J. Starker sought to assert an advantageous holding of that case in order to estop the government's defense. The Ninth Circuit relied on Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979), where the Supreme Court presented a new analysis for cases involving the offensive use of collateral estoppel. Although the Ninth Circuit remarked that the district court "did not have the benefit of *Parklane Hosiery v. Shore* when it decided [*Starker II*]" the court nevertheless applied the principles set forth in *Parkland Hosiery* and held that the government is estopped from pursuing its claims against T. J. Starker because of the final resolution in *Starker I*. 602 F.2d at 1349.

24. *Id.* at 1350.

25. The Timian property is a residence. The Bi-Mart property is a commercial building. T. J. Starker claims to have expended substantial time and money in maintenance and improvements in the three months before it was transferred to his daughter.

cause he was never given title to them. Title to both parcels was transferred from Crown directly to taxpayer's daughter.[26] Consequently, Timian[27] and Bi-Mart could not be considered properties received by taxpayer in exchange for his timberland.[28]

As to the remaining Booth property, despite the contingencies attached to the property,[29] including the possibility that T. J. Starker might receive cash,[30] the court found that taxpayer received the equivalent of a fee interest for purposes of section 1031.[31] Both issues of whether taxpayer had, in fact, received like-kind property and whether the exchange had to be simultaneous were also resolved in T. J. Starker's favor.[32] The court further held that the six percent growth factor taxpayer received was in fact disguised interest on Crown's unpaid credit balance.[33]

He also emphasizes that he controlled and ordered the property to be conveyed to her.

26. In 1968, taxpayer paid a gift tax on these two properties, but whether he actually owed this tax was not a issue. *Id.* at 1350 n.7.

27. Specifically as to the Timian property, the Ninth Circuit held that nonrecognition could not be given to residential property. *Id.* at 1350. The court declared that "it has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment," since losses on the sale or exchange of such property are not deductible. *Id., citing* Treas. Reg. § 1.165-9(a) (1954).

28. Under an analogous nonrecognition provision, § 1034 provides that maintaining continuity of title is paramount to receiving nonrecognition treatment. If title shifts from one taxpayer to another, with the exception of one's spouse, nonrecognition is denied. Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967). In some cases an identity of economic interests may be viewed between father and daughter. McWilliams v. Commissioner, 331 U.S. 694 (1974). However, the Ninth Circuit held that unity is insufficient to consider transfer of title to one the same as transfer of title to the other. 602 F.2d 1351.

29. Legal title for the Booth property had not passed by deed to the taxpayer. Rather, Starker held a third-party purchasers' right under a sales agreement which provided for a life interest to the original transferor. Until the life interest ends, legal title cannot pass. However, until then, purchasers are entitled to possession subject to restrictions. If any of the conditions are violated, the seller may elect, *inter alia*, to void the contract. *Id.*

30. *See* text accompanying notes 38 to 40 *supra*.

31. For purposes of determining whether the properties exchanged are of like-kind, a leasehold interest of 30 years or more is the equivalent of a fee interest. Century Elec. Co. v. Commissioner, 192 F.2d 155, 160 (8th Cir.), *cert. denied*, 342 U.S. 954 (1952). Treas. Reg. § 1.1031 (a)-1(c) (1954). *See* Rev. Rul. 72-601, 1972-2 C.B. 467 (A father and his son were both farm owners. The father owned in fee simple a 100-acre farm. The son owned in fee simple a 142-acre farm. Father and son conveyed their properties to each other. Son reserved a remainder interest in the property he transferred to his father. Likewise, the father reserved a life estate in the property he conveyed the remainder interest to his son. Neither conveyences by the father nor the son were found to qualify for nonrecognition under § 1031 of the Code).

32. *See* notes 39 to 49 *supra* and accompanying text.

33. Despite Starker's contention that the 6% merely compensated him for timber growth, the court pointed out that T.J. Starker was entitled to the payments regardless of the actual fate of the timber. 602 F.2d at 1356.

Finally, the court held that income arising out of taxpayer's rights in his contract with Crown was treated as being received at the time contract was made.[34]

While the Ninth Circuit decided numerous issues in *Starker v. United States*, this Note will focus on the most critical issues presented by the court: whether section 1031 requires simultaneity of deed transfers, and whether the exchanges were of qualified like-kind property. These issues arose primarily in the court's discussion involving the transfer of the Booth property and, therefore, will be discussed solely in that context.

C. The Court's Reasoning Behind the Booth Property

Two features of the Booth transaction were pinpointed by the court to trigger the recognition of gain. First, there was the likelihood that taxpayer would receive cash instead of real property. Second, a time gap existed in the transfers of exchange property.

The court began its analysis by adopting a broad and liberal interpretation of section 1031. It rejected the Government's argument that nonrecognition under section 1031 is to be narrowly construed under Treasury Regulation 1.1002-1(b).[35] The court pointed out that this interpretation of the regulation is to be

34. Since the Timian and Bi-Mart properties were deemed "boot," *i.e.*, not like-kind property under § 1031, Starker recognized gain to the extent of the fair market values of these properties on the dates which their title passed to taxpayer's daughter. However, as to the disguised interest, the Ninth Circuit reversed the district court, and held that T. J. Starker is liable for ordinary income in 1967. *Id.*.

This holding, which looks to the year taxpayer made the transaction rather than the year he actually received the income, has created a possible loophole. The Internal Revenue Service is usually blocked by the statute of limitations from collecting tax if the time lapse is over three years, as was the case in *Starker*. I.R.C. § 6501.(1954). The court acknowledged that some administrative difficulties might arise, but referred responsibility to Congress.

35. *Id.* at 1352, 1353. Nonrecognition under § 1301 is a noted exception to the general rule requiring recognition of all gains and losses. Treas. Reg. 1-1002-1 (c) (1954). Under subsection (b), the Government argued:

> The exceptions from the general rule. . . are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange if one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule.

602 F.2d at 1352.

seriously questioned in light of the lack of a clear underlying purpose[36] to section 1031 and a long line of cases liberally construing this section.[37]

Having adopted its liberal stance, the court first addressed the issue of whether the *possibility* that Starker might receive cash rendered section 1031 inapplicable. The court examined a series of cases involving the possibility of a cash transaction[38] and found that the mere possibility at the time of the agreement that a cash sale might occur does not prevent the application of section 1031.[39] The Government argued that the cases were distinguishable in that the possibility of a receipt of cash may have existed at the time of the exchange *agreement*, but did not exist at the time the taxpayer transferred the property.[40] This difference in timing, the Government argued, distinguished *Starker II* from the cases cited by the court.

Next, the Ninth Circuit, relying on the broad interpretation of section 1031 in the earlier cited cases, gave only cursory treatment to the requirement of a simultaneous transfer. *Redwing Carriers, Inc. v. Tomlinson*[41] was cited as being "at least one ap-

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36. The court pointed out the problem with applying a strict construction of § 1031 when the underlying purpose of the section is unclear and "elusive." Two major considerations loomed behind the drafters enactment of § 1031, but the *Starker II* court found that neither of them can be viewed as controlling.

According to the liquidity rationale, "the provision was designed to avoid the imposition of tax on persons who do not cash in on their investments in trade or business property." *Id.* at 1352. The valuation rationale grew from the supposed consideration of the drafters of the difficulty of valuing property exchanged for the sole purpose of determining gain or loss. *Id.*

37. *Id.* at 1353 & n.10.

38. *See, e.g.*, Carlton v. United States, 385 F.2d 238 (5th Cir. 1967)(Even though taxpayer received cash, the court indicated its agreement with the cash option approach when taxpayer retains right to receive like-kind property.); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963)(In this "three-corner exchange," taxpayer and the other party maintained the option to bring about a cash sale until closing.); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963)(Taxpayer entered into a cash sale agreement, but later changed to a like-kind exchange with sale option); Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935). (Taxpayer qualified for nonrecognition treatment because of intention to get other property, if possible, rather than cash.). *Cf.* Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976)(transfer of cash to and from taxpayer's hands defeated the application of § 1031).

39. 602 F.2d at 1354.

40. *Id.*

41. 399 F.2d 652 (5th Cir. 1968). In *Redwing Carriers*, taxpayer attempted to deduct a loss in the purchase of new trucks to replace his used trucks. To prevent nonrecognition exchange under § 1031, the parent corporation transferred the old trucks to a subsidiary who sold them to the manufacturer for cash, and the corporation then bought new trucks

pellate decision" which indicates that exchanges may not have to be simultaneous for section 1031 treatment.[42] In that case, the Fifth Circuit court permitted some lack of simultaneity. Despite the Government's contentions, the court, without elaboration, declined to draw a line distinguishing the time gap in the title exchanges of the previous cases from the more "substantial" period of time in *Starker*.[43]

Finally, the court addressed both of the Government's contentions that taxpayer's contract right to receive land was not "like" title to property. The Government insisted that the contract right to land was like cash, and asked the court to impose a "cash equivalency" test[44] to determine the applicability of section 1031. Declining to apply such a test, the Ninth Circuit stated, "that title to land is no more or less equivalent to cash than a contract right to buy land."[45] The force of the court's position rested in a re-emphasis on the purpose of section 1031: to avoid the inequity of taxpayer being forced to recognize a "gain which was still tied up in a continuing investment of the same sort."[46]

The Government also raised the argument that a contract right to land is a "chose in action."[47] Being personal property rather than real property, a "chose in action" would, therefore, not qualify as a like-kind exchange under section 1031.[48] The Ninth Circuit responded, stating:

> [T]itle to real property, like a contract right to purchase real property, is nothing more than a bundle of potential causes of action: for trespass,

for cash. The court disallowed the loss deduction holding that a tax-free exchange could not be transformed into two sales by the arbitrary separation of time and cash. *Id.* at 659.

42. 602 F.2d at 1355.

43. *Id.*

44. *Id. see generally* Scholossberg, *Cash Equivalent and Constructive Receipt—How These Doctrines Bring Immediate Taxation*, 22 J. TAX. 18 (1965).

45. *Id.*

46. *Id.*, *quoting* Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2nd Cir. 1959).

47. For a general definition, see 63 AM. JUR. 2d *Property* 26, 27 (1972). *Compare* Oregon Lumber Co. v. Commissioner, 20 T.C. 192 (1953) *with* Starker v. United States, 602 F.2d 1341 (9th Cir. 1979) In *Oregon Lumber*, land was exchanged for standing timber. The court held that an exchange of realty for personalty is not an exchange of like-kind property. Since this was a right to cut and remove property, similar to utilization of property, it can be distinguished from *Starker*. Starker actually received the right to the land itself, not personal property on the land.

48. For the relevant statutory language of § 1031, *see* note 2 *supra*.

> to quiet title, for interference with quiet enjoyment and so on. The bundle of rights associated with ownership is obviously not included from section 1031; a contract right to assume the rights of ownership should not be believe, be treated as any different than the ownership rights themselves.[49]

The court returned to a consideration of the statutory purpose of section 1031 and concluded that if taxpayer ultimately received property rather than cash, the exchange would qualify as like-kind.[50] This holding is supported by *Biggs v. Commissioner*,[51] where the Tax Court found that as long as taxpayer solely obtains contractual rights to qualifying property, instead of contractual rights plus cash, the transaction status is preserved as an exchange.[52]

D. Analysis of the Court's Reasoning

Simultaneity Not Required

The Ninth Circuit, by holding that exchanges need not be simultaneous to qualify under section 1031, has created a possible loophole for taxpayers wishing to avoid the taxation of gain on an eventual cash transaction. The *Starker II* court flatly refused to draw a line between "some lack"[53] of simuluaneity and a "substantial"[54] lack of simultaneity. This finding may well be erroneous in light of the weight of authority permitting only a *slight* delay in exchanges, and the potential result, allowing taxpayers to completely avoid taxation.[55]

The Government's argument, although not clearly articulated, was that the difference in timing of the exchanges renders *Redwing Carriers, Inc. v. Tomlinson*[56] and the *Alderson* line of

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49. 602 F.2d at 1355.

50. *Id.*

51. 69 T.C. 905 (1978).

52. *Id.* at 919. *See generally* Price, *Exchanging Like-Kind Property Under Section 1031*, 56 TAXES 594 (1978).

53. 602 F.2d at 1354-55. *See* Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 655 (5th Cir. 1968).

54. 602 F.2d at 1355.

55. Commentators have suggested the need for Congressional intervention. *See generally* Harrock, *Section 1031 Exchanges: Step Transaction Analysis and the Need for Legislative Amendment*, 24 U.C.L.A. L. REV. 351 (1976).

56. 399 F.2d 652 (5th Cir. 1968).

cases[57] inapplicable. This argument has some merit. In *Redwing Carriers*, the court relied on the fact that mutual transfers occured "at or about" the same time.[58] True, the transfers were not simultaneous, but they did occur within a matter of months, not years. *T. H. Baird Publishing Co. v. Commissioner*,[59] while not mentioned by the court, holds that a nonsimultaneous exchange qualifies under section 1031. Yet *Baird* is distinguishable on two grounds. First, although taxpayer deeded his property prior to the exchange, he retained beneficial ownership during the interim months. Thus, taxpayer conveyed beneficial ownership of property at the same time that he received like-kind property from the other party.[60] *Baird* has therefore been argued as representing a simultaneous exchange.[61] Second, like *Redwing Carriers*, the time delay in *Baird* was only a matter of months.

By eliminating simultaneity and permitting open-ended transactions the *Starker* court has allowed taxpayers the option to determine whether they want to receive property, or simply cash.[62] Taxpayer can, thereby, avoid being taxed on substantial gain by holding open beyond the statute of limitations those transactions which they do not intend to exchange for like-kind property.[63]

Contract Right Qualifies as Like-Kind

The court's position that Starker's receipt of a contract right to land was not equivalent to cash, but actually qualified as a

57. Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935).

58. 399 F.2d at 655.

59. 39 T.C. 608 (1962). *Baird* involved a three-party exchange where taxpayer deeded the property while retaining use of the property, rent free, until the other party acquired property on which to construct a new building. This building was to be transferred to taxpayer who would then relinquish use of its formerly deeded property. In order to obtain funds to purchase land on which to construct new building, the other party immediately deeded taxpayer's property to a third person. *See also* Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935).

60. In *Starker II*, perhaps taxpayer could have claimed that the 6% "growth factor" represented a beneficial ownership which was retained only to be conveyed at the same time that Crown transferred the exchange property. *See* Sloma, *The Five-Year Like-Kind Exchange*, 55 NEB. L. REV. 511, 517 (1976).

61. Brief for Appellant at 15, Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).

62. *See generally* Huskins, *Section 1031 Like-Kind Property Exchanges; Possibilities and Pitfalls*, 30 So. CALIF. TAX INST. 459, 489 (1978).

63. *See* note 34 *supra*.

like-kind exchange has been attacked by the Government[64] as well as commentators under a constructive receipt of cash argument.[65] The general constructive receipt rule states that if taxpayers actually or constructively receive cash for their investment, liquidation has occurred and section 1031 does not apply.[66] Under this principle, taxpayers, although not in actual physical control over cash, may be in such close relationship to its control that they will be considered in "constructive receipt" for tax purposes. For example, if income is credited to taxpayer's account, and all taxpayer must do is reach for it, then the income will be regarded as constructively received.[67] The only requirement, however, is that there must be no substantial limitations or restrictions on obtaining its use, nor on its expenditure.[68]

A constructive receipt argument may apply to the facts in *Starker II*, which would therefore mean that section 1031 should not apply.[69] T. J. Starker, although not having direct control over how the money was to be used, had rights[70] under the agreement providing sufficiently broad authority over the purchase of property as to be equivalent to control over cash.[71]

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64. Brief for Appellee at 27, Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).

65. *See generally* Sloma, *supra* note 60, at 514. In this Note the writer discussed the implication of *Starker I*. The perspective indicates that the definition of "exchange" was extended far beyond the contemporaneous swapping of property for which the section had previously been used.

66. Harrock, *supra* note 55, at 355.

67. *See* J. CHOMMIE, FEDERAL INCOME TAX § 82 (1973). For further discussion, see Horsley, *Tax Liability Without Cash: How "Constructive Receipt" Traps Taxpayers*, 31 J. TAX. 116 (1969).

68. J. CHOMMIE, *supra* note 67, at 224. For cases which stand for the proposition that where limitations upon the receipt of income are an integral part of the agreement between parties and that taxpayer does not have an unqualified right to receive cash, the funds are deemed not constructively received, *see* McCouley v. United States, 193 F. Supp. 938 (E.D. Ark. 1961); Woodbury v. Commissioner, 49 T.C. 180 (1967); Amend v. Commissioner, 13 T.C. 178 (1949).

69. The Government argued that the facts in *Starker* closely paralleled those in Carlton v. United States, 385 F.2d 238 (5th Cir. 1967). In *Carlton*, however, the taxpayer in exchange for the desired property was assigned not only purchase contracts, but was also given cash for the total amount of their purchase price.

Similarly, in Rogers v. Commissioner, 44 T.C. 126 (1965), taxpayer used the cash received on an option on his land to purchase the like-kind property. The court held that the receipt of cash caused the transaction to become a sale, rather than an exchange. *Id.* at 137.

70. Taxpayer was able to specify: what type of property he desired; when he chose to receive it; and how much of the credit balance was to be expended to obtain the property.

71. [1975] 61-3rd TAX MNGM'T (BNA)§ A—14.

Ultimately, the constructive receipt argument is too weak to prevail in *Starker II*. Taxpayer neither received cash nor had the right under the contract to demand cash instead of property; that right was reserved for Crown. Starker had no more control over the cash used by Crown to purchase exchange property than any other taxpayer in multi-party transfer.

E. The Result: A Modified Substance Over Form

Although the Ninth Circuit disavowed any reliance on the "substance over form" truism[72] in *Starker II* through its holdings the court has strongly reinforced the use of this argument when deciding section 1031 cases. Having long been limited to formally structuring transfers to fit within section 1031, taxpayers have gained added flexibility by this court-approved emphasis on the substance of the transaction. When using the substance over form argument for the application of section 1031, a taxpayer must merely show that the ultimate transaction constitutes an exchange of like-kind property rather than a sale.

The Ninth Circuit's holding is consistent with cases allowing unlimited flexibility in achieving nonrecognition under section 1031. Transactions have differed as to number of parties, to types of property exchanged, and to options and time of the transfers.[73] Furthermore, Congressional intent[74] not to tax a con-

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72. When the "substance over form" argument is advanced, taxpayers usually structure their transactions in a way that superficially will qualify under a Code section. The Government will ignore taxpayer's strict adherence to the form requirement and focus on the substance and result of the transaction. Typically, the Government has used Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and Gregory v. Helvering, 293 U.S. 465 (1935) to support its argument. Both cases involved corporate taxpayers who tried to structure transactions which would best take advantage of the Code; both corporations lost their cases. The courts emphasized the substance versus form dichotomy: "[P]utting aside, then, the question of motive in respect to taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find?" *Id.* at 469. In *Court Holding Co.*, the Court responded:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step from commencement of negotiations to the consummation of the sale, is relevant.

324 U.S. at 334.

Now courts have used these cases to support taxpayers who structure like-kind property exchanges under a tax avoidance motive. *See generally* Sloma, *supra* note 60; Huskins, *supra* note 63, at 491-94.

73. *See, e.g.*, Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); Alderson v. Com-

tinued investment in like-kind property also enhances a "substance over form" approach. It does, therefore, appear consistent for the Ninth Circuit to relax the rigid timing formality to not require a simultaneous exchange; and to expand the types of qualifying property exchanges to include a contract right to land to be like-kind to title to real property.

At least one major form element is still required for section 1031 treatment. Taxpayers are cautioned to avoid the receipt of or control over cash.[75] This constraint is clearly illustrated by the harsh result in *Carlton v. United States*,[76] where the Fifth Circuit taxed the transaction as a sale because cash passed through taxpayer hands. While courts are increasingly more tolerant for added flexibility in section 1031 transactions, a major form requirement remains. The effect has been the courts' adoption of

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missioner, 317 F.2d 790 (9th Cir. 1963); Biggs v. Commissioner, 69 T.C. 905 (1978); Baird Co. v. Commissioner, 39 T.C. 608 (1962); Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935).

74. The Report accompanying the 1934 Revenue Act provided some insight into the legislative intent of § 1031:

> [P]rofit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in the case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value. The Treasury Department states that its experience indicates that this provision does not in fact result in tax avoidance. If all exchanges were made taxable, it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year, and for the time being, at least, claims for theoretical losses would probably exceed any profits which could be established. The committee does not believe that the net revenue which could thereby be collected, particularly in these years, would justify the additional administrative expense. Consequently, the exchange provisions have not been changed.

H. R. REP. No. 704, 73d Cong., 2nd Sess. 1939-1 (1934).

Some commentators argue that such allowance of formality to prevail over substance of a transaction has resulted in frustration of the legislative purpose behind § 1031. *See generally* Harrock, *supra* note 55.

75. The House debates on the Revenue Act of 1924 indicate that gain must be recognized if property is reduced to cash at any time during the transaction. 65 CONG. REC. 2799 (1924).

76. 385 F.2d 238 (5th Cir. 1967).

nonrecognition under section 1031 in cases, such as *Starker II* and *Redwing Carriers* involving sale-reinvestment transactions.[77]

E. Conclusion

It is difficult to ascertain the Ninth Circuit's intended scope on the nonsimultaneity issue. By failing to limit nonsimultaneous exchanges to months as in *Redwing Carriers*, as opposed to years as in *Starker II*, the court has paved the way for taxpayers to avoid taxation on a cash transaction. Finally, despite the court's unwillingness to apply a "substance over form" approach, this concept inherently exists in the court's holdings. As a result, taxpayers have added flexibility to the extent of timing and the kind of qualifying like-kind property.

Carol M. Kingsley

II. THE *DAVIS* DECISION: EXPANSION OF NON-RECOGNITION OF INVOLUNTARY CONVERSIONS

A. Introduction

During the past term, the Ninth Circuit Court of Appeals was faced in *Davis v. United States*[1] with two important issues concerning nonrecognition of involuntary conversion. First, can a taxpayer who has invested condemnation proceeds in improvements to previously purchased property qualify for nonrecognition of gain under section 1033 of the Internal Revenue Code of 1954?[2] Second, is subsection (a)[3] or subsection (g)[4] the proper

77. Policy reasons may be raised as to the undersirability of such a result. Arguably, the holdings in *Redwing Carriers* and now *Starker II*, have extended § 1031 too far and perhaps are encouraging abuse under the Code. *But see* Harrock, *supra* note 55 for a discussion of the desirability of such an extension.

1. 589 F.2d 446 (9th Cir. Jan., 1979)(per Wallace, J.; the other panel members were Chambers and Anderson, JJ.).

2. I.R.C. § 1033 (1954). The predecessor was 26 U.S.C. (I.R.C. 1939) § 112(f)(3)(A).

3. I.R.C. § 1033(a)(3)(A) (1954) provides in part:

> (a) General rule. If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted— . . . .
>
> (3) Conversion into money where disposition occurred after 1950.—Into money or into property not similar or related in service or use to the converted property . . . the gain (if any)

vehicle for this expansion of section 1033?

Affirming the district court's finding, the Ninth Circuit decided that a taxpayer can qualify for nonrecognition of gain by maintaining a substantial continuation of its prior commitment of capital through appropriate improvements. Hence, investment by purchase of new real property is not necessary under section 1033. Although the district court and the Ninth Circuit held for the taxpayer, their reasonings were different. Instead of examining the soundness of the lower court's application of the "like kind" test of subsection (g), the court of appeal went directly to subsection (a) and used the "similar or related in service or in use" standard. By doing so, the Ninth Circuit undoubtedly reinforced, as a matter of law, the broad applicability of this code section, but unfortunately for the tax practitioner, failed to provide much direction in the appropriate selection and use between subsections (a) and (g) and their respective tests.

B. Background

In *Davis*, taxpayers reinvested proceeds from the condemna-

> shall be recognized except to the extent hereinafter provided in this paragraph:
> (A) Nonrecognition of gain.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock.

With minor modifications not relevant here, this section has been redesignated as section 1033(a)(2)(A) by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(128)(A),(B), 90 Stat. 1785 (1976).

4. I.R.C. § 1033(g)(1) (1954) provides:

> (g) Condemnation of real property held for productive use in trade or business or for investment.— (1) Special rule.—For purposes of subsection (a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

This section has been redesignated as § 1033(f)(1) by the Tax Reform Act of 1976. Pub. L. No. 94-455, § 1901(a)(128)(C), 90 Stat. 1920 (1976).

tion of their agricultural and fishery property in improvements on their previously purchased industrial park.[5] The improvements consisted of the installation of a storm drainage and water system, the grading of land, and excavation of a roadway.[6] Reinvestment was made within the requisite period prescribed in section 1033(a)(3)(B).[7] The Internal Revenue Service did not consider these expenditures to be qualified replacement property and assessed a deficiency against taxpayers.[8] Taxpayers paid the addi-

5. As trustees of the estate of James Campbell, the taxpayers owned and leased real property at various locations in the state of Hawaii. The land included industrial and agricultural property, with a sea fishery adjacent to the agricultural property. In the will of James Campbell, trustees were admonished to keep the land intact and not to sell it unless it was in the best interest of the trust. As a result, the trustees had established and consistently followed a policy of leasing trust lands while continually improving the land for purposes of increasing the production of income. Since 1901, the Campbell trustees had sold less than 4% of the land in private sales. *See* Brief for Appellees, Davis v. United States, 589 F.2d 446 (9th Cir. 1979).

In the late 1960's and early 1970's portions of taxpayers' agricultural land were condemned by the state for the construction of highways. As a result of the condemnations, plaintiffs realized a net amount exceeding $260,000 during the years 1966, 1968, and 1971. Taxpayers realized an additional $7,700 in 1970 from the condemnation of a fishing area and land zoned for agriculture. Again, in 1971, an additional $25,000 was realized from the condemnation of the fishery.

Taxpayers' leased lands, which had been condemned for highway purposes, had been used primarily for livestock grazing and the cultivation of sugar cane. Most of the condemnation proceeds from these lands were used in the regular course of the estate's business operations. However, in 1972, taxpayers expended approximately $335,800 in permanent improvements in land they owned at Campbell Industrial Park. Davis v. United States, 411 F. Supp. at 964-65 (1976).

6. Taxpayers reinvested $296,154.06. This included: $171,000 for land grading; $36,849.60 for a storm drainage system; $79,380 for a water system; and $48,600 for roadway excavation. Although the total cost of the improvements was $335,829.60, the amount of condemnation funds used for improvements was $296,154.06. The difference, $40,675.54, was paid out of the taxpayers' general business funds. *See* Brief for Appellees, *supra* note 5.

7. Pursuant to the provisions of § 1033(a)(3)(B) of the Internal Revenue Code of 1954, the time for purchasing qualified replacement property so as to allow taxpayers to qualify for nonrecognition with respect to their gain on the condemnations, had been extended to December 31, 1973. *See* Brief for Appellant, Davis v. United States, 589 F.2d 446 (9th Cir. 1979).

The time period specified by § 1033 usually begins with the date of the disposition of the converted property, or the earliest date of threat of condemnation, whichever is the earlier, and ending—

(i) 2 years after the close of the first taxable year in which any part of the gain is realized, or

(ii) subject to such terms, conditions and later dates as may be specified by the Secretary on taxpayer's application.

8. The Internal Revenue Service reasoned that because the investments were improvements on land already owned by taxpayers, it did not qualify as replacement property under § 1033.

tional tax plus interest[9] and filed timely claims for refunds. Following the administrative denial of the refund claims, suit was subsequently filed in the district court.

C. Nonrecognition of Gain under Section 1033(g): The "Like Kind" Test

Legislative History

In determining whether gain is to be recognized from the investment of condemnation proceeds into improvements to real property, two tests have been used by the courts.[10] Both tests are provided in section 1033 of the 1954 Internal Revenue Code. Under section 1033(a)(2)(A)[11] gain is not recognized on involuntarily converted property if the replacement property is similar or related in use to the converted property.[12] The scope of this nonrecognition provision was extended under section 1033(g)[13] which allows the broader "like kind" test to be applied in situations involving condemned real property. Previous to the new law, involuntary conversions of property resulting from condemnation which was held either for productive use in trade or business or for investment was subject to the same strict constraints of subsection (a).[14] Consequently, inequities resulted whereby

9. The amount attributed to the condemnation proceeds was $106,050. 589 F.2d at 447.

10. Although courts have typically applied two tests for the nonrecognition of involuntary conversions, the Internal Revenue Service applies an additional third test. Apart from the "like kind" test, the Service has divided the "similar in service or use" test into two discrete tests. The basis of the division as set forth in Revenue Ruling 64-237, 1964-2 C.B. 319, is the distinction between two classes of owners: owner-users and owner-lessors. A "functional" test applies to owner-users of property. *Id.* at 319-320. For owner-lessors, the test focuses more on the relationship of the lessor to both the converted property and the replacement property. *Id.* at 320. For a discussion of the uncertainty of standards resulting in poor tax planning see Comment, *Involuntary Conversions and the Question of Qualified Replacement Property,* 38 Ohio St. L.J. 331 (1977).

11. For the text of § 1033(a)(2)(A), *see* note 3 *supra.*

12. *See* note 25 and 26 *infra,* and accompanying text.

13. For the text of § 1033(g), *see* note 4 *supra.* Section 1033(g) was added to the Internal Revenue Code of 1954 by amendment in 1958. Section 46(a), Technical Amendment Act of 1958, 72 Stat. 1641.

14. Section 1033 of the 1954 Internal Revenue Code provides for the nonrecognition of gain or loss where the proceeds of property involuntarily converted are reinvested in "property similar or related in service or use to the property so converted." The courts construe that phrase very strictly to require that the property be very similar in economic usage to the property destroyed, condemned or otherwise involuntarily converted. J. Rabkin and M. Johnson, Federal Income, Gift and Estate Taxation § 43.08 (1954). The construction given to the similar property requirement of section 1033 was much stricter than the construction given to the phrase "property of a like kind" in the case of exchanges

persons who voluntarily traded property were afforded much more freedom than persons who involuntarily parted with property.[15] Many landowners whose property was condemned by reason of changing social and economic factors were faced with the choice of either reinvesting their proceeds in land which qualified under the requirements of subsection (a), but which was in an entirely different geographic area, or of paying the gains tax. The spirit of section 1033 was to protect taxpayers from taxation of all involuntarily realized income if they took steps to replace the converted property in such a way as to represent a continuity in investment. Subsection (g) was added to specifically protect the interests of landowners subjected to real property condemnation.

The District Court Decision

Since taxpayers' improvements were not of the "same general class"[16] as the condemned agricultural land, the improvements did not qualify for nonrecognition of gain as "property similar or related in service or use" within the meaning of section 1033(a)(3)(A). Rather the district court concluded that the improvements were "like kind" and that taxpayers could elect to defer recognition of gain under subsection (g). The court looked to section 1.1031(a)-1(b) of the Treasury Regulations[17] which has

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of property held for investment or for productive use in a trade or business. *Id.* § 43.10(2). *See* Thompson, *Liberalization of Rules Providing for Tax Free Treatment of Reinvestment of Proceeds of Condemnation Award,* 1959 So. CALIF. TAX INST. 52.

15. For example, the owner of a farm might exchange his farm for income producing real property without recognition of gain. If, on the other hand, the farm was condemned, the proceeds could not be invested in income real estate without the realization of gain. *Id.*

16. This was a phrase first used in Steuart Brothers, Inc. v. Commissioner, 261 F.2d 580 (4th Cir. 1958). *Steuart Brothers,* was also the first of a series of cases that established the rule that considered the investment character of property to be important in the qualification of replacement property under § 1033(a)(2)(A). In *Steuart Brothers,* taxpayer was engaged in a real estate business and owned a tract of land that he planned to rent as a warehouse or grocery store. After the property was condemned, taxpayer bought two new properties, both of which were rental properties. In reversing the Tax Court, the Fourt Circuit compared the real estate held by the taxpayer before and after the conversion. The court concluded that real estate held for investment is similar or related in service or use if the reinvestment is in real estate of the "same general class." However, the court gave no elucidation on what it meant by that phrase. This approach was approved in S.E. Ponticos, Inc. v. Commissioner, 338 F.2d 477 (6th Cir. 1964).

The district court in *Davis* relied on Filippini v. United States, 200 F. Supp. 286 (N.D. Cal. 1961). In *Filippini,* a farm and drive-in theater were replaced by urban lots on which taxpayer erected an office building. The lower court held that the replacement property was not of the "same general class" as the condemned property and therefore was not "similar or related in service or use" within the meaning of subsection (a). *Id.* at 294.

17. The term "like kind" was first used in section 1031 of the Internal Revenue Code

defined "like kind" as referring to "the nature or character of the property and not to its grade or quality."[18] For further clarification, the court cited *Commissioner v. Crichton*[19] which stated that "the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property."[20] Therefore, since both their improvements and their condemned property were real property, taxpayers qualified for nonrecognition under the definition of "like kind."

Additionally, the lower court looked to the purpose of the statute and whether or not the improvements made by taxpayers "re-establishes [their] prior commitment of capital."[21] Code section 1033 is to be liberally construed to accomplish this purpose. Referring to *Filippini v. United States*,[22] the court pointed out that under the "like kind" test, "it appears that the replacement of one investment property for another investment property, without regard to any dissimilarity of characteristics or uses, would be allowable."[23] Thus, in keeping with the spirit of the Code, the lower court found that taxpayers made a substantial continuation of their prior commitment of capital and specifi-

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of 1954 which provides nonrecognition for voluntary exchanges of "like kind" property. For the application of this section, the test is set forth in Treas. Reg. § 1.1031(a)-(1)(b) (1979). Treas. Reg. § 1.1033(g)-(1)(a) (1979) has adopted this same test to be used in the application of I.R.C. § 1033(g).

18. The definition of "like kind" in Treas. Reg. § 1.1031(a)-1(b) further provides:

> one kind of class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

19. 122 F.2d 181 (5th Cir. 1941). In *Crichton*, taxpayer exchanged her undivided interest in rights to oil, gas, and other minerals, all produced from rural lands, for undivided interests in a hotel. Using a broad interpretation of "like kind," the court held the exchange non-taxable under section 112(b)(1), Rev. Act of 1936, predecessor to I.R.C. § 1031(a). *Id.* at 182.

20. For the broad construction given the term "like kind" see Alabama By-Products Corp. v. Patterson, 258 F.2d 892 (5th Cir. 1958); Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953). *See also* 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION, § 20.171, at 803 (rev. ed. J. Malone 1972); Rev. Rul. 55-749, 1955-2 C.B. 295; Rev. Rul. 70-511, 1970-2 C.B. 166.

21. Filippini v. United States, 318 F.2d 841, 844 (9th Cir.), *cert. denied*, 375 U.S. 922 (1963).

22. 200 F. Supp. 286 (N.D. Cal. 1961).

23. *Id.* at 294. However, because the amended § 1033(g) was made expressly applicable only to the involuntary conversions of real estate occurring after the date of the taxpayers' conversion, the taxpayers in *Fillipini* could not benefit from the new amendment.

cally, that their improvements qualified for nonrecognition under the requirements of subsection (g).

D. CONTINUITY OF INVESTMENT UNDER SECTION 1033(a): THE "SIMILAR OR RELATED IN USE" STANDARD

Given taxpayers' substantial continuation of their prior commitment of capital, the Ninth Circuit held that the district court erred in concluding that improvements to the park were not "similar or related in service or in use" to their prior investment in agricultural land. Part of the basis of the court's opinion rested on public policy reasons which were attributed to the district court. Some attention was also given to additional factors identified as reasons for the lower court's granting a refund to taxpayers. The bulk of the opinion, however, concentrated on the appropriate use of the requirements in *Filippini* for determining the applicability of subsection (a). Whether or not the district court correctly granted relief under subsection (g) was a question never reached by the appeals court.[24]

Agreement with the "Unstated Opinion" of the District Court

In part, the Ninth Circuit attributed the district court's granting of a refund on several public policy reasons. First, it was virtually impossible for taxpayers to reinvest in agricultural land with an adjacent sea fishery. Hawaii had declared a public policy of absorbing ownership of sea fisheries into the public domain. Additionally, the state's plantation economy had changed to a mixed industrial, commercial, resort, and agricultural economy. What little agricultural land was available, would be unaffordable to prospective agricultural tenants.

The court of appeal also credited the lower court with the following reasons for their judgment. Virtually the same risk was attendant to taxpayers' investment in the Industrial Park as would have been in an investment in agricultural property. The cost of managing either industrial or agricultural tenants was substantially the same also. Finally, since taxpayers did not provide substantial management services to either the industrial or

24. As the court noted, even if it disagreed with the reasoning of the district judge, it could affirm the lower court's disposition "on any ground squarely presented on the record." 589 F.2d 446, 448 n.3. *See* Grosz v. Andrus, 556 F.2d 972, 974 n.3 (9th Cir. 1977); M.O.S. Corp. v. John I. Haas Co., 375 F.2d 614, 617 (9th Cir. 1967); *see also* Jaffke v. Dunham, 352 U.S. 280, 281 (1957) (per curiam).

agricultural tenants, the services provided were essentially alike.[25]

Interestingly enough, the Ninth Circuit enumerated all of the above reasons as the basis for taxpayers' refund granted by the district court. Yet the district court judge did not expressly include any of these factors in his opinion.

The Filippini *Influence*

In *Filippini v. United States,*[26] the taxpayer purchased urban property and erected an office building using money received from the condemnation of substantially rural property. The district court compared the characteristics and uses of the two properties and, after finding that the properties were dissimilar and not even of the "same general class," refused to allow nonrecognition of the taxpayer's gain. However, when the district court applied the same line of reasoning in *Davis,* the Ninth Circuit found the judgment in error. Rather the court interpreted *Filippini* to not require that the replacement property be of the "same general class" as the condemned property before it can qualify under subsection (a).[27]

Instead, the court adopted a long-established test to determine the applicability of subsection (a).

> The test is a practical one. The trier of fact must determine from *all* the circumstances whether the taxpayer has achieved a sufficient continuity of investment to justify nonrecognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments are such as to compel the conclusion that he has taken adantage of the condemnation to alter the nature of his investment for his own purposes.[28]

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25. All of these factors listed as reasons for the district court's judgment are factors which *Filippini,* 318 F.2d 841, requires in determining the applicability of the "similar or related in use" test. *See* notes 29 to 31 *infra,* and accompanying text.

26. 318 F.2d 841 (9th Cir.),*cert. denied,* 375 U.S. 922 (1963).

27. The court specifically rejected resolution of the issue by "simplistic talismanic rules." Rather, the court again emphasized the importance of using the test which compares all of the circumstances surrounding the two investments. That taxpayers' condemned agricultural land is not of the "same general class" as its improvements to the park is thus not determinative. Rather, taxpayers' relationship to the two investments controls. 589 F.2d at 450.

28. *Id.* at 449, *quoting* Filippini v. United States, 318 F.2d 841, 844-45 (9th Cir.), *cert. denied,* 375 U.S. 922 (1963).

To meet the requirements of *Filippini* the court of appeal considered a broad range of factors in determining taxpayer's relationship to both the condemned and replacement property in order to find a sufficient continuity of investment.[29] Since the taxpayers held both the condemned and the replacement properties to generate rental income, the inquiry specifically included "the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties."[30] General factors which influence the choice of any investment, such as the character of the particular properties and the market of which each is a part, were examined as well.[31] After applying the test to the facts of the instant case, the Ninth Circuit stated that taxpayers were entitled to relief under subsection (a).[32]

E. SIGNIFICANCE

The most important practical outcome of the *Davis* decision is that it substantially broadens the tax opportunities available to a taxpayer replacing involuntarily converted real property. In *Davis,* taxpayers, as recipients of a condemnation award, *expended* their proceeds for improvements on land that they already owned. Both the lower court and the Ninth Circuit held the property eligible for nonrecognition; although it generally has been held that a *purchase* of new replacement property is neces-

29. The Internal Revenue Service originally took the position that the statutory phrase, "similar or related in service or use" meant that the property acquired had to have a close "functional" similarity to the property converted. Under this test, the physical characteristics and the end use of the converted and replacement properties had to be similar. *See* Loco Realty Co. v. Commissioner, 306 F.2d 207, 211-14 (8th Cir. 1962). The Ninth Circuit and several other courts of appeals, however, rejected this approach. Filippini v. United States, 318 F.2d 841, 844-45 (9th Cir.), *cert. denied,* 375 U.S. 922 (1963); Clifton Inv. Co. v. Commissioner, 312 F.2d 719, 721-22 (6th Cir.), *cert. denied,* 373 U.S. 921 (1963); Pohn v. Commissioner, 309 F.2d 427, 429-30 (7th Cir. 1962); Loco Realty Co. v. Commissioner, 306 F.2d at 215 (8th Cir. 1962); Liant Record, Inc. v. Commission, 303 F.2d 326, 328-29 (2d Cir. 1962); Steuart Bros., Inc. v. Commissioner, 261 F.2d 580, 584 (4th Cir. 1958). The Service therefore reconsidered its position in regard to property held for investment, and now focuses attention on "the similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner." Rev. Rul. 64-237, 1964-2 C.B. 319, 320. The tax court has also adopted this test. *See* Wheeler v. Comm'r of Internal Revenue, 58 T.C. 459, 463 (1972); Johnson v. Commissioner, 43 T.C. 736, 741 (1965). *See also* 589 F.2d 446, 449 n.8.

30. *Id.* at 449. *See also* Filippini v. United States, 318 F.2d at 845, quoting Liant Record, Inc. v. Commissioner, 303 F.2d 326, 329 (2d Cir. 1962).

31. 589 F.2d at 449.

32. *Id.*

sary to qualify under 1033.[33]

As the Ninth Circuit illustrated in its opinion, the facts of the *Davis* case clearly qualified for nonrecognition within the spirit of the Code. Public Policy and the changing economic base of the state of Hawaii were correctly considered in deciding the case. The court's application of both the "similar or related in use" test and its flexible interpretation of *Filippini*,[34] not to require replacement property to be of the "same general class," were reasonable. All of the circumstances surrounding taxpayers' relationships to their investments had remained essentially the same. Thus, the appeals court's decision seemed clearly correct that in keeping with subsection (a), taxpayers' investment represents a sufficient continuation of their original investment.

Yet, there are several omissions which limit the usefulness of the *Davis* opinion. For years tax practitioners have struggled with the lack of clear guidelines for determining whether subsection (a) or (g) is the appropriate section to apply to qualify for nonrecognition of gain.[35] The Ninth Circuit's inattentiveness to these issues resulted in its loss of an opportunity to clarify some of this confusion. To the relative exclusion of all other authority, the court relied on *Filippini* in deciding *Davis*.[36] Most emphasized was the test used for determining the applicability of subsection (a). From the application of the "similar or related in service or use" test, the court concluded that taxpayers' reinvestment qual-

33. Before replacement property can qualify for nonrecognition under either subsections (a) or (g) of section 1033, it must first meet the requirement of having been acquired by "purchase". In *Davis*, taxpayers conceded that they did not "purchase" land in replacement of the condemned land. Rather, taxpayers "expended" money for improvements on other land which they already owned.

Following the reasoning of the court in Dettmers v. Commissioner, 430 F.2d 1019 (6th Cir. 1970), the district court was satisfied that the expenditures made by the taxpayers in *Davis* met the "purchase" requirement. In *Dettmers*, the court traced the legislative history of § 1033(a)(3). The court concluded that when the requirement that proceeds from the involuntary conversion be "expended" was replaced by timely "purchase," no substantive change was intended in the nature of the relief afforded under the statute. Additionally, the court believed that the reason the language was changed from "acquisition" to "purchase" was that "Congress wanted to specify that the acquisition be by purchase rather than, for example, by gift or devise." *Id.* at 1022.

34. *See* note 27 *supra*, and accompanying text.

35. *See generally* Willis & Steinmann, *Davis Decision May Increase Flexibility in Replacing Involuntarily Converted Real Property*, 56 TAXES 272 (1978); and Comment, *Involuntary Conversions and the Question of Qualified Replacement Property*, 38 OHIO ST. L.J. 331 (1977).

36. *See* cases cited at notes 37 and 38 *infra*.

ified for nonrecognition under subsection (a). In reinforcing its decision, the court reiterated, again from *Filippini,* that the purpose of section 1033 "is to relieve the taxpayer of unanticipated tax liability arising from involuntary conversion of his property . . . . The statute is to be liberally construed to accomplish this purpose."[37] Numerous cases and revenue rulings have addressed and decided controversies relating to the application of section 1033, many of which were used persuasively in counsels' arguments.[38] Yet the court ignored even the most relevant of these.[39]

Despite the court's holding being in complete agreement with Revenue Ruling 67-255,[40] this and all other pertinent rulings were left unacknowledged.[41] In Revenue Ruling 67-255, the Internal Revenue Service held that, "[l]and is not of the same nature or character as a building, or a storm drain, or a water system, or a road."[42] Thus, such improvements as these, on property already owned, were not deemed to qualify under the definition of "like kind." Rather, the facts were to be applied to the "similar

37. 589 F.2d at 450 (1979). *See also* Ponticos, Inc. v. Commissioner, 338 F.2d 477, 479 (6th Cir. 1964); Filippini v. United States, 318 F.2d 841, 844 (9th Cir.), *cert. denied,* 375 U.S. 922 (1963); Loco Realty Co. v. Commissioner, 306 F.2d 207, 215 (8th Cir. 1962).

38. *See* Commissioner v. P.G. Lake, 356 U.S. 260 (1958); Alabama By-Products Corp. v. Patterson, 258 F.2d 892 (5th Cir. 1958); Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953); Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941); Rev. Rul. 73-120, 1973-1 C.B. 369; Rev. Rul. 70-511, 1970-2 C.B. 166; Rev. Rul. 68-394, 1968-2 C.B. 338; and Rev. Rul. 67-255, 1967-2 C.B. 270.

39. Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953); Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941); and Rev. Rul. 67-255, 1967-2 C.B. 270.

40. *Id.* at 271. Taxpayer constructed a building on land already owned. The IRS held that neither the building nor storm drains, water systems and roads constructed on land already owned qualified as replacement property under § 1033(g) as being of a like kind to the land converted involuntarily. However, reference is made to Rev. Rul. 67-254, 1967-2 C.B. 269. Here investment of part of the proceeds of an involuntary conversion, in the construction of a garage on property already owned, qualified as replacement property under § 1033(a)(3)(A).

41. *See also* Rev. Rul. 76-391, 1976-2 C.B. 243 (construction of commercial building on land already owned by taxpayer held not to qualify as property of like kind to condemned farmland); Rev. Rul. 76-390, 1976-2 C.B. 243 (construction of motel on remaining portion of property held not to qualify as property of like kind to condemned mobile home park); Rev. Rul. 73-120, 1973-1 C.B. 369 (held that replacement of a utility company's water plant and appurtenant pipe lines, mains, etc., with a large apartment complex qualified as a like kind replacement); Rev. Rul. 71-41, 1971-1 C.B. 223 (construction of gas station on land already owned by taxpayer held not to qualify as property of like kind to condemned land and warehouse construction); Rev. Rul. 67-254, 1967-2 C.B. 269, (held that construction of improvements may be treated as a purchase of qualifying replacement property under section 1033(a) for condemned improved land where such improvements are "related in service or use" to the condemned improvements).

42. *Id.* at 270.

or related use" test of subsection (a). This was precisely the course followed by the Ninth Circuit, but no indication was given showing that to be its intention.

Finally, the most glaring shortcoming of the opinion was its lack of attention to subsection (g). Some investments may fall within the purview of both subsection (a) and subsection (g), though the focus of inquiry to determine the applicability of each subsection differ.[43] However, in its analysis, the court went directly to section 1033(a) and applied the test in *Filippini.*[44] After finding that the taxpayers qualified for relief under subsection (a), the court did not even reach the question of whether the district court correctly granted relief under subsection (g). In light of the expressed legislative intent of subsection (g), when added to the Code and the interpretation of its application by Revenue Ruling 67-255,[45] the district court quite logically reasoned the application of subsection (g) in this case. Considering the confusion that is enshrouded around the use of the subsection, the Ninth Circuit should have examined the lower court's application of subsection (g) and have provided a definitive statement to tax practitioners as to the appropriate selection and use of subsections (a) or (g) for nonrecognition of involuntary conversions.

Conclusion

From *Davis* it is now clear that construction of improvements on land owned by a taxpayer is a qualified replacement of converted land under section 1033. At least such is the case when the involuntary conversion is due to condemnation of property by the government. The "similar or related in use" test can be successfully applied for determining nonrecognition under subsection (a); since that was the vehicle used by the Ninth Circuit for this expansion of section 1033. However, still in question is whether this same type of replacement could qualify for nonrecognition under the "like kind" provisions of subsection (g).

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43. 589 F.2d at 448.

44. *See* note 28 *supra* and accompanying text.

45. *See* the discussions of the legislative history of § 1033(g) at notes 13 to 15, and note 42 *supra*, and accompanying text.

III. DEDUCTIBILITY OF START-UP COSTS OF BANK CREDIT CARD PROGRAMS

A. Factual Background

In *First Security Bank v. Commissioner,*[1] the Ninth Circuit held that costs initially incurred for participation in a national bank credit card system constituted ordinary and necessary expenses in carrying on a trade or business.[2]

For the 1966 taxable year, the First Security Bank of Idaho and the First Security Bank of Utah (the taxpayers) deducted fees paid to Bank-Americard Service Corporation under an agreement instituting a bank credit card system. The disputed deductions involved, for each bank, an initial, non-recurring payment of $12,500. Of this amount, $7,500 was allotted to the costs of a computer program and servicing. The other $5,000 covered costs for operating manuals, advertising and publicity aids, marketing "know-how," forms and agreements, training sessions and other instructions in setting up and running a credit card operation.[3]

The Commissioner of Internal Revenue (Commissioner or the Government) disallowed each deduction of $12,500, maintaining that the cost should have been capitalized since it was for a franchise right of indefinite duration.[4] The taxpayers filed a petition in Tax Court where the Commissioner argued that the expenditures were non-deductible pre-operating costs associated with the banks' entrance into a new line of business, or in the alternative, the costs were capital expenditures providing future economic benefits of an unknown duration.[5] The Tax Court, however, ruled against the Government and held that the costs were fully deductible.[6]

1. 592 F.2d 1050 (9th Cir. Mar., 1979) (per Kilkenny, J.; the other panel members were Duniway, J. and Belloni, D.J.).

2. I.R.C. § 162(a) (1954) provides: "(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

3. 592 F.2d at 1051. For a more complete description of the agreement entered into and the items for which expenditures were made, see Rolph and Ruempler, *Bank Credit Cards: The IRS 'New Business' Gambit,* 93 Banking L.J. 269, 273-77 (1976).

4. *Id.*

5. 63 T.C. 644, 649 (1975).

6. *Id.* at 649-51. The Tax Court cited Jack E. Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd,* 445 F.2d 985 (9th Cir.), *cert. denied,* 404 U.S. 940 (1971), in which it announced its policy of making decisions in accordance with the circuit to which the case

On appeal, the Ninth Circuit addressed the issue of whether the initial cost of participation in a bank credit card system constituted ordinary and necessary expenses incurred in carrying on a trade or business, deductible under section 162(a)[7] of the Internal Revenue Code. In affirming the Tax Court's decision, the court stated, without elaboration, that it adopted the decision of the Tenth Circuit in *Colorado Springs National Bank v. United States*[8] as the law of the Ninth Circuit.[9] It specifically approved two other cases, *First National Bank v. United States*[10] and *Iowa-Des Moines National Bank v. United States,*[11] which involved banks joining credit card programs.[12]

This Note will examine the Ninth Circuit's decision in *First Security Bank* as a part of a growing trend permitting deductibility of expenditures where no identifiable asset has been purchased or created. In addition, this Note will reveal the judiciary's reluctance to deny deductibility of start-up costs in developing new markets or new products by going concerns.[13]

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would be appealable. In *First Security Bank,* the taxpayers' cases were consolidated. Since one taxpayer was a Utah corporation, an adverse ruling would have been appealed to the Tenth Circuit which had previously decided the issues in favor of the taxpayer. *See* Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974). The Tax Court specifically noted that it was making no determination "as to our policy should we be faced with consolidated cases appealable to more than one circuit in which one of those circuits has spoken on a particular issue and we disagree with said circuit's position." 63 T.C. at 650 n.19.

7. 592 F.2d at 1051. For the relevant language of § 162(a), see text accompanying note 14 *infra.*

8. 505 F.2d 1185 (10th Cir. 1974).

9. 592 F.2d at 1052.

10. 558 F.2d 72 (4th Cir. 1977).

11. 68 T.C. 872 (1972), *aff'd,* 592 F.2d 433 (8th Cir. 1979).

12. The facts and issues presented in First Security Bank v. Commissioner, 592 F.2d 1050 (9th Cir. 1979); First Nat'l Bank v. United States, 558 F.2d 72 (4th Cir. 1977); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974); and Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. 872 (1972), *aff'd,* 592 F.2d 433 (8th Cir. 1979), were essentially the same and will be hereafter referred to as "the bank credit card cases."

13. The Internal Revenue Service (the IRS or Service) has pursued these issues aggressively with other types of businesses. Therefore, the reasoning in the bank credit card cases has application beyond that class of taxpayer. *See, e.g.,* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973) (expansion of a distribution system of a candy company); Madison Gas & Elec. Co., [1979] TAX CT. REP. DEC. (P-H) 72-284 (training expenses prior to operation of a nuclear power plant operated by the taxpayer and others as a joint venture); Jack's Cookie Co. v. United States, 597 F.2d 395 (4th Cir. 1979) (lease reserve payments made to a local government by a cookie company). At the time of *First Security Bank,* there were approximately 4,000 banks being challenged on the credit card start-up costs issues.

B. Were the Banks Entering a New Trade or Business?

In order for an expenditure to be currently deductible under section 162(a) of the 1954 Code, "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense.[14] In the bank credit card cases,[15] the Government never contended that the costs were not paid or incurred during the taxable year or that the costs were not a "necessary" expense.[16] Rather, the Government argued that the costs were start-up costs of a new business activity and, therefore, not deductible. It also argued that the expenditures were not "ordinary" expenses within the meaning of the Internal Revenue Code.

New Trade or Business Theory

In support of its first contention that the credit card system start-up costs were not deductible because the banks were entering a new trade or business, the Commissioner relied on *Richmond Television Corp. v. United States.*[17] In *Richmond Televi-*

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14. Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971).

15. *See* note 12 *supra.*

16. In Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 358, the Supreme Court stated: "Our decisions have consistently construed the term 'necessary' as imposing only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business.' "

17. 345 F.2d 901 (4th Cir.), *vacated on other grounds,* 382 U.S. 68 (1965). In *Richmond Television* no real problem was posed by expenditures which would have had to be capitalized regardless of when they were incurred. The difficult question involved costs which would have been currently deductible if incurred after the business became a "going concern." The court stated:

> The issue therefore is at what point of time did [the taxpayer's] business begin. . . . While decisions are to be found holding that particular taxpayers were or were not engaged in a trade or business, there is little discussion of the question of when, in point of time, a trade or business actually begins.

Id. at 905.

The Regulations issued under § 162 do not define what constitutes "carrying on a trade or business." In Snow v. Commissioner, 416 U.S. 500 (1974), the Supreme Court contrasted the words "carrying on a trade or business" under § 162(a) with § 174(a)(1) allowing deductions for experimental expenditures paid or incurred "in connection with a trade or business." The Court held the taxpayer was entitled to such deductions prior to the point where the product was marketable, stating that § 162 was "not helpful" in defining "in connection with a trade or business" since it was "more narrowly written." *Id.* at 503.

Compare the holding in *Richmond Television with* Treasury regulations issued under I.R.C. §§ 248 and 355. Section 248 provides that a corporation may elect to deduct its organizational expenditures over a period not less than 60 months beginning in the *sion*, the taxpayer had applied to the Federal Communications Commission (F.C.C.) for a license to operate a television station. A competitor had also applied for a license in the same area. Prior to receiving F.C.C. approval, the taxpayer bought out its competitor by reimbursing it for costs incurred in training television station operators. The taxpayer also incurred further training expenses before it went on the air. It deducted all these costs in the tax year prior to its receiving its broadcasting license.[18] The Fourth Circuit held that a taxpayer "has not 'engaged in carrying on any trade or business' within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized,"[19] and, therefore the court denied the deduction.

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month that the corporation began business. Treas. Reg. § 1.248-1(a)(3) (1956) provides:

> The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized. . . . If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

Treas. Reg. § 1.355-1(c) (1955), defines an "active business" for purposes of a distribution of stock of a controlled corporation.

> [F]or purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.

18. 345 F.2d at 904.

19. The $25,799.19 paid to acquire the competitor's trained staff was deemed "the acquisition of a capital asset whose value to the taxpayer would continue for many years, even though from time to time individual staff members could be expected to leave its employ. *Id.* at 907. *Accord*, Radio Station WBIR v. Commissioner, 31 T.C. 803 (1959) (legal and engineering fees, travel and other expenses of prosecuting its applications for an F.C.C. license); KWTX Broadcasting Co. v. Commissioner, 31 T.C. 952 (1959), *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959) (payment to competitor to dismiss its application for an F.C.C. license held to be in the nature of obtaining an intangible asset); Frank B. Polachek v. Commissioner, 22 T.C. 858 (1954) (costs incurred in planning a new business investment advisory service); Petersberg Television Corp. v. Commissioner, 20 T.C.M. (P-H)¶ 271 (1961) (costs related to seeking television license). The Fourth Circuit found particularly instructive Cohn v. United States, 57-1 U.S.T.C. (CCH) 9457 (D.C.W.D. Tenn. 1957), *aff'd on other grounds*, 259 F.2d 371 (6th Cir. 1958) (training,

In the bank credit card cases, the Commissioner attempted to extend this reasoning to new business activities undertaken by going concerns.[20] Only the *Colorado Springs* court discussed the issue thoroughly.[21] In *Colorado Springs,* the Tenth Circuit found that the credit card system enabled the banks "to carry on an old business in a new way,"[22] for example, by simplifying the procedures for granting loans on merchants' accounts receivables and on extending credit for personal consumer loans.[23] The court distinguished *Richmond Television* on the ground that the tax-

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legal and other expenses incurred prior to the opening of aviator training schools).

The holding in *Richmond Television* has been criticized. Erbacher, *Start-Up Costs: Are They Deductible by a Corporation for Federal Income Tax Purposes?* 48 TAXES 488 (1970); Solomon, *Tax Treatment of Pre-Opening Expenses,* 46 TAXES 521 (1968). In *J. Rabkin & M. Johnson, Federal Income Gift and Estate Taxation* § 3.02 (1963 & Supp. 1980), the authors state: "The Fourth Circuit has adopted the unrealistic rule that 'carrying on' a trade or business requires the performance of the ultimate activities for which the business was organized."

For other articles dealing with the subject of deductibility of start-up costs, see Buell, *Business Start Up Costs: Analyzing and Planning for Current Deductibility,* 43 J. TAX. 278 (1975); Mandell, *Deductibility of Pre-Operating Expenses: Successful and Unsuccessful Ventures,* 25 N.Y.U. INST. FED. TAX. 1235 (1967); Seago, THE TAX TREATMENT OF START-UP COSTS, 9 TAX ADVISER 410 (1978).

20. The Commissioner has not been very successful with the extension of the theory. *E.g.,* Hillcone Steamship Co. v. Commissioner, 22 T.C.M. (CCH) 1096 (1963) where a steamship company was permitted to deduct costs of raising hops, pasturing cattle, leasing stone quarries and cutting timber because these activities constituted a part of the operations of a farm purchased by the taxpayer and were not an effort to enter separate businesses. Realtors who concentrate in one area of real estate, such as residential real estate, may deduct expenses incurred in entering a different area of expertise, such as commercial real estate. Malmstadt v. Commissioner, 578 F.2d 520 (4th Cir. 1978); York v. Commissioner, 261 F.2d 421 (4th Cir. 1958). *See also* Equitable Life Ins. Co. v. Commissioner, 36 T.C.M. (CCH) 1184 (1977), where the Tax Court held that a subsidiary, organized to sell annuity life insurance contracts, had actually begun carrying on business when it made a private sale of such insurance to its parent's pension fund. "[The taxpayer's] business was not limited to public sales of insurance and annuity contracts, but simply sales of such contracts." *Id.* at 1189.

Cf. Madison Gas & Elec. Co., [1979] TAX CT. REP. DEC. (P-H) 72-284 (1979), where the taxpayer entered into a joint venture to open a nuclear power plant. As part of the cost of participation in the enterprise, the utility incurred costs of training personnel to operate the power plant once it came on line. The Tax Court held that the expenses "were those of the partnership, not the [utility], and that as pre-operational costs of the partnership's initial activity those expenditures must be capitalized." *Id.* at 72-310. However, the Commissioner conceded that had the construction of the nuclear plant been solely for use in business, such pre-operating expenses would have been currently deductible.

21. With the exception of *Colorado Springs,* the remaining bank credit card cases merely adopted the reasoning of *Colorado Springs.* First Security Bank v. Commissioner, 592 F.2d at 1052, *aff'g* 63 T.C. at 649; First Nat'l Bank v. United States, 558 F.2d at 723-24; Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. at 877-78.

22. 505 F.2d at 1190.

23. *Id.*

payer was not in business during the years the expenses were incurred.[24] Therefore, the *Colorado Springs* court concluded: "A new method [of doing business] is distinguishable from a new business."[25]

Future Benefits vs. Asset Creation

Having decided that the banks were already engaged in the trade or business of credit arrangements, the courts in the credit card cases turned to the more far-reaching question of whether the banks had acquired something which would benefit future economic periods, and if so, whether this circumstance alone required capitalization of the expenditure.

In *First Security Bank*, the Commissioner argued that the taxpayers had acquired "several new, separate assets" when they made the initial payments on the BankAmericard system.[26] Prior to *First Security Bank*, however, the Commissioner had insisted that the initial one-time payments should be capitalized under section 263[27] because it "provides future economic benefits of an

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24. *Id.*

25. *Id.* The court found the facts in Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973), *rev'g* 31 T.C.M. (CCH) 171 (1972) more persuasive. In *Briarcliff*, the taxpayer was a New York candy company. In order to recapture sales lost when people moved to the suburbs, it set up a "franchise" division to make agency and "franchise" agreements with drugstores and other merchants. The taxpayer deducted its costs incurred as part of this promotional campaign. The Second Circuit held that taxpayer's expenditures fit clearly within the long-standing principle allowing an ordinary and necessary expense deduction for costs incurred in protecting an existing investment, a continuing business or preserving existing income from loss or diminution. *Id.* at 787 (citations omitted).

26. 592 F.2d at 1052.

27. I.R.C. § 263 (1954) includes "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Treas. Reg. § 1.263(a)-2 (1958) gives the following examples of capital expenditures:

> (a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.
> (b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments.
> (c) The cost of defending or perfecting title to property.
> (d) The amount expended for architect's services.
> (e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commis-

unknown duration."[28] The courts gave little weight to the Government's theory[29] and instead embraced the trend which re-

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sions may be treated as an ordinary and necessary business expense.
(f) Amounts assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. Such amounts are capital investments and are not deductible. *See* section 118 and § 1.118-1.
(g) A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.
(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

28. *See* First Nat'l Bank v. United States, 413 F. Supp. 1107, 1111 n.5 (D.S.C. 1976), *aff'd,* 558 F.2d 721; Colorado Springs Nat'l Bank v. United States, 505 F.2d at 1191; First Security Bank v. Commissioner, 664 T.C. at 649. In Iowa-Des Moines Nat'l Bank v. United States, 867 T.C. 872, 878 the Government argued that the expenses were "nonrecurrent and gave rise to assets or *secured benefits* having an indefinite useful life." (Emphasis added).

29. The future benefits argument arose out of dicta in Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950), where the court stated that an expenditure should be capitalized "if it brings about the acquisition of an asset having a useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year." This language was repeated verbatim in United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957), *cert. denied,* 355 U.S. 956 (1958). However, in *Colorado Springs,* the Tenth Circuit pointed out that the future benefits argument enunciated in *Hotel Kingkade* and *Akin* had been "to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute role requiring the automatic capitalization of every expenditure of providing the taxpayer with a benefit enduring for a period in excess of one year." 505 F.2d at 1192, *quoting* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). The court further distinguished all cases which involved "acquisitions of, or improvements to, a distinct and recognizable property interest. Participation in the Master Charge system has no extrinsic or marketable value. It creates no property right." 505 F.2d at 1192.

At the Tax Court level, the Government in *First Security Bank* cited the Tenth Circuit cases and three other cases to support its future benefits argument. 63 T.C. 644. Two cases involved a recognizable intangible asset—Dow Corning Corp. v. Commissioner, 53 T.C. 54 (1969) (costs for use of a trademark) and Radio Station WBIR, Inc. v. Commissioner, 31 T.C. 803 (1959) (costs of acquiring a television station license). The third case, Glenn L. Heigerick v. Commissioner, 45 T.C. 475 (1966), involved a physician's payments for medical staff privileges at a hospital. The Tax Court, however, without much discussion, cited Cubbedge Snow v. Commissioner, 31 T.C. 585, 593 (1958):

> [W]hile capital expenditures ordinarily result in the acquisition of assets having periods of useful life in excess of 1 year, it does not follow that an expenditure must be deemed a capital outlay merely because the ultimate benefit may accrue in a year or years subsequent to the year or payment.

ceived its impetus, if not its inception, from the Supreme Court's asset-creation approach enunciated in *Commissioner v. Lincoln Savings & Loan Association.*[30]

In *Lincoln,* the Supreme Court summarized the previous decisions dealing with the meaning of ordinary and necessary expenses and stated: "The principal function of the term 'ordinary' in section 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset."[31] The Court specifically rejected the Government's argument that the "presence of an ensuing benefit that may have some future aspect is . . . controlling."[32] The Court then enunciated the basic test:

In *Cubbedge Snow,* the taxpayer attorneys deducted payments made to a savings and loan which they had started with the explicit objective of promoting an additional source of legal fees from title searches.

Finally, in the remaining bank credit card cases, Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. 872, 879, and First Nat'l Bank v. United States, 413 F. Supp. 1107, 1112 (D.S.C. 1976), *aff'd,* 558 F.2d 721, the courts again rejected and disposed of the Government's future benefit theory. In *Iowa-Des Moines Nat'l Bank,* the Tax Court held that the "mere presence of some possible future benefit from an expenditure is not controlling where such payment was made to promote the taxpayer's existing business and does not create or enhance a separate and distinct asset or property interest." 68 T.C. at 879. In *First Nat'l Bank,* the Government cited Georator Corp. v. United States, 485 F.2d 283, 285 (4th Cir. 1973) where the *Georator* court commented: "Nor is it necessary that an expenditure increase the value of an asset in order to be classified as a capital expenditure. . . . Costs of defending title to property, although adding nothing to the value of the property, have been held to be capital expenditures." The district court noted that the Government's reliance on this passage was misconstrued if it was argued that there need be no asset at all to which items classified as capital expenditures can be tied. 413 F. Supp. at 1112. It went on to say that *Georator* involved a definite asset—a trademark—and was not inconsistent with permitting deduction in full of the bank credit card start-up costs "where neither party can identify or define any asset upon which taxpayer's assessment expenditures have had any effect." *Id.*

30. 403 U.S. 345 (1971). In *Lincoln,* the taxpayer paid premiums to the Federal Savings and Loan Insurance Corporation, a corporation created by § 402 of the National Housing Act, 12 U.S.C. § 1725 (1969). The payments were made to a general reserve and to a secondary reserve, in which each savings and loan had a pro rata share. It was the payments to this secondary reserve which the Court held to be non-deductible.

31. *Id.* at 353, *citing* Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966).

32. 403 U.S. at 354. In the bank credit card cases, the Government cited United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972), as authority for its future benefits test. In *Mississippi Chemical,* the taxpayer argued that certain payments made to a farm cooperative established by Congress were, in fact, hidden interest charges and, therefore, deductible. The Court held that it was a payment for a security interest, stating that "since the security is of value in more than one taxable year, it is a capital asset. . . ." *Id.* at 310. The Government's reliance on *Mississippi Chemical* is misplaced since the *Mississippi Chemical* Court devoted its entire analysis on whether or not the payments were for the purchase of an asset.

> What is important and controlling, we feel, is that the . . . payment serves to create or enhance for [the taxpayer] what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) in the absence of other factors not established here.[33]

In *Briarcliff Candy Company v. Commissioner,*[34] the Second Circuit interpreted the *Lincoln* holding as "[bringing] about a radical shift in emphasis and directing the inquiry . . . to the question whether or not [the taxpayer] ha[s] created or enhanced . . . what was essentially a separate and distinct additional asset."[35] The Court noted that prior to 1971, the often repeated and generally applied standards had been that if an expenditure resulted in agreements or other benefits for a term exceeding one year, it was not ordinary but capital in nature.[36] However, since the courts have consistently rejected the Government's future benefits argument,[37] the majority view among the federal courts is the Second Circuit's interpretation of *Lincoln.*[38]

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33. 403 U.S. at 354.

34. 475 F.2d 775 (2d Cir. 1973). *See* note 25 *supra.*

35. *Id.* at 782. One commentator points out that the earlier approach began with an analysis of deductibility of business costs, by first determining whether the cost was "ordinary" or "necessary" under § 162(a). Modernly, the courts first determine whether the expenditure must be capitalized under § 263. *See* Note, *Market Development Costs: Business Expense or Capital Investment?,* 40 BROOKLYN L. REV. 1447, 1449 (1974).

The view that *Lincoln* represents a radical shift in emphasis is disputed. For a thorough discussion of the subject matter, see Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset,* 15 B.C. INDUS. & COM. L. REV. 443, 444 (1974).

One commentator views the bank cases as a trend in which the question of deductibility or non-deductibility is resolved along the lines of generally accepted accounting principles. See, Brown and Lee, *Deductibility of Start-Up Expenditures Under Section 162—The "Clear-Reflection-of-Income" Test,* 61 CORNELL L. REV. 618, 631-38 (1976).

36. *Id.* at 782.

37. *See* the bank credit card cases, note 12 *supra*; *see also* note 29 *supra* and accompanying text.

38. This question does not appear to have been litigated in the First, Third, Fifth, Sixth or Seventh Circuits. The Court of Claims recently considered whether a company could deduct the cost of a survey of its oil and gas reserves, stating:

> The prior decisions on the tax treatment of the cost of producing surveys said to be comparable to [this] report all seem to have gone off on the postulate of considering the survey as part of some underlying property.
>
> In this instance, however, *the Government disavows* that approach and asks us to treat the . . . report by itself, as property having a useful life in taxpayer's business lasting beyond the taxable year. . . .

Therefore, on appealing *First Security Bank* to the Ninth Circuit, the Commissioner chose not to rely on the "future benefits" approach. Instead, the Government argued that the cost was for purchase of several assets, including the right and license to use the BankAmericard service marks and distinctive emblem, promotional materials and a computer program.[39] The Ninth Circuit, however, affirmed the Tax Court findings that: (1) the right to use the BankAmericard indicia was not within the scope of the initial costs paid, since a bank, already possessing the operation know-how and computer programming, would not have been required to pay the initial fees;[40] and (2) there was nothing to differentiate the promotional materials from other advertising and office supplies which are deductible.[41]

Two judges on the Ninth Circuit panel were "unable to distinguish between the 'computer costs' involved in the *Colorado Springs* case and the amounts paid for a 'computer program' " by the Idaho and Utah banks.[42] Judge Duniway disagreed.[43] He

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> Our difficulty with that line-of-reasoning is that the [engineer's] report, if "property" is not the kind of property which should be capitalized by itself, even if its usefulness happens to last beyond the year in which it is produced. [The] study was scarcely the sort of "separate and distinct asset" that the Court in *Lincoln Savings & Loan Association* . . . found "important and controlling."

Southland Royalty Co. v. United States, 582 F.2d 604, 616-17 (Ct. Cl. 1978) (citations omitted).

39. 592 F.2d at 1052. This was not the first time that the Commissioner sought to identify several assets. In *Colorado Springs*, the district court ruled in favor of the Commissioner that an initial $10,000 membership fee paid to Master Charge was a capital expenditure. The fee was a one-time, non-refundable payment that could not be separately transferred. The taxpayer did not appeal this ruling. 505 F.2d at 1187-88. *Accord*, Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. 872 (1977), where the Government argued that payments to a telephone solicitation concern responsible for creating a list of approved credit customers, similar to a subscription or customers list, were costs which must be capitalized. The Tax Court disagreed holding that the cost was merely for credit screening which was an expense normally incurred by the bank. 68 T.C. at 880, *aff'd on this point*, 592 F.2d 433 (8th Cir. 1979).

40. 592 F.2d at 1052.

41. *Id.*

42. *Id.*

43. *Id.* at 1053 (Duniway, J. dissenting). It appears that Judge Duniway was correct. In *Colorado Springs*, the computer costs were for keypunching and inserting its customer account data into the computer system, in addition to fees paid for the addition of each new merchant and cardholder to the system, as well as a maintenance fee. 505 F.2d at 1187. This would appear to differ from a computer program, which is a set of coded instructions so that the computer can accept and manipulate the data on a recurring basis. However, the Tenth Circuit compared the functions of a computer program with the training of clerks, finding that "[c]omputer charges are recurring just as are clerical

compared computer programs to a punched paper music roll used to activate a player piano. He noted that if a restaurant owner bought a player piano for his establishment, he would be required to amortize the cost of the music rolls over their useful life, whereas, if he paid a musician to play for the diners, the wages would be ordinary expenses.[44]

C. ANALYSIS

In *First Security Bank*, the Ninth Circuit, in ruling that initial costs for participating in a national bank credit card system are deductible as ordinary and necessary expenses, has joined a marked trend by courts. This trend permits a taxpayer already engaged in a trade or business to deduct expenses of expanding markets or new product lines if they are at all related to the products of services already provided by the going concern. It is clear, too, that the Ninth Circuit, as well as other courts, are concerned that if *Richmond Television* was extended to include existing businesses, national economic growth and profits might be inhibited.[45] Illustrating this concern, the district court in *First*

salaries." *Id.* at 1191. There is one difference, however. The computer program can be sold to someone else; the clerk cannot.

44. 592 F.2d at 1053.

45. As the Tenth Circuit in *Colorado Springs* noted: "The intent to make a future profit is obvious. Changes in methods of operation often have a direct bearing on costs and profits. . . . The credit card system takes advantage of modern technology. . . . To paraphrase the Comptroller [of the Currency], the use of these modern facilities furthers the objectives of our expanding national economy." 505 F.2d at 1190.

The Government is not likely to prevail in extending *Richmond Television* to include existing businesses, except in cases where a taxpayer sets up subsidiaries either in corporate or partnership form. It was recently reported that the

> Appeals Office in a District located in the Fourth Circuit is of the opinion that the *Richmond Television* case applies where expansion activities of an ongoing business are conducted by the use of separately incorporated subsidiaries. In the matter before the Appeals Office, the taxpayer, a consolidated group, was engaged in a service-type business, and had multiple operations, each operation conducted by a separately incorporated subsidiary. It is the position of the Appeals Office that had taxpayer's activity been conducted by divisions rather than subsidiaries, preopening expenses would not be at issue.

ABA Section on Taxation, *Points to Remember*, 32 THE TAX LAWYER 790 (1979).

However, in Baltimore Aircoil Co., Inc. v. United States, 333 F. Supp. 705 (D. Md. 1971), a parent corporation was permitted to deduct certain expenses in connection with opening a plant for a California subsidiary. The taxpayer filed consolidated returns. The Commissioner argued that "the trade or business of [the California subsidiary was] not the trade or business of Aircoil since they [were] separate and distinct entities, each engaged in separate, though similar, trades or businesses. The Government argued that the payments by Aircoil are capital contributions. . . ." *Id.* at 709. The court, applying the

National Bank prefaced its discussion of this issue by noting that "[t]he vital role which bank credit cards play in modern American Society is unquestionably a property subject for judicial notice."[46]

The courts have also been reluctant to adopt a future benefits test, as promulgated by the Commissioner, especially where the taxpayer is not permitted to amortize the costs that are capitalized. As the Tenth Circuit stated in *Colorado Springs*:

> We do not know how the useful life of the asset, which the government says was acquired, would be determined. The government insists that the point is immaterial because we are not concerned with amortization . . . . The government's theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.[47]

"substance over form" doctrine in favor of the taxpayer found that the California subsidiary was a "mere branch or division" of the parent. *Id.* at 771.

But see Madison Gas & Elec. Co., [1979] TAX CT. REP. DEC. (P-H) 72-284, where an electric utility was denied deduction of the cost of training nuclear plant employees where the nuclear power plant was to be conducted through a joint venture with other employees. The Government relied on *Richmond Television;* the taxpayer relied on *Baltimore Aircoil.* The court distinguished the utility's position from that in *Baltimore Aircoil* on the ground that the utility did not wholly own the nuclear power plant and that economic realities necessitated the need for joint ventures. *Id.* at 72-309.

46. 413 F. Supp. at 1110. A footnote, however, points out that "[t]he astronomical balances and resulting interest charges which some cardholders inflict upon themselves lead the court to question whether the cards are a boon to the consumer as well as to the banks. In retrospect, to those of a more conservative philosophy, bankcards are immoral for encouraging debt, sometimes reckless debt." *Id.* at 1110 n.4.

47. 505 F.2d at 1192. This sentiment echoes that of the Second Circuit in *Briarcliff* where the court remarked that "it [was] anybody's guess" as to what intangible assets were deductible. 475 F.2d at 782. The court stated:

> The interpretation and application of the statutes and regulations with regard to tangibles in deciding whether a particular expenditure is for repairs or for a capital addition or improvement are sometimes difficult, but guidelines have been established which give a taxpayer clues as to what is correct and what is not.
>
> In the realm of intangibles, however, the rulings and decisions are in a state of hopeless confusion particularly where the issue concerns an intangible contribution . . . to an intangible asset. . . . Many decisions in this area rest upon administrative fiat, fortified by the requirement that the taxpayer show clear error. . . . The taxpayer, who may be exposed to interest and

The Government's position, extended to its logical conclusion, would require the capitalization of nearly all costs of a business, because they are incurred to create or enhance a valuable intangible asset—goodwill, which is the sum total of the preservation and improvement of existing income.[48]

The courts have also found it difficult to find some distinct guidelines to simplify the determination of what expenses are ordinary, particularly where no tangible asset or clearly identifiable intangible asset is involved. However, the bank cases indicate that courts believe, that because of *Lincoln,* they have found some ground with which they are familiar in rendering federal income tax decisions. The Supreme Court's test requiring a "distinct and recognizable property interest" has been the touchstone.[49]

The courts in the bank cases have mentioned several factors which would have to be present in order to find that such a property interest exists. Foremost is that the "thing" should be saleable,[50] transferrable,[51] or have a marketable value.[52] Other qualities courts mention include an "asset from which [the taxpayer can] . . . recoup assessments,"[53] that has "intrinsic value,"[54] amounts to "a property right,"[55] is something "corporeal"[56] and non-"recurring."[57] Thus, it would appear that if the

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> penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are.

Id. at 785.

Generally the costs of most intangible assets are not amortized. However, a few exceptions have been permitted. Organization expenditures of a corporation (IRC § 248) and the costs of developing newspaper or magazine circulation (§ 173) may be amortized over a period of not less than 60 months. In 1956, Congress amended the Code to permit 60-month amortization for trademarks (IRC § 177), and organizational costs of partnerships. (IRC § 709).

48. Goodwill cannot be amortized. Treas. Reg. 1-167(a)(3).

49. Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. at 355.

50. First Nat'l Bank v. United States, 558 F.2d at 723, Colorado Springs Nat'l Bank v. United States, 505 F.2d at 1192; Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. at 878.

51. First Nat'l Bank v. United States, 558 F.2d at 723.

52. Colorado Springs Nat'l Bank v. United States, 505 F.2d at 1192.

53. First Nat'l Bank v. United States, 558 F.2d at 723.

54. *Id.*

55. Colorado Springs Nat'l Bank v. United States, 505 F.2d at 1192.

56. *Id.*

57. *Id. See also* First Nat'l Bank v. United States, 413 F. Supp. at 1112; Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. at 879. The criteria mentioned conform to

Service is to prevail in future cases, it will have to be able to articulate the asset which has been created or enhanced. Indeed, it has already begun to do so, with success.[58]

Taxpayers, on the other hand, will need to structure their arrangements so that the expenditures are closely related to usual and recurring expenses, rather than the acquisition of a property right. An example of successful structuring can be seen in the BankAmericard contracts entered into by the Idaho and Utah banks. The initial one-time fees were apportioned among various services and supplies which the banks were to receive.[59] However, some Master Charge contracts, which did not apportion the costs of the initial payment, were held to be membership fees which must be capitalized.[60]

D. Conclusion

The Ninth Circuit, in its brief and conclusionary opinion in *First Security Bank,* has incorporated a number of cases, the weight of which will inure to the benefit of those taxpayers who are planning to make expenditures to expand their business, enter new fields or adopt new methods. In so doing, it is likely they will prevail against the Government in deducting those costs unless a recognizable intangible asset is involved.

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the opinion of the Second Circuit, which noted that § 263(a) could apply to intangible assets "provided they have an ascertainable and measurable value in money's worth, so that they are no longer regarded as an expense but as a distinct and recognized property interest." Briarcliff Candy Corp. v. Commissioner, 475 F.2d at 785 (2d Cir. 1973).

58. See Madison Gas & Elec. Co., [1979] Tax Ct. Rep. Dec. (P-H) 72-284; Jack's Cookie Co. v. United States, 597 F.2d 395 (1979) (reserve payments in monthly rental payments made to a governmental agency, placed in a fund required by bond agreements, must be capitalized).

59. First Security Bank v. Commissioner, 63 T.C. at 646, 647 n.9.

60. Colorado Springs Nat'l Bank v. United States, 505 F.2d at 1187. Iowa-Des Moines Nat'l Bank v. United States, 68 T.C. at 880-81. In First Nat'l Bank v. United States, 558 F.2d 721, the banks were members of a non-profit corporation formed to establish a computerized system under Master Charge. There was no stock and no stockholders. The bank members had no interest in the assets, and upon dissolution of the corporation, all of its net assets were to be paid to a tax-exempt organization. The members' initial fees were specifically for costs of the organization and were computed in a manner similar to the monthly recurring charges. *Id.* at 723.

IV. OTHER DEVELOPMENTS IN TAX

In *Bing Crosby Productions v. United States,* 588 F.2d 1293 (9th Cir. Jan., 1979), the court examined whether motion picture and television films and tapes qualify for an investment tax credit. The court held that the master negatives and intermediate printing articles qualified for investment tax credit. The court also held that as long as property is located within the United States for 50% of the year, its predominant use is considered to be within the United States.

In *McDonnell Douglas Corp. v. General Telephone Co.,* 594 F.2d 720 (9th Cir. Jan., 1979), a telephone customer brought suit against the telephone company seeking to recover excise taxes paid on telephone services. The district court granted the telephone company's motion for summary judgment and the customer appealed. The court of appeals, adopting a Second Circuit holding, held that the Excise Tax Reduction Act of 1965 did not impose any duty on the telephone company to separate charges for private branch exchange services from charges for normal telephone services in its bills to the customer, and therefore left the billing practices within the utility's discretion.

In *Wood v. United States,* 590 F.2d 321 (9th Cir. Jan., 1979), a taxpayer brought suit to recover income taxes paid on a lump sum received upon termination of employment due to disability. The taxpayer's company plan included both a profit sharing funded retirement plan and disability coverage. The court noted that the nature and taxable status of a payment must be determined by the event that triggers payment. Since the payment was made on the basis of disability, the court held that the lump sum was excludable from income.