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TAX BENEFIT RULE AND RELATED DOCTRINES AS APPLIED TO THE RECAPTURE OF RESEARCH AND OTHER INTANGIBLE DEVELOPMENT COSTS

MATTHEW B. KRASNER*

PREFACE

As this article was being edited for publication, the Internal Revenue Service ("Service") promulgated Revenue Ruling 85-1861 in which it reversed the long-standing position set forth in Revenue Ruling 72-528,¹ that deductions claimed for research and development costs pursuant to section 174(a)³ of the Internal Revenue Code⁴ must be recaptured as ordinary income pursuant to application of the tax benefit rule⁵ upon the subsequent sale of the developed technology. That reversal validates the conclusion of this article, but does not confirm its principle thesis that the tax benefit rule operates to require the recognition of income but does not characterize income recognized without benefit of the operation of the rule.

Precisely that issue was presented by the facts of the revoked revenue ruling. There the proceeds of insurance from the destruction of a pilot model whose development costs had been deducted pursuant to section 174(a) were taxed as ordinary income by applying the tax benefit rule. Ordinarily, such insurance proceeds would have been accorded capital gain treatment.⁶ The effect of applying the rule was not merely to recognize income that would otherwise escape taxation but to convert capital gain to ordinary income. That result was based on the ruling's erroneous assump-

* Assistant Professor, Columbus School of Law, Catholic University of America; A.B., University of Chicago, 1951; B.S. Economics, University of Pennsylvania, 1953; LLB., Harvard Law School, 1956; J.D. Georgetown Law Center, 1961.
¹ 1985-46 I.R.B.
³ See infra note 25.
⁵ See infra note 18 and accompanying text.
⁶ See infra note 26.
tion that the insurance proceeds were in fact a recovery of the previously deducted research and development expenses. Those costs, however, had been transmuted into the technology represented by the pilot model. The insurance proceeds represented a recovery of the value of the newly developed technology, not of the previously deducted development expenses. The recovery of an expense necessary to application of the tax benefit rule was absent. Moreover, the Code has specific recapture provisions that apply to the disposition of property to recharacterize capital gain as ordinary income. These provisions are inapplicable to the disposition of technology whose costs have been deducted pursuant to section 174(a) and the ruling should not have applied the tax benefit rule to vitiate the mandate of these specific statutory rules.

Relying on the "fundamentally inconsistent event" test enunciated by the Supreme Court in *Hillsboro National Bank v. Commissioner,* the new ruling reverses the consequence of this error by holding that the tax benefit rule is inapplicable for purposes of recapturing research and development costs previously deducted pursuant to section 174(a). According to the *Hillsboro* standard, the tax benefit rule may be invoked if an event occurring in a subsequent year is fundamentally inconsistent with the premise upon which the prior year’s deduction was based. That determination requires an analysis of whether the prior year’s deduction would have been permitted had the subsequent event occurred in the year of the deduction, taking into account the purpose and function of the provision allowing the earlier deduction.

Revenue Ruling 85-186 provides the following required analysis in applying the *Hillsboro* standard. Legislative history indicates that section 174 has two purposes: to encourage research and experimentation and to eliminate the necessity of allocation between those research costs that are currently deductible and those properly chargeable to capital account. These purposes are considered fulfilled in the year of the deduction, since it would be inconsistent to grant relief from the requirement to allocate costs in the year of the deduction only to impose it in the year in which the technology is sold. It is concluded, therefore, that the subsequent sale of the developed technology is an event of independent significance, which is not fundamentally inconsistent with the purpose of the

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7 See infra notes 43-44.
prior deduction.

This analysis is instructive not only in confirming the inapplicability of the tax benefit rule to research and development expenses currently deducted under section 174(a), but also to currently deductible development costs of other intangibles such as circulation lists under section 173,9 and trademarks and tradenames under section 177.10 The legislative history11 of both these provisions parallels that of section 174 in its intended alleviation of the practical problems of allocation between those development costs that are currently deductible and those that are properly chargeable to capital account. With this similarity of legislative history it would be difficult to justify a difference in result. The ruling does, however, leave open the question of amortization deductions taken pursuant to section 174(b). In that instance, the application of the tax benefit rule must be reconciled with the depreciation recapture rules of section 1245.12

More importantly, Revenue Ruling 85-186 and its predecessor, Revenue Ruling 72-528, both involve an economic recovery resulting from a sale rather than an event, as in Hillsboro, that of itself does not require the recognition of income. Why then is the “fundamentally inconsistent event” standard of Hillsboro used, rather than an analysis that seeks to resolve the issue, presented by the facts of both rulings, of whether or not recognized income should be recharacterized by application of the tax benefit rule? By failing to address this issue directly, the ruling creates a degree of uncertainty as to its scope, as well as to the possible continued application of the tax benefit rule to recharacterize recognized income, at least in those circumstances in which the transaction resulting in the recognition of income constitutes a fundamentally inconsistent event.

For example, suppose a taxpayer acquires the stock of corporation X for $100 plus an additional sum based on X’s earnings computed by the seller’s accountant. That computation results in an additional payment of $50. The X stock is sold later in the taxable year for $225 and a long term capital gain of $75 is reported. Soon thereafter it is determined that the accountant miscalculated the contingent portion of the purchase price and the taxpayer re-

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9 See infra note 118.
10 See infra note 119.
11 See infra note 120.
12 See infra note 87 and accompanying text.
ceives a refund in the succeeding taxable year of a portion of the original purchase price in the amount of $10. Must that refund be reported as ordinary income pursuant to the tax benefit rule, or is it merely an additional capital gain reflecting an adjustment to the taxpayer’s basis of the stock sold? Clearly the refund is fundamentally inconsistent with the gain as previously reported, since had the refund been received in the same taxable year as the original purchase and sale, it would have constituted an adjustment to the basis of the stock and thereby increased the reportable capital gain. Indeed, there is authority,\textsuperscript{13} on facts similar to these, that applies the tax benefit rule to tax the refund as ordinary income.

Nevertheless, it is submitted that the refund postulated in the example should not result in ordinary income. The tax character of the refund should be determined in a manner that is consistent with the event to which it is related—the capital cost of the stock—and not by arbitrarily classifying it as ordinary income because that income is recognized through application of the tax benefit rule. In the example the need for a refund would not have occurred but for the stock purchase and the two events are, therefore, integrally related. Under these circumstances the rationale of \textit{Arrowsmith v. Commissioner}\textsuperscript{14} should be applied to characterize the refund as capital gain rather than ordinary income, despite the applicability of the tax benefit rule.\textsuperscript{15}

This is wholly consistent with the application of the “fundamentally inconsistent event” test as applied in Revenue Ruling 85-186, in which the sale of the technology was considered to have significance independent of the deduction taken under section 174(a) for the development costs of that technology. Because the sale was an independent event it was not inconsistent with the prior deduction, and the tax benefit rule was held to be inapplicable. Similarly, the lack of interdependence between the two events destroys the relationship necessary under \textit{Arrowsmith} for characterizing the later transaction consistently with the earlier transaction. Thus, under the facts of the ruling, the tax benefit rule is inapplicable and the character of the gain recognized on the dispo-

\textsuperscript{13} Mittelman v. Commissioner, 7 T.C. 1162 (1946).

\textsuperscript{14} 344 U.S. 6 (1952).

\textsuperscript{15} See Deely v. Commissioner, 73 T.C. 1081, 1096-97 (1980). In Deely, the \textit{Arrowsmith} rationale was applied to characterize the recovery of a non-business bad debt as a short term capital gain rather than as ordinary income because the debt was initially deducted under I.R.C. § 166(d) (West Supp. 1985) as a short term capital loss. See 73 T.C. at 1096-97.
sition of the technology is determined by the tax characteristics of that disposition, not by those of a prior event. When, however, the deduction and subsequent recovery (or other fundamentally inconsistent events) are mutually interdependent, as in the example, the rationale of *Arrowsmith* should be applied in conjunction with the tax benefit rule to determine the character of the income recognized. This is only appropriate, given that the object of both the tax benefit rule and *Arrowsmith* is to provide transactional equity.\(^\text{16}\)

A variation of the example presents another question left unanswered by the Service’s reversal of position. Suppose the property acquired by the taxpayer was depreciable property rather than stock, that the rebate of $10 represents payment by the seller with respect to a breach of a warranty, and that the rebate is received by the taxpayer in the year following the purchase and a subsequent resale. Assume further that the taxpayer deducted $30 of depreciation with respect to the property prior to resale. The same issue of the tax character of the recovery is presented, but the analysis is complicated by the fact that the taxpayer depreciated the overstated basis prior to resale. Should the recovery be taxed as ordinary income pursuant to the tax benefit rule? If so, what consideration should be given to the ordinary income previously recognized at the time of disposition of the property pursuant to the depreciation recapture rules? In this circumstance, the depreciation recapture rules would have been applied to the sale of the equipment in the earlier year, with the result that $30 of the $105 aggregate gain would have been taxed at ordinary rates and the $75 balance as long term capital gain. If, as a consequence of the application of the tax benefit rule, the $10 recovery were taxed as ordinary income rather than as capital gain, the result would not conform to that which would have obtained had all of the transactions occurred in a single taxable year—an unacceptable result if transactional equity is the effect desired.

If the $10 recovery is accorded capital gain treatment, however, the same result would be achieved as that which would have occurred if all of the transactions had been consummated in the earlier year of purchase—the result contemplated by *Hillsboro* in the determination of what constitutes a “fundamentally inconsistent event” and that desired as a matter of transactional equity. In

\(^{16}\) *Compare infra* note 66 with note 101 and accompanying text.
the latter circumstance, the taxpayer presumably would have reduced his basis in an amount equal to the $10 recovery and adjusted the amount of his depreciation deduction as a result of that reduction in basis. Assuming that depreciation was reduced from $30 to $28 as a result of the lower basis, the sale would have produced an aggregate gain of $113 (the selling price of $225 minus the basis of $112 ($140 less depreciation of $28)) of which $28 would have been characterized as ordinary pursuant to the recapture rules and the balance of $85 as capital gain. Precisely the same capital gain would be recognized if the recovery is taxed at capital rates when received in the later year; whereas, if the recovery were taxed at ordinary rates pursuant to the tax benefit rule, the taxpayer would recognize only $75 rather than $85 of capital gain. Certainly the latter result more closely approximates transactional equity than does the former.

The issue is complicated further if it is assumed that the sale price of the equipment was $140 rather than $225. In that case, if the recovery had occurred in the earlier year in which the sale took place, the entire gain would have been attributable to the $28 of depreciation properly deducted for that year. However, $30 of depreciation was in fact deducted and only a $20 gain, all taxable at ordinary rates because of section 1245 recapture, was reported in the year of sale. In the later year, the full $10 recovery should be taxed as ordinary income, not by virtue of the tax benefit rule, but by application of the Arrowsmith rationale. The result will then be consistent with that intended by virtue of the application of the depreciation recapture rules. An aggregate of $30 of ordinary income will be recognized in both years. This amount is inconsistent with the $28 of depreciation which would have been deducted and recaptured as ordinary income if all the events had taken place in the earlier year of purchase and resale. Nevertheless, the full $10 (not merely $8 of the recovery) should be taxed at ordinary rates in the year of receipt. This is proper because $30 of depreciation was in fact deducted and not the lesser hypothetical amount of $28, which would have been deducted had the basis adjustment been

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17 A result consistent with this approach has been achieved without reference to the tax benefit rule in Freedom Newspapers Inc. v. Commissioner, 36 T.C.M. (CCH) 1755 (1977), in which Arrowsmith was applied to adjust the basis of property acquired in an earlier taxable year. Id. at 1759; see also Bresler v. Commissioner, 65 T.C. 182, 187 (1975) (proceeds of antitrust suit received as partial compensation in respect of prior sale of assets characterized as ordinary income in reliance on Arrowsmith.)
made in the earlier year of purchase and resale.

Thus, the reversal of position set forth in Revenue Ruling 85-186 is a welcome first step, but it does not answer the broader question of whether the tax benefit rule will be applied by the Service to characterize arbitrarily all income recognized as a result of the rule's application as ordinary in character. Further clarification is necessary. Hopefully, it will be consistent with the thesis of this Article, that tax benefit principles should not be so applied.

**INTRODUCTION**

The tax benefit rule\(^{18}\) has long operated to reconcile the diffi-

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\(^{18}\) The tax benefit rule is comprised of two elements, one which is statutory and exclusionary in nature, and the other which is a product of judicial evolution and inclusionary in character. The inclusionary element, providing that a deduction taken in a prior year should be included as income for the year in which it is recovered, was first recognized by the Internal Revenue Service in the context of recoupment of losses, typically the recovery of bad debts previously deducted. Hilliboro Nat'l Bank v. Commissioner, 460 U.S. 370, 405 (1983); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 131 n.10 (1943) [hereinafter cited as Plumb, *The Tax Benefit Rule Today*]. The Bureau flip-flopped on the issue of whether the inclusion was required only to the extent the taxpayer actually took or benefited from the previous deduction. Initially it took the position that inclusion was required even though no prior deduction had been taken. See Plumb, *supra*, at 131 (citing S.R. 2940, IV-1 C.B. 129, 129-30 (1925)). The Service briefly reversed its position in G.C.M. 18525, 1937-1 C.B. 80, 83, but returned to its original position in G.C.M. 22163, 1940-2 C.B. 76, 80.

The inequity of requiring the inclusion regardless of whether the taxpayer benefited from the prior deduction, or indeed whether he took the deduction at all, prompted Congress to enact the exclusionary element of the rule as part of the Revenue Act of 1942, ch. 619, § 116, 56 Stat. 798, 812-13 (1942) (current version at I.R.C. § 111 (West Supp. 1985)), which provided for inclusion only to the extent the taxpayer benefited from the earlier deduction. The current version of the statute, § 111, provides generally, for the exclusion from income of a recovery of bad debts, taxes and delinquency amounts that, when initially deducted, provided no tax benefit. For example, the recovery in 1985 of a bad debt deducted in an earlier tax year in which the taxpayer reported a net operating loss, determined without taking the bad debt deduction into account, would be excluded from income in the year of recovery. Section 111 addresses only the exclusionary element of the rule but by implication ratifies the inclusionary component. *See Bittker & Kanner, The Tax Benefit Rule*, 26 UCLA L. REV. 265, 271-72 (1978).

The Service has extended the reach of statute beyond the items specifically enumerated. Treas. Reg. § 1.111-1(a) (1956) extends the exclusionary, and by implication the inclusionary, element of the rule to "all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years . . ." *Id.*; *see Begley & Lancaster, I.R.S. Rulings Could Pose Threat to R&D Limited Partnerships*, 15 TAX ADVISER 716, 719 (1984); Bittker & Kanner, *supra*, at 271-72.

culties inherent in the use of an annual accounting period for income reporting purposes and the often transactional nature of business dealings that do not fit within such nicely delineated time frames.\(^9\) As expressed by Judge Tannenwald, concurring in *Estate of Munter v. Commissioner*:\(^{10}\)

The most common, and most nearly accurate, explanation of the rule is that it recognizes the “recovery” in the current year of taxable income earned in an earlier year but offset by the item deducted.\(^{21}\)

The tax benefit rule is an acknowledgment that the recovery of a previously deducted item does not readily conform to the concept of economic gain necessary to the imposition of a tax.\(^{22}\) The recovery of a prior year’s deduction is included in income to “balance out” the prior benefit generated by the allowance of that deduction.\(^{23}\) Thus, it is a rule intended to achieve transactional par-

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\(^{18}\) See *Estate of Munter v. Commissioner*, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring).

\(^{19}\) Id. at 678 (Tannenwald, J., concurring).

\(^{20}\) See *Bittker & Kanner, supra* note 18, at 266. In *Eisner v. Macomber*, 252 U.S. 189, 207 (1920), the Supreme Court defined “income” as the “gain derived from capital, from labor, or from both combined . . . .” Id. The repayment of a loan does not constitute income within this definition since it represents a return of capital rather than a gain derived from capital. The deduction of the amount of the loan as a bad debt in a year prior to repayment does not, technically, alter the character of such repayment as a return of capital. However, a gain has been realized by virtue of the tax benefit derived from the bad debt deduction. In *National Bank of Commerce v. Commissioner*, 115 F.2d 875 (9th Cir. 1940), the court held that the prior deduction in these circumstances converts the debt from capital into a potential right to income which would be realized when the debt was repaid. Id. at 877.

\(^{21}\) See *South Dakota Concrete Prods. Co. v. Commissioner*, 26 B.T.A. 1429 (1932). In *South Dakota Concrete*, the Board of Tax Appeals acknowledged that an “adjustment” to income was necessary to balance out the prior deduction. Id. at 1432. This is a recognition of the transactional nature of the tax benefit rule, since a true balancing occurs naturally if the recovery was received in the same taxable year as that in which the deduction was initially claimed. Differences merely in the timing of the deduction and the recovery were not permitted to impose substantially different tax results.
ity in the recognition of income as between similarly situated taxpayers, when differences exist only in the timing of events. But should this purpose of achieving transactional parity be extended not only to the recognition of income but also to the characterization of income recognized, without resort to the tax benefit rule?

For example, research and development costs may be deducted as expenses of a trade or business in the year incurred even though such expenditures might otherwise be capitalized. A suc-

At least two other theories, apart from the balancing of entries, have been advanced to explain the inclusion of a recovery in income. In National Bank of Commerce v. Commissioner, 115 F.2d 875 (9th Cir. 1940), the “transmutation of capital into income” theory was stated as the transformation into income of the recovery of a deduction taken against income in a prior year. See id. at 876-77. A more complicated viewpoint was expressed in Philadelphia Nat’l Bank v. Rothensies, 43 F. Supp. 923 (E.D. Pa. 1924), in which the recovery of a previously deducted bad debt was conceded to be a return of capital, but was nevertheless held taxable on the theory of implied consent or waiver by the taxpayer. See id. at 925. For a more detailed explanation of these rationales, see generally Bittker & Kanner, supra note 18, at 267-72.

24 See Hillsboro Nat’l Bank v. Commissioner, 460 U.S. 370, 383 (1983). Absent the tax benefit rule there is no transactional parity; a taxpayer who recoups his losses in the same year in which they otherwise would have been subject to a deduction is treated unfairly as compared with a taxpayer who takes a deduction of losses in one year and recoups them in a later year, since only the latter would be entitled to the deduction. See id. at 383-84.

25 See I.R.C. § 174 (1982). Prior to the enactment of I.R.C. § 174, deductions for research and development were governed by § 23(a), the predecessor of § 162, which provided deductions for “ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” Revenue Act of 1928, ch. 852, § 23(a), 45 Stat. 791, 799.

This phrase was then defined as “holding one’s self out to others as engaged in the selling of goods or services.” Deputy v. du Pont, 308 U.S. 488, 499 (1940) (Frankfurter, J., concurring). Because new businesses had difficulty making such a showing, they often were not permitted to take the deduction. Congress intended to remedy this with the less restrictive language of § 174, which allows the deduction for expenses incurred “in connection with” rather than in “carrying on” a trade or business. See 100 Cong. Rec. 3425, 3998 (1954). Section 174(a) provides in part:

(a) Treatment as expenses—

(1) In general.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) When method may be adopted.—

(A) Without consent.—A taxpayer may, without the consent of the Secretary, adopt the method provided in this subsection for his first taxable year . . .

(B) With consent.—A taxpayer may, with the consent of the Secretary, adopt at any time the method provided in this subsection.

(3) Scope.—The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary, a change to a different method is authorized with respect to part or all of
cessful research and development program eventually produces valuable technology. The sale of that technology ordinarily is accorded capital gain treatment, provided the requisite holding period has been satisfied, and effects a “recovery” of the previously deducted research and development costs that are reflected in the value of the technology sold but not in its basis. This recovery is taxed without resort to the tax benefit rule, since the recognized capital gain is greater than it otherwise would have been by the amount of the research and development costs that were deducted rather than capitalized and included in basis. Thus, the true effect of applying the tax benefit rule would, in these circumstances, be to convert capital gain into ordinary income. This is a function for which the tax benefit rule was neither intended nor appropriate.

A. Research and Development Costs.

1. Revenue Ruling 75-528

The initial published expression of the Service’s position in applying the tax benefit rule to the disposition of technology is found in Revenue Ruling 75-528. In that ruling a pilot model was such expenditures.


The disposition of property qualifies for long-term capital gain treatment provided three requirements are satisfied: (1) the disposition is a sale or exchange; (2) the property, if acquired after June 22, 1984, and before January 1, 1988, has been held for a period of six months; and (3) the property sold or exchanged qualifies as a capital asset under I.R.C. §1221. I.R.C. §1222 (West Supp. 1985). Intangible personal property, including technology, falls within the definition of a capital asset unless it is excluded as being property used in the taxpayer’s trade or business that is subject to the allowance for depreciation. In that case it will nevertheless qualify for capital gain treatment pursuant to I.R.C. §1231(a) (West Supp. 1985). Only if such property is stock in trade, inventory, or property held for sale to customers in the ordinary course of business will I.R.C. §1221 capital asset classification and I.R.C. §1231 capital gain treatment be denied. See I.R.C. §1231(b)(1) (West Supp. 1985).

I.R.C. §1016(a)(14) (West Supp. 1985) provides for adjustments to basis only with respect to deferred expenses amortizable under I.R.C. §174(b)(1) (West Supp. 1985). Expenses currently deducted pursuant to I.R.C. §174(a) may not also be capitalized, and therefore, are not reflected in basis. See I.R.C. §263(a)(7)(b) (West Supp. 1985); Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974) (“The purpose of §263 is to reflect the basic principle that a capital expenditure may not be deducted from current income”).

Cf. Davis v. Commissioner, 74 T.C. 881, 889-903 (1980), aff’d, 746 F.2d 357 (6th Cir. 1984). In Davis, tax benefit principles were asserted by the Commissioner in an unsuccessful attempt to recharacterize a special allocation of partnership capital gain as ordinary income to the recipient partner. See id. at 900-01.


Id. at 481-82.
developed as part of research and experimental activities conducted in connection with the taxpayer corporation's business of manufacturing various types of new machinery and equipment. The costs of the pilot model were deducted in the year in which they were incurred pursuant to section 174(a), and provided a tax benefit. More than six months after having been placed in service, the pilot model was completely destroyed by fire, and the taxpayer was fully reimbursed for its loss by the proceeds of insurance.

The ruling concludes that the insurance proceeds must be taxed at ordinary rather than capital rates to the extent of the development costs previously deducted pursuant to Section 174 through application of the tax benefit rule. It recognizes that an exception exists with respect to applying the rule to depreciation expense, but distinguishes the section 174 expenditures from depreciation without analysis. The ruling apparently presumes a basis for such distinction in the perceived difference between depreciation as the annual recovery of capital costs throughout the extended time period of their utilization in the taxpayer's business and the immediate recovery afforded research and development expenditures through the allowance of a current deduction.

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81 See Treas. Reg. § 1.111-1(a) (1956). This depreciation expense exception is founded on I.R.C. § 1016(a)(2), which requires that the basis of the property must be adjusted by the depreciation allowed or allowable, which, in turn is determinative of the gain to be recognized on the disposition of that property. See Plumb, The Tax Benefit Rule Today, supra note 18, at 146-48. The principle was reflected in early decisions of the Supreme Court that make it clear that this statutory determination of basis is made without consideration of tax benefit. See, e.g., Virginia Hotel Corp. v. Helvering, 319 U.S. 523, 525 (1943) (basis adjustment required for full amount of depreciation allowed, although only part of that deduction had provided tax benefit); United States v. Ludey, 274 U.S. 295, 304 (1927) (basis of property adjusted by full amount of depreciation allowable, not merely lesser amount actually allowed).

This exception to the application of the rule has been statutorily negated to the extent that depreciation expense is now recaptured as ordinary income when there is a disposition of the depreciable real or personal property with respect to which such deductions were taken. See infra notes 43 and 44. But the exception remains in effect when the statutory rules of recapture are inapplicable.

82 In United States v. Ludey, 274 U.S. 295 (1927), the Court stated:

The depreciation charge permitted as a deduction from the gross income in determining taxable income . . . for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will . . . suffice to provide an amount equal to the original cost.

Id. at 301.

83 See I.R.C. § 174 (West Supp. 1985). Section 174 allows a taxpayer immediately to
This distinction was recognized in a slightly different context in *Commissioner v. Anders.* The revenue ruling cites *Anders* to support application of the inclusionary aspect of the tax benefit rule to section 162 expenses; the section 174 expenses are then treated, at least inferentially, as being more akin to section 162 expenses than to exempted depreciation deductions. The issue in *Anders* arose in the course of a corporate liquidation under section 337. Despite this non-recognition provision, the court applied the tax benefit rule to override section 337 and to recognize ordinary income on the sale of certain rental supplies that had a useful life of between twelve to eighteen months but that had been expensed upon acquisition. In requiring recognition of ordinary income with respect to these expensed items, the court attributed the gain realized on the sale solely to the previous deduction and not to any increase in asset values. The proceeds of the sale attributable to the expensed property were viewed as the recovery of the previously deductible cost of the property. These proceeds were treated as ordinary income under tax benefit principles rather than as gain qualifying for non-recognition pursuant to section 337.

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deduct from gross income all research and development expenditures incurred in connection with the taxpayer's trade or business. See id.; Arem, *Tax Benefits of Research and Development Expenses Increased by New Credit,* 10 Tax'n for Law. 208, 208 (1982); Note, *The Tax Treatment of Research and Development Expenditures: A Comparison Between Financial Accounting Standards and Section 174 of the Internal Revenue Code,* 10 Rutgers Computer & Tech. L.J. 149, 149 (1984). This deduction is an exception to the general rule that current business expenditures that are expected to yield economic benefits in subsequent years must be amortized over those years. See Note, supra, at 149-50.

*See 414 F.2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969).*

*See id. at 1285. I.R.C. § 337 provides that gain or loss generally will not be recognized by a corporation that adopts a plan of liquidation and disposes of its property and completely liquidates within twelve months thereafter. See I.R.C. § 337(a) (West Supp. 1985).*

*See 414 F.2d at 1287. The defendant's deductions were authorized pursuant to Treas. Reg. § 1.162-3 (1958), which permits the cost of materials and supplies to be deducted only to the extent consumed during the taxable year for which the deduction is claimed, provided they were not previously deducted. The cost of *incidental* materials and supplies may be deducted when purchased rather than capitalized if no record of consumption or physical inventory is maintained and the deduction does not materially distort income.*

*See 414 F.2d at 1288-89; see also Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 401 (1983) ("rule is now well established that the tax benefit rule overrides the nonrecognition provision"); Connery v. United States, 460 F.2d 1130, 1133 (3d Cir. 1972) ("tax benefit principles apply to a § 337 transaction"); Spitalny v. United States, 430 F.2d 195, 197 (9th Cir. 1970) (tax benefit rule applies to § 337 fully expensed "property"); Bishop v. United States, 324 F. Supp. 1105, 1110 (M.D. Ga. 1971) (tax benefit rule provides unstated exception to nonrecognition of gain from sale of property accorded by § 337). An argument could be made that the rental supplies in *Anders* were not incidental and thus were not
The court specifically rejected the taxpayer's argument that "the expense charges were the same as depreciation which is not subject to recapture, and that the proceeds of the rental items should be treated as gain from a sale above a depreciated basis at zero . . . ." Agreeing that depreciable property was not subject to tax under tax benefit principles, the court nevertheless, stated:

While some comparisons may be drawn between depreciation and the charges to expense made by [the corporation] at purchase of the rental items, we conclude that in substance the methods are not the same. By charging to expense the full cost of the rental items at purchase and not capitalizing them, there was no real depreciation method employed . . . so as to qualify the disposition of the rental items for treatment as gain from a sale above a depreciated basis. There was no realization of appreciation in value entitled to such treatment.39

38 414 F.2d at 1288. The taxpayer's argument was based on Fribourg Navigation Co. v. Commissioner, 383 U.S. 272 (1966). In Fribourg, the taxpayer purchased a used Liberty Ship in late 1955 and claimed depreciation expense using the straight line method. See id. at 274. In 1957, the taxpayer adopted a plan of complete liquidation and thereafter sold the ship for an amount in excess of both the original cost of the ship and its adjusted basis at the commencement of the year of the sale. See id. This increase in value was caused by the demand for ships resulting from the seizure of the Suez Canal in 1956. See id. The depreciation claimed for the year of sale was disallowed by the Commissioner on the theory that the taxpayer should be permitted to recover only its "actual net cost" through deductions for depreciation. See id. at 275-76. Because the sales price exceeded the adjusted basis at the start of 1957, use of the ship during that year "cost" the taxpayer nothing. See id. at 276. In rejecting this argument, the Supreme Court emphasized that the Commissioner had improperly "comingled two distinct and established concepts of tax accounting—depreciation of an asset through wear and tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market value." Id. Thus the Court recognized what had been implicit in an earlier case, namely, that physical wear and tear as represented by depreciation deductions did not also reflect fluctuations in market value. See United States v. Ludley, 274 U.S. 295 (1927). This, in turn, provides a rationale for excluding the gain realized on the disposition of depreciable property from application of the tax benefit rule. While depreciation is an appropriate adjustment to the basis of depreciable property in determining gain, such gain may reflect fluctuations in market value rather than depreciation previously deducted. In other words, the increase in value resulting from changes in pricing levels caused by market factors may exceed the decline in value represented by physical wear and tear. As such, the gain realized does not necessarily represent a recovery of depreciation expense, and in the absence of a recovery, application of the tax benefit rule is inappropriate.

39 414 F.2d at 1288.
The similarity between the current deduction allowed for research and development expenses under section 174(a) and the current expense permitted for short-lived assets under the section 162 regulations involved in Anders is, however, more superficial than real, and does not provide support for the conclusion reached in Revenue Ruling 72-528.

The underlying assumption made in Anders, as evidenced by the last quoted sentence and by the section 162 regulations, is that a material fluctuation will not occur in the value of short-lived assets. This assumption is simply not factually accurate as applied to the intellectual content of technology, whether or not the costs of development of that property are currently expensed under section 174(a). Such value is not ordinarily related in any specific or recognizable way to the level of cost incurred in its development. Technology is developed precisely for extended use in business and its value is tied to the market factors that impact on how the specific capabilities of that technology satisfy such use. As in Fribourg Navigation Co. v. Commissioner, realization of the value of that technology is independent of the prior development expense. To that extent the deduction of these development costs bears a closer resemblance to depreciation than to expensed supplies, and should be accorded the same exception to application of the tax benefit rule. Stated differently, depreciation as a method of recovering capital costs is unrelated to the continuing value of that investment in capital. Research and development expenditures, as costs of creating capital, similarly have no relationship to the value of the technology created.

Thus, Revenue Ruling 72-528 should be viewed as providing the proper result only if it is limited to its specific facts. Since the

40 Inventories of supplies and similarly expensed items are acquired for consumption in the relatively short term. See Rev. Rul. 68-104, 1968-1 C.B. 361 (cost of rental diapers with average useful life of less than one year deductible as ordinary and necessary business expense); Treas. Reg. § 1.263(a)-2(a) (1958) (capital expenditures include property having useful life substantially beyond taxable year). Given the nature of most supplies and the fact of short term utilization in the business, there is little likelihood of significant appreciation. Even in those instances in which a supply item, such as cattle feed, may appreciate in value due to fluctuations in commodity prices, the importance of such fluctuations would appear to be insignificant in comparison to the need for consumption of that item in the business. Cf. Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 395 (1983) (business expense deduction predicated on consumption of asset in trade or business).

41 383 U.S. 272 (1966); see supra note 38.

42 If Rev. Rul. 72-528 is limited to its specific facts, the result reached in the ruling may be justified, at least in part, by use of an alternative rationale. The Treasury Regulations
pilot model was totally destroyed, the technology represented in and by the model was not transferred for value. The insurance proceeds presumably were reimbursement only for the development cost of the pilot model and not for the market value of the inherent intellectual content. As such, the proceeds could be viewed merely as the recovery of the previously deducted costs of a consumed asset akin to the supplies in *Anders*.

If not so limited, Revenue Ruling 72-528 appears suspect in terms of its lack of consistency with existing congressional policy and judicial authority. After section 174 was enacted as part of the Internal Revenue Code of 1954, the depreciation recapture provisions of sections 1245 and 1250 were introduced into the Code without comparable modifications for the recapture of research and development costs. More importantly, the single legislative provide that some of the costs of development of depreciable property are not deductible under I.R.C. § 174 even though such property may be used in connection with research and experimentation. See Treas. Reg. § 1.1742(b)(2), (4). These costs include the costs of component materials of depreciable property, the costs of labor or other elements involved in its construction and installation, and costs attributable to the acquisition or improvement of the property. See id. § 1.174-2(b)(4). Thus, it is possible that at least part of the costs of the pilot model involved in Rev. Rul. 72-528 included these excluded costs and should have been charged to capital account and depreciated rather than deducted. If this were true, the expensed costs would have been taken in lieu of proper depreciation. The recapture provisions of I.R.C. § 1245, and not the tax benefit rule, would then be applied to recover those costs as ordinary income. See infra note 43.

*Revenue Act of 1962,* Pub. L. No. 87-834, § 13(a), 76 Stat. 960, 1032 (1962). I.R.C. § 1245 applies, generally, to convert the proceeds of a disposition of depreciable personal property from capital gain to ordinary income to the extent of the lesser of the gain realized or the depreciation expense previously deducted with respect to such property. For an explanation of the operation of this provision as it pertains to the recapture of research and development costs deducted under § 174, see infra notes 83-89 and accompanying text.

*Revenue Act of 1964,* Pub. L. No. 88-272, § 231(a), 78 Stat. 19, 100. I.R.C. § 1250 applies, generally, to convert the proceeds of a disposition of real property from capital gain to ordinary income to the extent of the lesser of the gain realized or the excess of accelerated depreciation deducted with respect to such property over the deduction which would have been available using the straight line method of depreciation.

*Section 1252 of the Code,* enacted in the *Tax Reform Act of 1969,* Pub. L. No. 91-172, § 214, 83 Stat. 487, 572, applies, generally, to convert the proceeds of a disposition of farm land from capital gain to ordinary income, to the extent of the lesser of the gain realized or a designated percentage (which varies with the period the land has been held prior to the disposition) of the previously deducted costs incurred under I.R.C. § 175 (relating to farmers' land clearing expenditures). *Section 1254 of the Code,* enacted in the *Tax Reform Act of 1976,* Pub. L. No. 94-455, § 206(a), 90 Stat. 1525, 1633, applies, generally, to convert the proceeds of a disposition of oil, gas, or geothermal property from capital gain to ordinary income to the extent of the lesser of the gain realized or the intangible drilling and development costs previously deducted in respect of the property under I.R.C. § 263(c).

In each instance, prior to the statutory enactment, the pertinent deduction was not subject to recapture as provided in I.R.C. § 1245. See H.R. Rep. No. 668, 94th Cong., 1st
effort to provide for broader application of the recapture provisions of section 1245, if enacted, would have provided for recapture of the “purchase price” of property that had been properly expensed, but would not have embraced the recovery of research and development costs deducted pursuant to section 174(a). The House Report specifically stated:

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

Judicial precedent is also consistent in failing to characterize any part of the proceeds from a sale of technology as ordinary income based on application of the tax benefit rule. If ordinary in-
come is imposed with respect to a disposition of technology, such characterization results from a failure to satisfy the sale or exchange requirement and not through an attempt to recapture previously deducted development costs. In only one case has the sale of technology resulted in the imposition of a tax at ordinary rates as a consequence of applying the tax benefit rule to previously deducted research and development expenses.49

In Altec Corp. v. Commissioner,50 a corporation engaged in the distribution and sale of electronic products, adopted a plan of complete liquidation pursuant to section 337 and then sold its assets. Included in the sale were previously expensed drawings, tooling, and artwork used in the development and sale of amateur radio kits. Pursuant to an independent appraisal, these expensed assets were allotted a reproduction cost of $1,015,000 and a market value based on continued use in the business of $623,700. The latter amount was recorded as the cost of these assets on the books of account of the purchaser and subsequently depreciated. In holding that the tax benefit rule applied to these expensed assets, the Tax Court relied on its prior decision in Anders, and required the selling corporation to include $623,700 of the purchase price as ordinary income despite the non-recognition requirements of section 337.51 The court did not consider—in fact probably did not perceive—any differences between the items of expensed laundry supplies involved in Anders and the expensed technology found in Altec. This view may be entirely appropriate depending upon the interpretation given to the facts.

It is unclear whether, as in Revenue Ruling 72-528, it can be argued that there was no intellectual value attributable to the drawings, tooling and artwork. Some support can be found for this


49 See Altec Corp. v. Commissioner, 36 T.C.M. (CCH) 1805 (1977).

50 Id.

51 See id. at 1804-05. Because the disposition occurred in the context of an I.R.C. § 337 liquidation, gain would not have been recognized absent the Altec court’s application of the tax benefit rule to recapture the proceeds from the sale of the technology as ordinary income. Therefore, the case represents the question of recognition versus non-recognition typical of the tax benefit rule. It is difficult to appraise its precedential value to a sale transaction outside the context of a non-recognition provision, which would raise the issue of characterization rather than recognition of income.
view since the $623,700 fair market value of these assets was less than their $1,015,000 cost of reproduction. As such, the view taken by the Tax Court may have been that the sale merely recovered prior production costs. Since a recovery of the value of the intellectual content of technology, rather than a recovery of the production costs of technical renderings of that technology, is the basis for distinguishing depreciable property from expensed assets, its perceived absence from the factual context of Altec might permit the drawings and tooling to be taxed as ordinary income pursuant to the tax benefit rule. However, this is a great deal to read into the opinion. It is at least as likely that the appraised market value represented the intellectual content of the technology, not merely its mechanical renderings, and that an analogy to depreciable property is appropriate, thereby rendering the tax benefit rule inapplicable.

2. Technical Advice Memorandum 8409009

Despite the lack of judicial and Congressional support, the next expression of the Service’s position with respect to the recapture of research and development expenses pursuant to tax benefit principles was more expansive in scope. In this technical advice memorandum the Service relied upon the legislative history of section 174 and the rationale of the Supreme Court in Hillsboro National Bank v. Commissioner to justify application of the tax benefit rule to research and development expenses. On analysis, however, neither the legislative history of section 174 nor the Hillsboro decision justifies the recapture of previously deducted research and development costs at the time the underlying technology is sold.

In 8409009, the taxpayer was engaged in extensive, in-house research and development to develop both patented and unpatented technology for use in its business. An occasional sale or other disposition occurred only when the technology no longer suited the taxpayer’s long-term strategy of product offerings. The three dispositions in question were made for valid business reasons and each constituted a sale of all of the taxpayer’s substantial rights in the technology. They qualified, therefore, for capital gain treat-

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54 See id.; see also infra notes 57-61 and accompanying text.
ment under either section 1221 as to the "know how" or unpatented technology, or section 1231 as to the patented technology. In each instance the basis of the transferred technology was zero because the development costs had been deducted pursuant to section 174(a). The technical advice memorandum applied the tax benefit rule to each transaction, taxing the proceeds of sale as ordinary income to the extent of the previously deducted research and development expenses that had resulted in a tax benefit. Any remaining proceeds were accorded capital gain treatment.

(a) Legislative History

The technical advice memorandum determined that the purpose of section 174(a) in providing a current deduction for research and development costs was to avoid the necessity of determining the useful life of the technology thereby created. It concludes that, for purposes of applying the tax benefit rule, all expensed research and development costs, whether or not the resulting technology has a useful life in excess of one year, should be treated in the same manner as a current deduction permitted under the section 162 regulations. This analysis is flawed because it is based on an

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55 See, e.g., Davis v. Commissioner, 491 F.2d 709 (6th Cir. 1974). In Davis, the taxpayer acquired all of an investor’s interest in an apparatus designed to skin sausages. See id. at 710. Subsequently, the inventor executed an application for a letter patent on the invention. The Court of Appeals for the Sixth Circuit held that despite the fact that the patent application was not allowed by the patent office until 10 months after the sale of the inventor’s interest, the property was not depreciable and proceeds from the sale were entitled to capital gain treatment under § 1221. See id.; see also Lan Jen Chu v. Commissioner, 58 T.C. 598 (1972) (assignment of patent application held not to produce ordinary income), aff’d, 485 F.2d 696 (1st Cir. 1973); Estate of Stahl v. Commissioner, 52 T.C. 591 (1969) (sale of patent application is non-depreciable property subject to the provisions of § 1221), aff’d, 442 F.2d 324 (7th Cir. 1971).


57 See IRS Letter Ruling 8409009 (11/23/83). The ruling states in part: When Congress substituted a current deduction under section 162 for R & D expenditures with the option of a current deduction under section 174(a)(1), it did not indicate that the tax benefit rule, which applies to certain expenditures deducted under 162, would not apply to section 174(a)(1). We believe that, once a taxpayer chooses to deduct R & D expenses currently under section 174(a)(1),
erroneous factual assumption. Developed technology with an extended useful life will not ordinarily be consumed or used in the taxpayer’s business within a short period of time, and the effect of applying the tax benefit rule to such technology would be to recover values created by market considerations rather than the actual costs of development.

An examination of the legislative history reveals a practical resolution to a factual issue concerning the determination of useful life that places section 174 in closer proximity to a depreciation type recovery of costs pursuant to section 167, than to the economic assumptions underlying section 162. The Senate Committee Report explains the purpose of section 174 as follows:

No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in connection with abandoned projects, and recovery through amortization is provided where the useful life of these capital items is determinable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures.

To eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the House and your committee’s bill provide that these expenditures . . . may, at the option of the taxpayer, be treated as deductible expenses. It also provides that a taxpayer may elect to capitalize such expenditures and if no other means of amortization is provided, may write them off over a period of not less than 60 months, beginning with the month in which benefits are first realized.58

Thus, the enactment of section 174 was not intended to affect those development costs that were otherwise required to be capitalized and amortized over a determinable useful life. Permission to deduct those costs currently rather than to amortize them merely affected the timing of the deduction. With respect to tech-

such deduction should not be treated differently, for purposes of the tax benefit rule, from a section 162 deduction under prior law.

nology with a determinable useful life, the grant of a current deduction is in the nature of a special accelerated allowance as an alternative to amortization under section 167. Certainly, section 174 was not intended to provide a tax result less beneficial than that available under preexisting law with respect to the costs of technology having a determinable useful life, one that would discourage rather than encourage research and experimentation contrary to the avowed purpose of section 174. But precisely such an adverse result would obtain if the current deduction allowed under section 174(a) was subjected to recapture at ordinary rates through application of the tax benefit rule. The deduction for amortization available under section 167, on the other hand, remained within the recognized exception to such recapture afforded depreciation expense.5

Whether research and development costs are currently expensed or amortized, their inherent nature and the technology derived therefrom do not differ; only the period over which the costs are recovered is different. A change in the period of recovery of these costs does not alter their intrinsic nature; they continue to have a value that is subject to market factors and rising price levels. The latter factors are present with respect to depreciable property but are not presumed to be present with respect to short-lived assets, which may be currently expensed pursuant to the Regulations under section 162.80 Because of this fundamental difference, the tax benefit rule should not be applied to recapture currently deductible research and development costs. Rather, in the absence of a statutorily mandated requirement for recapture,

59 Until the enactment of I.R.C. § 1245, eight years after the passage of I.R.C. § 174(a), research and development costs of technology with a determinable useful life were amortizable under I.R.C. § 167, and would have been encompassed within the recognized exception to application of the tax benefit rule accorded depreciation expense. See Commissioner v. Anders, 414 F.2d 1283, 1287-88 (10th Cir.), cert. denied, 396 U.S. 958 (1969); supra notes 36-42 and accompanying text. It would have been logically inconsistent to preclude application of the tax benefit rule to amortization taken pursuant to I.R.C. § 167 in respect of technology with a determinable useful life while applying it to recapture a current deduction allowed in lieu thereof under I.R.C. § 174(a) with respect to such technology.

The enactment of I.R.C. § 1245 created an anomaly in that amortization pursuant to I.R.C. § 167 of capitalized research and development costs with respect to technology with a determinable life is now subject to recapture. But that anomalous result can be avoided by deducting these research and development costs under I.R.C. § 174(a) rather than capitalizing and amortizing them under I.R.C. § 167. Availability of this election is not a reason to extend the reach of the tax benefit rule to recapture currently expensed research and development costs not within the ambit of statutory depreciation recapture.

60 See supra note 46.
those costs should be accorded the same exemption from tax benefit recapture as depreciable property under section 111 and existing judicial precedent.\textsuperscript{61} The accelerated write off was intended as an incentive to further research, and it should not be administratively altered to provide a contrary result by allowing recapture of expenditures at ordinary income rates.

(b) Hillsboro National Bank v. Commissioner

\textit{Hillsboro National Bank v. Commissioner}\textsuperscript{62} is the consolidation on appeal of two cases, each of which presents the question of whether a true economic recovery is necessary to apply the tax benefit rule or whether the rule may be applied on the basis of subsequent events that prove the premise underlying a prior year’s deduction to have been erroneous.\textsuperscript{63}

In \textit{Hillsboro}, the first case, the State of Illinois imposed a property tax on Illinois bank shares held by individuals. This tax was customarily paid by the bank and deducted pursuant to section 164(e). In 1970, the Illinois constitution was amended to prohibit the imposition of that tax. The amendment was promptly challenged as unconstitutional. Pending disposition of this challenge, Illinois passed a law permitting collection of the tax and its placement in escrow. Eventually, the constitutional challenge was defeated and the appropriate portion of these amounts plus accrued interest was paid to Hillsboro’s shareholders. The Commissioner included these amounts as income to the bank.

In the second case, \textit{Bliss Dairy, Inc. v. United States},\textsuperscript{64} the taxpayer purchased and properly deducted the cost of cattle feed for its fiscal year ending June 30, 1972. Two days into the succeeding fiscal year, Bliss adopted a plan of complete liquidation, distributing its assets, including the unconsumed cattle feed, to shareholders. Bliss did not report any income from the liquidation, relying on the non-recognition provisions of section 336.\textsuperscript{65} The

\textsuperscript{61} \textit{See} \textit{Anders}, 414 F.2d at 1289 (rental items already fully expensed not subject to capital gain treatment).

\textsuperscript{62} 460 U.S. 370 (1983).


\textsuperscript{64} 460 U.S. 370 (1983).

\textsuperscript{65} Bliss, 645 F.2d at 20; \textit{see} I.R.C. § 336 (West Supp. 1985). Section 336 provides that, with certain exceptions, “no gain or loss shall be recognized to a corporation on the distribu-
Commissioner contested the corporation's treatment of the liquidation and asserted that the value of the unconsumed feed distributed in liquidation had to be included in Bliss' income.

In each of these cases, the taxpayer asserted that an economic recovery was necessary for application of the tax benefit rule while the government argued that the presence of an event inconsistent with the basis for claiming that prior deduction was sufficient. While rejecting the necessity for an economic recovery, the Supreme Court also disagreed with the government's formulation and forged its own concept of the fundamentally inconsistent event needed to invoke the tax benefit rule. The Court stated:

Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if the event had occurred within the same taxable year, it would have foreclosed the deduction.
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By way of illustration, the Court used the example of a currently deductible rental payment made on December 15, for a thirty-day lease, and the destruction of the building by fire on January 10, of the succeeding year. It then compared the destruction with a taxpayer's conversion of the same building from business to personal use. While the destruction by fire was considered an accepted risk of the business, and thus not a fundamentally inconsistent event, the conversion from business to personal use was inconsistent. The Supreme Court's analysis requires not only a fundamentally inconsistent event, but also when that event occurs in the context of a non-recognition transaction as in Bliss, a further determination as to whether the applicable non-recognition provision or the tax benefit rule prevails.67

Applying these principles to Hillsboro, the Court determined that the legislative purpose of section 164(e) was to grant relief to the corporation upon payment of the shareholder tax. The focus of Congress was on the act of payment, not on the use to which the funds were put by the state. The state's refund to the bank's shareholders, therefore, was not viewed as fundamentally inconsistent with the premise upon which the deduction was initially taken. Thus, the bank was not required to recognize income pursuant to the tax benefit rule and the decision below was reversed.

In Bliss, the Court held that the distribution of the expensed cattle feed to shareholders in liquidation of the corporation was the analogue of conversion of property from business to personal use and, as such, required the amount of the previous deduction taken with respect to the unconsumed feed to be included in income. The Court also held that the non-recognition provisions of section 336 provided a shield to the taxation of market appreciation and were not a bar to the recognition of other types of income as exemplified by the well-settled precedent of applying the tax

benefit rule to section 337 liquidations. The latter section was considered a companion non-recognition provision intended to provide the same tax results as section 336 in related circumstances.

The Service’s reliance in the technical advice memorandum on the “fundamentally inconsistent event” test of Hillsboro was misplaced for a number of reasons. Initially, Hillsboro must be viewed as involving the question of whether or not income is to be recognized in the absence of an economic recovery. The technical advice memorandum, however, involved an economic recovery in which the issue is not whether income should be recognized but rather whether clearly recognizable income should be characterized as capital gain or ordinary income. The inconsistent event analysis of Hillsboro does not focus on the issue of income characterization and should not have been so applied. Moreover, there is nothing fundamentally inconsistent in the recognition of income at capital gain rates merely because the expenses or costs incurred in the generation of that income were deducted against ordinary income. The provisions of section 1250 are an example. That section taxes the gain recognized on the sale or exchange of certain real property at ordinary income rates to the extent that accelerated depreciation taken with respect to such property exceeds straight line depreciation. Section 1250 is silent as to the balance of the gain, which is ordinarily taxed at capital gain rates pursuant to either section 1221 or section 1231.68 Extension of the Service’s position adopted in the technical advice memorandum to that portion of the gain attributable to straight line depreciation would subject such depreciation to tax at ordinary rates, since the deduction was initially taken against ordinary income, and would be treated by the technical advice memorandum as fundamentally inconsistent with reporting the gain at capital gain rates. It is unlikely that the Service would seriously advance that contention, or if advanced that it would gain judicial favor, because it would vitiate the provisions of sections 1221 and 1231.69


69 See supra notes 43-44 for the statutory basis underlying characterization of gain realized on the sale of depreciable property. I.R.C. §§ 1245 and 1250, concerning the sale or other disposition of depreciable property, allow for the recapture of depreciation taken prior to the disposition of an asset. Thus, to the extent of the depreciation taken, any gain on the disposition of such property is taxable as ordinary income. See Frigbourg Navy Co. v. Com-
Similarly, the interest expense incurred to purchase an investment asset is deductible against ordinary income. The Service has not attempted to apply the tax benefit rule to tax as ordinary income a portion of the gain upon disposition of the investment asset. To do so would appear to be an unwarranted attempt to extend rules similar to those of section \textsection{265}, as they relate to the acquisition of certain investment assets, to a much broader range of assets without an appropriate statutory foundation. Finally, there is authority for taxing the proceeds of a sale of technology at capital gain rates when the factual context clearly indicates that the costs of development were expensed against ordinary income.\footnote{See \textcite{Heil Co. v. Commissioner}, 38 T.C. 989, 1003 (1962) (sale of patents, manufacturing and engineering information held to be taxable as long term capital gain); \textcite{Golconda Corp. v. Commissioner}, 29 T.C. 506, 510 (1957) (sale of patent for cutting saw held to be transfer of capital asset).}

Nevertheless, the technical advice memorandum concluded that taxation of the proceeds of sale of technology at capital gain rates was fundamentally inconsistent with prior current deductions of the costs of development of that technology pursuant to section 174(a). It reasoned that the allowance of a current deduction for research and development costs was equivalent to their treatment as section 162 expenses, and thereby subjected them to the same presumption of short-term consumption upon which section 162 deductions are premised. The value of expensed technology was

\footnote{I.R.C. \textsection{265} disallows the deduction of interest on an indebtedness incurred by the taxpayer for the purpose of purchasing tax-exempt obligations. \textcite{Rev. Proc. 72-18, 1972-1 C.B. 740}. When the taxpayer's investment in tax-exempt obligations is substantial, or when the indebtedness incurred is for personal consumption or within the active conduct of trade or business, it will not normally be inferred that the purpose of carrying a debt is to finance tax-exempt obligations. \textcite{Rev. Proc. 72-18, 1972-1 C.B. 740}, require a tracing of the proceeds of the indebtedness to the purchase or carrying of tax-exempt obligations. See id. at 741. If these circumstances are not present, a presumption is created that the indebtedness was incurred to finance the tax-exempt obligations. To deny a deduction for interest incurred with respect to a debt, Treas. Reg. \textsection{1.265-2} and Rev. Proc. 72-18, 1972-1 C.B. 740, require a tracing of the proceeds of the indebtedness to the purchase or carrying of tax-exempt obligations. See \textcite{Treas. Reg. \textsection{1.265-2}; Rev. Proc. 72-18, 1972-1 C.B. 740}. For a rule similar to I.R.C. \textsection{265} to be applicable with respect to the interest expense incurred to purchase an investment asset, a causal connection between the interest deduction and the subsequent sale of the investment asset would have to be shown. See infra note 101.}

\footnote{Capital gain under I.R.C. \textsections{1221 and 1231}, however, does not fall within the scope of I.R.C. \textsections{1245 and 1250}. To treat gain realized under \textsections{1231 and 1221} as ordinary income rather than capital gain would be to disregard the exception to the application of the tax benefit rule afforded depreciation expense, which existed prior to the introduction of statutory depreciation recapture. Presumably, this exception continues to exist to the extent that I.R.C. \textsections{1245 and 1250} are inapplicable.}
then likened to the unconsumed cattle feed distributed in Bliss, thereby requiring the same tax result. As discussed, this assumption of short-term consumption was totally inappropriate to technology. Moreover, the analysis failed to consider the difference in the tax characteristics between unconsumed cattle feed and technology developed through expenditures deducted currently under section 174(a). The cattle feed in Bliss was in the nature of an inventory of supplies, and remained so when distributed in liquidation. Research and development expenses deducted pursuant to section 174, on the other hand, are incurred in the development or production of a specific technology and, at some point in time, are transformed into a different asset, separate and distinct from any of the costs incurred in producing it. The tax consequences resulting from the sale of that technology should be based on the tax characteristics of the finished product, not on those of the antecedent costs of its development.

This emerges as the more appropriate analysis when consideration is given to the tax effect of consumed rather than unconsumed cattle feed in a situation similar to Bliss. Assume a corporate taxpayer, engaged in breeding cattle, incurs expenses for feed in year one and in year two the cattle consume a portion of that feed prior to being sold. Bliss and Anders require that the de-

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72 See supra note 41 and accompanying text.
73 See Hillsboro, 460 U.S. at 401. The cattle feed purchased by Bliss was inventory, and as such it failed to satisfy the definition of a capital asset under I.R.C. § 1221(a). Thus any gain recognized on its disposition was taxable as ordinary income. Even if the cattle feed did qualify as a capital asset under the statutory definition, the income recognized on the disposition would still be characterized as ordinary since the feed was used as a supply item in the ordinary course of business. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 47, 50 (1955) (sale of corn futures held to be integral part of manufacturing business, thus taxable as ordinary income). Thus, disposition of the cattle feed produces ordinary income whether such disposition involves the tax benefit rule or not, and characterization is not at issue as it is in the attempt to apply the rule to recapture research and development expenses on the disposition of developed technology. Cf. Hillsboro, 460 U.S. at 402 n.37.

Our discussion of the tax consequences on the sale of an expensed asset does not suggest that the entire amount of proceeds on sale is attributable to the tax benefit rule. The appreciation would be recognized as gain in the ordinary sale, regardless of whether the taxpayer had expensed the asset upon acquisition.

74 Contrary to the sale of expensed supply items, the sale or exchange of the technology would result in the realization of capital gain. See Continental Ill. Nat'l Bank & Trust Co. v. Commissioner, 69 T.C. 357, 372-76 (1977), acq. 1978-2 C.B. 1.
75 See I.R.C. § 1231(a), (b)(3)(A) (West Supp. 1985). Capital gain treatment is accorded the sale or exchange of cattle held for breeding purposes provided the required two-year holding period is satisfied. Id.
ducted but unconsumed feed be recaptured at ordinary rates pursuant to the tax benefit rule. But what of the consumed feed? It has increased the value of the cattle and, as a consequence, has increased the capital gain recognized on their sale. Thus, the deduction at ordinary rates for cattle feed has been recovered at capital gain rates on sale of the cattle. Should a part of that gain, equal to the cost of the consumed feed, be recaptured at ordinary rates? No such assertion was made in Bliss or Anders or related cases. The consumed feed has been transformed into a distinctly different asset for tax purposes in the same manner that research and development costs are transformed into technology. The latter should be subjected to tax without application of the tax benefit rule as are, apparently, the proceeds of sale allocable to values produced by consumed feed.

Moreover, given the Supreme Court's reasoning in Hillsboro, the recovery of research and development expenses at capital gain rates upon the sale of developed technology would not be considered fundamentally inconsistent with the original deduction taken pursuant to section 174(a). In Hillsboro, the effect of payment of the shareholders tax by the bank pursuant to section 164(e) was to shift the deduction for the payment from the shareholder to the bank. What was a constructive dividend to shareholders resulting from the bank's payment of their tax liability was converted by virtue of the refund into a cash dividend to the shareholders. The Supreme Court determined that the legislative history of section 164(e) concerned itself only with the payment by the bank of the tax that was imposed upon its shareholders, and not with the use to which the collected tax was put by the State of Illinois. Thus, the refund of the tax to the shareholders was not fundamentally inconsistent with the allowance of the deduction to the bank. Similarly, the legislative intent underlying section 174 was to facilitate the deduction of research and development costs by eliminating the uncertainties inherent in determining the useful life of the developed technology. It is not in the least concerned with the con-

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76 See, e.g., Spitalny v. United States, 430 F.2d 195, 197 (9th Cir. 1970). The expense deduction as permitted by regulation is intended to reflect the cost of feed actually consumed during the taxable year and to accomplish over a period of years roughly the same result as would have been had through use of the inventory method, but by a simpler form of accounting.

Id.

77 See supra note 58 and accompanying text.
sequences of the disposition of that technology. Therefore, such
disposition is no more fundamentally inconsistent with the prior
deduction of the costs of development than was the disposition of
the collected tax by the State of Illinois in *Hillsboro*.

Approached less narrowly it can be argued that *Hillsboro*
seeks to impose transactional equity so that events are treated con-
sistently with those that are related but subsequent in time, but
not at the cost of disregarding well-defined but contrary Congres-
sional intent or judicial precedent. When a concept of general ap-
pliability such as transactional equity conflicts with a more spe-
cific congressional or judicial policy or precedent, the latter should
prevail. The application of the tax benefit rule to research and
development costs to achieve tax equity and consistency is pre-
cisely that case.

Congressional policy clearly favors preferential treatment for
the development and disposition of technology. That policy is ex-
emplified by the enactment of section 1235 specifically to remove
administrative impediments to taxing the disposition of patented
technology under section 1231 at capital gain rates. Another in-

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78 Compare *Hillsboro*, 460 U.S. at 404, 421 (Stevens, J., concurring in part and dissent-
ing in part) (rejecting majority's view that purpose of tax benefit rule was to parallel results
created by tax system based on transactional rather than annual accounting, in absence of
legislative action repudiating Court's approach over past half century) with *Fribourg Navi-
gation*, 383 U.S. at 283-86 (Commissioner's position, which ignored congressional mandate
that recapture of depreciation as ordinary income limited to percentage of excess over
straight line depreciation, untenable).

79 I.R.C. § 1235 (West Supp. 1985) was enacted as part of the Internal Revenue Code of
1954 and provides, generally, for capital gain treatment to the creator of a patent provided
all substantial rights to the patent are transferred. Payments for the transfer of these rights
may extend over the life of the patent or be made contingent on its productivity, use or
disposition.

1231 in 1942, only technology not held for use in a trade or business or not subject to a
depreciation allowance because of its indeterminate useful life qualified as a capital asset,
resulting in the realization of capital gain upon its disposition. Section 1231 changed this by
qualifying depreciable technology used in a trade or business for capital gain treatment.
Generally, capital gain treatment was denied only when an inventor was considered to have
depreciable property for sale to customers in the ordinary course of business. One of
the factors used to determine whether an inventor was engaged in a trade or business was
the number of sales of technology made. The number of sales transactions necessary to
effect this transformation was uncertain. Accordingly, "professional" inventors, who sold nu-
merous patents, received different tax treatment from "amateurs" who were not as prolific.
An additional uncertainty in capital gain treatment for patent sales occurred when consider-
ation for the disposition was contingent on the use or productivity of the transferred tech-
nology. The Service argued that such a transfer was a license, rather than a sale, and the
proceeds received were royalties taxable as ordinary income. Although overwhelmingly re-
stance of preferential treatment is the recent enactment of the tax credit provided in section 44F for incremental research and development costs.\textsuperscript{81}

Section 174 is but a further indication of this favored treatment. It eliminated uncertainties as to the deductibility of development costs caused by factual problems in determining the useful life of developed technology. It did so either by permitting a current deduction for research and development costs (whether or not the developed technology had a determinable useful life) or by allowing such costs to be amortized over a period of not more than sixty months (but only when the technology did not have a determinable useful life). These provisions create a regime in which the costs of technological development are currently deductible pursuant to section 174 and the proceeds of sale are taxed at capital gain rates. If that regime is to be altered so that a portion of the proceeds of sale are to be taxed at ordinary rather than capital rates, it should be done explicitly by act of Congress. Alteration by the Service merely creates new administrative uncertainties, in place of those Congress sought to eliminate, that would inhibit technological development. Indeed, there is a specific statutory provision, section 1245, which recaptures the costs of development of technology but under limited circumstances. It does not reach development costs deducted under section 174 and the more generally applicable tax benefit rule should not be invoked to provide that result.\textsuperscript{82}

\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure}
\caption{Graphical representation}
\end{figure}

\textsuperscript{81} Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221(a), 95 Stat. 172, 241 (1981). Section 44F(a) permits credit equal to 25\% of the excess of the qualified research expenses incurred in a taxable year over the base period research expenses. See Arem, supra note 33, at 208. A qualified research expense is incurred in connection with the taxpayer's trade or business and includes in-house research, contract research, and specified corporate programs financing basic research by colleges, universities, and certain research organizations. See id. at 208-09. A base period research expense is defined as the mean of the qualified research expenses over three taxable years prior to the taxable year for which the credit is claimed. See id. at 210.

\textsuperscript{82} In GCM 39162, an internal memorandum supporting the technical advice, the Service asserted that footnotes 20 and 33 of the Hillsboro opinion support the proposition that I.R.C. § 1245 and the other statutory recapture provisions are not exclusive in their application and the tax benefit rule can be invoked without specific statutory authorization. Footnote 20 of the Hillsboro opinion states that the applicability of the tax benefit rule depends upon the specific Code provision involved. See Hillsboro, 460 U.S. at 386 n.20. The Hillsboro Court stated that the opinion merely gave the method of analysis to use in determining whether the tax benefit rule requires the recognition of income upon the gift or bequest of
Section 1245 provides for the recapture of depreciation deductions taken in respect of section 1245 property. Intangible personal property that is depreciable pursuant to section 167 is included within the meaning of section 1245 property. Thus, the costs of development of a patent that are charged to capital account and depreciated pursuant to section 167, rather than deducted pursuant to section 174(a), are subject to recapture at ordinary income rates. This is a specific and limited exception to the capital gain treatment otherwise provided pursuant to section 1235 or section 1231.

When, however, the costs of development are not charged to capital account but are currently deducted pursuant to section 174(a), the resulting intangible property is not depreciable under section 167 and thus not subject to recapture. Similarly, the costs of developing technology that has an indeterminate useful life are not depreciable under section 167. Although, upon making the appropriate election, these costs may be amortized over a period of not more than sixty months under section 174(b), such deductions,
while serving the same function as depreciation, are not the statutory equivalent of amortization pursuant to section 167. Thus, the costs of developing technology with an indeterminate life are not subject to recapture pursuant to section 1245.

Even if technology whose costs had been deducted or amortized under section 174 were includible within the meaning of section 1245 property, ordinary income would not be recaptured on its disposition since section 174 deductions are not included in the definition of recomputed basis found in section 1245(a)(2). Section 1245 provides for recapture in an amount equal to the lesser of the difference between (1) the recomputed basis or (2) the amount realized or fair market value, whichever is applicable, and the adjusted basis of the property. Thus, recapture cannot exceed the difference between the adjusted basis and the recomputed basis of the property. The Code sections enumerated in section 1245(a)(2), which are to be used in the determination of recomputed basis, include depreciation and a detailed and specific list of other similar deductions, but fail to include the deductions taken under section 174. Thus, the adjusted basis of technology when disposed of would be the same as its recomputed basis and there would be no depreciation recapture. Only if the reference to depreciation in section 1245(a)(2) could be interpreted to include section 174 deductions would a different result occur. That would appear unwarranted under the definition of depreciation found in the reg-

87 I.R.C. § 174(b) (1982) is not included within the definitional scope of § 1245 property, which includes only depreciable property under I.R.C. § 167 (West Supp. 1985), or property amortizable under I.R.C. § 185 (1982). See supra notes 83-86. Amortization pursuant to I.R.C. § 174(b) (1982), cannot be considered the equivalent of depreciation or amortization under I.R.C. § 167 (West Supp. 1985), since such amortization is specifically permitted only if it is taken with respect to nondepreciable property. See I.R.C. § 174(b) (1982). I.R.C. § 185(a) (1982) deals only with the amortization of railroad grading and tunnel bores and is apparently included within the meaning of § 1245 property because such amortization is "in lieu of any depreciation . . . ." I.R.C. § 185(a) (1982).

88 I.R.C. § 1245(a)(2) (1982) provides in part:  
(2) Recomputed basis. For purposes of this section the term "recomputed basis" means—  
(A) with respect to any property referred to in paragraph (3)(A) or (B), its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961 . . . reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168 (as in effect before its repeal by the Tax Reform Act of 1976), 169, 179, 184, 185, 188, 190, 193, 194, or (in the case of property described in paragraph (3)(C)) 191 . . . .

Id.
Thus, section 1245 recaptures only those costs of development of intangible property with a determinable useful life that have been charged to the capital account and depreciated under section 167. This specific provision for the recapture of depreciation and amortization expenses at ordinary rather than at capital rates does not provide for the recapture of current expenses or amortization of intangible research and development costs deducted pursuant to section 174. Congress enacted section 1245 precisely to alleviate the perceived problem of the utilization of depreciation deductions as an offset to ordinary income while the proceeds of sale of the property thus depreciated were accorded capital gain treatment under section 1231. Despite the fact that section 1245 was enacted nearly a decade after section 174 and has since been amended to include deductions for amortization under other sections, no attempt has specifically been made to include the deductions available under section 174 within its scope. In light of this and of the proposed amendment to section 1245 in which research and development costs were specifically excluded from the proposed expanded application of that section, it is unlikely that Congress intended that the incentives to research and development provided by section 174 be withdrawn or mitigated through application of the tax benefit rule.

This same result should also obtain in circumstances unlike those in the technical advice memorandum but similar to those of Bliss, in which an economic recovery is not present. The distribution of technology, the costs of which were expensed pursuant to section 174(a), in the course of liquidation is no more inconsistent with that deduction than is the disposition of such technology by means of a sale or exchange. In Bliss, a section 333 liquidation

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88 See supra notes 85-87 and accompanying text.
91 See supra notes 46-47 and accompanying text.
92 I.R.C. § 333 provides, generally, for the nonrecognition of gain to qualifying electing
was an inconsistent event only because it precluded the taxpayer from thereafter satisfying the premise upon which the prior deduction for cattle feed was based.\textsuperscript{84} When Bliss ceased to exist as a corporation, the feed could no longer be consumed for tax purposes in the business in which it was acquired. That result, however, is not true of every liquidation.

For example, if Bliss had been wholly owned by another corporation and liquidated pursuant to section 332\textsuperscript{85} rather than section 333, the business would have continued to exist in corporate form, with the basis of its assets unchanged.\textsuperscript{86} Essentially the same business would have continued to use the unconsumed cattle feed. Assuming the feed was ultimately consumed in full, nothing inconsistent would have transpired with respect to the prior expense except a change in corporate form. It would be erroneous to impose recapture through application of the tax benefit rule when in comparable circumstances the statutory rules of recapture under sections 1245 and 1250 are specifically made inapplicable.\textsuperscript{87}

Distribution of developed technology in the course of a liquidation of whatever kind is not an event that forever precludes fulfillment of the purpose underlying section 174(a)—that of fostering the development of technology by eliminating the need to prove a determinable useful life for developed technology in order to de-

shareholders, except to the extent that the distributing corporation has accumulated earnings and profits or distributes cash and securities acquired after December 31, 1953, with respect to liquidating distributions made within one calendar month. I.R.C. § 333(a), (e), (f) (1982). With regard to an individual qualifying electing shareholder, the character of any recognized gain is ordinary to the extent of such shareholder's ratable share of the corporation's accumulated earnings and profits, and capital to the extent that the cash and after acquired securities distributed exceed such ratable share of earnings. \textit{Id.} § 33(e). A qualifying electing corporate shareholder recognizes only capital gain in these circumstances. \textit{Id.} § 333(f).


\textsuperscript{85} I.R.C. § 332 provides for the nonrecognition of gain to a parent corporation upon the distribution of property in liquidation of a subsidiary corporation in which it owns at least 80% of the combined voting power of all classes of stock entitled to vote and of each other class, except nonvoting stock which is limited and preferred as to dividends. I.R.C. § 332 (1982).

\textsuperscript{86} I.R.C. § 334(b)(1) (1982).

\textsuperscript{87} See Feld, supra note 67, at 462; see also I.R.C. § 1245(b)(3) (1982) (if basis of property in hands of transferee is determined by reference to basis in hands of transferor by reason of application of § 332, amount of gain to transferor shall not be greater than amount of gain recognized by transferor on transfer of such property); I.R.C. § 1250(d)(3) (1982) (if basis of property in hands of transferee is determined by reference to transferor's basis by reason of application of § 332, amount of gain to transferor shall not be greater than amount of gain recognized by transferor on transfer of such property).
duct the costs of development. This purpose is not frustrated by the transfer of technology, whether by means of a liquidating distribution, a sale or otherwise. Rather, it has been fulfilled upon the creation of new or improved technology. Its use by the transferee in a liquidation or sale does not subvert that objective. On the contrary, the imposition of a tax at ordinary rates to recapture the previous section 174(a) deduction when such technology is transferred would have that precise effect because it would be tantamount to a denial of the deduction and the congressional policy supporting it. Application of the tax benefit rule in this manner would be equivalent, transactionally, to requiring that the costs of development be capitalized, thereby reducing the capital gain upon disposition and increasing ordinary income by an equivalent amount. It was exactly this result that section 174 was intended to, and did, obviate. With respect to depreciation recapture, this result should be invoked only by an equally unambiguous statutory assertion of Congressional intent and not by application of the tax benefit rule.

3. Characterization As Affected By Related Doctrines.

Although the tax benefit rule may not be appropriate to the task, there is considerable authority that the character of a transaction is determined by previously transpired events. These au-

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88 Application of the tax benefit rule to a sale of technology would recharacterize capital gain as ordinary income to the extent of the research and development costs previously deducted under I.R.C. § 174(a). The full amount realized from such a sale, however, would also be recognized as gain under I.R.C. § 1001(a), since the basis of the technology being sold would remain at zero due to the prior deduction. This would result in a duplication of income: the amount of the recovery taxed at ordinary rates under the tax benefit rule would also be reflected in the gain determined under § 1001 and taxed at capital rates. Such a duplication should not be permitted under general principles of tax law, and to avoid that result, an upward adjustment to basis should be made under I.R.C. § 1016(a) in the amount of the gain characterized as ordinary income pursuant to the tax benefit rule.

A duplication of income is not generated by recapture of depreciation under I.R.C. § 1245 which merely recharacterizes a portion of the gain determined with respect to the disposition of depreciable under I.R.C. § 1001(a) as ordinary income. Thus, no adjustment to the basis of such property is necessary or provided. In effect, recapture pursuant to the section created the interrelationship between value and depreciation expense found wanting in Fribourg Navigation Co. v. Commissioner, 383 U.S. 272 (1966). Ordinary income results to the extent that depreciation expense has reduced the basis of the property being sold by a greater amount than market forces have reduced its value.

89 See, e.g., Rees Blow Pipe Mfg. v. Commissioner, 41 T.C. 598, 604 (1964) (amount paid by seller in satisfying judgment for misrepresentation in sale of building held capital loss), aff'd per curiam, 342 F.2d 990 (9th Cir. 1965); Estate of Shannonhouse v. Commis-
TAX BENEFIT RULE

thorities do not, however, require that the gain realized on the disposition of developed technology be taxed at ordinary rates to the extent of research and development costs previously deducted under section 174.

In *Arrowsmith v. Commissioner*, the taxpayers had reported capital gain on the liquidation of their corporation. In a year subsequent to the liquidation, a judgment was rendered in favor of creditors of the corporation and the taxpayers, as transferees, were required to satisfy it. They then attempted to deduct that payment as an ordinary loss. The Supreme Court, however, required that the deduction be treated as a capital loss rather than as an ordinary loss despite the literal absence of a sale or exchange in the year of payment. In the Court's view the integral relationship between the two events, the liquidation and the payment to creditors, required that they be treated consistently for tax purposes. The capital nature of the liquidation was in essence permitted to characterize the subsequent payment to creditors.

Had the payment of the judgment in *Arrowsmith* occurred in the same taxable year as the liquidation, the assets available for distribution and the capital gain realized by the shareholders would have been decreased by an equivalent amount. The fact that the two events transpired in different taxable years was not permitted to change that fundamental result. The effect of the decision was to offset the later payment of the judgment against the previously realized capital gain because the obligation to pay the judgment arose out of the liquidation without the intervention of an event of independent significance.

The relationship between the sale of technology and the costs incurred to develop it, however, is of an entirely different nature. Although the technology would not exist "but for" the previous...
ously incurred development costs, once created, an independent judgment must be made either to retain that technology in the business or to sell or otherwise dispose of it based on its relative value in these disparate uses. The disposition does not arise out of the act of creation in the same manner as the payment of the judgment by shareholders arises out of the prior liquidation. Even if the sale of the technology were to occur in the same taxable year as that in which the section 174(a) costs were deducted, the result should not change: the creative process has no bearing on the decision to sell. That decision derives from other considerations.

Moreover, tax expenditures for research and development, when successful, result in the creation of an asset entirely different in character from those costs, destroy the necessary relationship between the two events, and renders Arrowsmith inapplicable. This analysis is supported by Continental Illinois National Bank & Trust Co. v. Commissioner, in which a corporation, prior to filing for bankruptcy, guaranteed certain conditional sales contracts and chattel mortgages that had been purchased by the petitioner. Pursuant to an arrangement in bankruptcy, the bankrupt corporation distributed its stock and two debentures to petitioner in satisfaction of the contingent liability arising out of the guarantee. Petitioner claimed a bad debt deduction measured by the difference between its unrecovered cost for the conditional sales contracts and chattel mortgages and the value of the securities received. In a later year, petitioner exchanged the debentures for additional stock of the guarantor and contributed all of the stock to charity. A charitable deduction was claimed equal to the value of the stock, which, at that time, exceeded the amount of the bad debt previously deducted. The government argued that the charitable deduction effected the equivalent of a double deduction condemned in United States v. Skelly Oil Co., and that “this should ‘always’ be viewed as relating back to the prior bad debt charge—off . . . ‘to invoke the tax benefit rule.’” The court rejected this assertion, holding that the receipt of the bankrupt’s stock and debentures closed the initial transaction in which the bad debt was claimed. The subsequent benefit derived from the charitable deduction was attributed to appreciation of the stock.

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105 Continental Illinois, 69 T.C. at 365.
received. This was a new and different investment involving risks different from the conditional sales contracts and chattel mortgages originally held, and thus did not constitute a tax benefit recovery of the previously deducted bad debt.

This same position was asserted by the Service in Revenue Ruling 66-320\textsuperscript{108} in which X was indebted to Y for $5,000 and partially satisfied that indebtedness by a transfer of property worth $3,000. Y properly deducted the unsatisfied portion of the obligation of $2,000 as a bad debt in 1961 without tax benefit. Y sold the property in 1965 for $5,000 realizing a gain of $2,000 which it attempted to exclude from income pursuant to section 111 on the ground that it represented a recovery of the bad debt previously deducted without tax benefit in 1961. In denying this contention, the ruling states:

Under the above circumstances, the acquisition by the creditor of the property in partial satisfaction of the indebtedness is separate and distinct from the subsequent sale of such property, and the gain realized on such sale does not represent income attributable to a recovery of the unsatisfied portion of the original indebtedness.\textsuperscript{107}

It is submitted that the transformation of deductible research and development costs into a new and separate asset, technology, having tax and investment characteristics entirely different from those originating costs, should similarly vitiate the essential nexus between the initial deduction and the subsequent recovery and should thereby render the tax benefit rule inapplicable.

In Skelly Oil, the taxpayer included certain contested customer receipts in income and deducted 27 and \(\frac{1}{2}\) percent thereof as the allowable percentage depletion allowance.\textsuperscript{108} In the subsequent taxable year, the contested receipts were required to be refunded and the taxpayer deducted the full amount of the rebate without reduction for the previously deducted depletion allowance. The Supreme Court refused to permit a deduction of the full amount of the rebate since that would grant “the practical


\textsuperscript{107} Id. at 38.

equivalent of a double deduction”109 absent a clear expression of congressional intent to that effect. Instead it required that the deduction with respect to the rebate be reduced by the depletion allowance previously expensed. The Court recognized the transactional nature of the issue by relying on Arrowsmith for the proposition that “if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.”110

This analysis has been criticized111 as a misapplication of the principle of Arrowsmith, which explicitly decided the characterization of a current deduction as capital or ordinary based upon the degree of relationship of prior events to that deduction. Arrowsmith, however, did not involve the duplication of tax benefits, all at ordinary tax rates, as presented in Skelly Oil. While the characterization involved in Arrowsmith can work either to the benefit or to the detriment of the government, the duplication of benefits under Skelly Oil operates to the government’s detriment in every instance.112

The combination of the deduction of research and development costs against ordinary income and the recovery of those costs upon the sale of the developed technology at capital gain rates appears to provide the duplication of tax benefits prohibited by Skelly Oil. But the resulting benefit is from the characterization of the gain realized on disposition of the technology, which does not always produce the quantitative duplication of benefits with which Skelly Oil is concerned. For example, realization of a long term capital gain on disposition of technology would not produce a tax advantage to the extent the taxpayer was required to offset such gain with short term capital losses otherwise available to offset ordinary income.113

Skelly Oil involves the reduction in the amount of a claimed deduction to prevent what the Court considered the equivalent of a double deduction; it did not concern itself with the generation of income resulting from the recovery of a prior deduction, as is tradi-

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110 394 U.S. at 685.
112 See 394 U.S. at 686.
113 See Rabinovitz, supra note 102, at 127-28.
tionally involved in the application of the tax benefit rule. Nevertheless, the Court in its approach to these differing situations recognized a certain similarity between them. With the decision in Hillsboro, the analogy between Skelly Oil and application of the tax benefit rule has become more manifest. By virtue of Hillsboro, an economic recovery is no longer required; only an event fundamentally inconsistent with the prior deduction is necessary to apply the tax benefit rule. That requirement was fully satisfied in Skelly Oil since the refund of customer fees, if it had occurred in the same taxable year in which those amounts were received, would have resulted in no income having been reported. As a result, a deduction for depletion based on the rebated receipts would not have been allowed. Hillsboro, therefore, can be seen as expanding the scope of the tax benefit rule to situations involving a duplication of tax benefits, such as Skelly Oil, that were formerly analogous but not directly pertinent to application of that rule.

Nevertheless, approached as a tax benefit case, Skelly Oil should not deny capital gain treatment to the sale or exchange of technology whose costs have been previously deducted pursuant to section 174(a). Skelly Oil recognizes that a duplication of tax benefits is permitted when Congress clearly so intends. In other words, there is no fundamentally inconsistent event if Congress intends a duplication of benefits. Congress has provided a clear expression of its intention to allow a duplication of benefits by permitting the section 174(a) deduction for research and development costs and by permitting capital gain treatment for the sale of the technology thereby developed pursuant to either section 1221, 1231 or 1235. These congressional mandates should not be ignored through an unwarranted extension of the tax benefit rule.

**Applicability of Tax Benefit Rule to Other Intangible Asset Development Costs**

The characteristics of research and development costs of technology that justify an exception to the application of the tax bene-

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114 394 U.S. at 685-86.


116 See 394 U.S. at 684.
fit rule are equally pertinent to the costs of development of other intangible assets, such as circulation expenditures incurred in the creation of a subscription list and trademark and tradename expenditures.

Each of the latter provisions was enacted to ameliorate problems of distinguishing between those expenditures properly chargeable to capital account and those that are appropriate current period expenses. For example, assume a magazine makes an extensive promotional mailing greatly in excess of its usual efforts and that the mailing is made by the regular, full-time employees of the circulation department of the magazine. In the absence of section 173, should all of these expenses be currently deducted as period costs incurred in the ordinary course of business to maintain existing operating revenues, or should they be capitalized, either in whole or in part, as providing benefits to future periods? Should characterization depend upon the relative size of the mailing compared to normal operations, and whether it is undertaken by the regular employees of the circulation department or temporary employees hired specifically for that purpose? The right to deduct

117 The legislature has provided for the recapture of specific intangible development expenses. See, e.g., I.R.C. § 1252(a)(1) (1982) (soil and water conservation and land clearing expenditures converted from capital gain to ordinary income on sale of farm land); id. § 1254(a)(1) (converts proceeds of disposition of oil, gas or geothermal property from capital gain to ordinary income to extent of intangible drilling and development costs previously deducted).

118 See id. § 173 (West Supp. 1985) (expenditures to establish, maintain or increase circulation of newspaper or periodical not chargeable to capital account allowed as deduction).

119 See id. § 177 (trademark or tradename expenditure allowed as deduction at election of taxpayer); see also Danskin, Inc. v. Commissioner, 331 F.2d 360, 362 (2d Cir. 1964) (dictum) (section 177 permits taxpayer to elect to treat as deduction what otherwise would be capital expenditure).


121 Prior to the introduction of I.R.C. § 173, money spent to increase magazine circulation was held to be a capital expenditure and thus not deductible as an ordinary expense. See Meredith Publishing Co. v. Commissioner, 64 F.2d 890, 891 (8th Cir. 1933). Recoupment of such costs would occur only upon disposition of the list, since amortization of the capitalized development costs were prohibited in the absence of a determinable useful life for the list. See id. at 891-92. But see Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1251 (5th Cir. 1973) (depreciation deduction allowed after jury determination that purchased circulation list is intangible asset with determinable useful life), cert. denied, 414 U.S. 1129 (1974); Manhattan Co. v. Commissioner, 50 T.C. 78, 93 (1968).
currently all such expenditures dispenses with these problems of classification. Similar problems exist with respect to trademarks and tradenames. Although the expenses of creation, such as salaries or consulting fees of those responsible for the initial creative effort, may be more readily distinguishable as capital rather than current period expenses, the costs incurred in developing recognition of such trademark or tradename, including extensive current period advertising expenses, may be more difficult to classify as either capital or ordinary.

It would be anomolous to recreate these issues of classification and allocation as they existed prior to enactment of section 173 and section 177 by requiring the proceeds of disposition of the created subscription list or trademark to be taxed in part as ordinary income rather than as capital gain. Application of the tax benefit rule clearly would have that effect since an allocation would be required to determine those expenses that were truly current and thus unrelated to development of the intangible asset values realized as a result of the disposition. Since these current expenses would not be recovered as part of the proceeds of sale, they would not be subject to recapture. However, development expenditures that were truly capital in nature would have contributed to the

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122 The development costs of a trademark or tradename, if capitalized prior to the introduction of I.R.C. § 177, were recovered only upon sale, since amortization of those costs was ordinarily denied in the absence of a determinable useful life for the trademark or tradename. See Norwich Pharmacal Co. v. Commissioner, 30 B.T.A. 326, 329 (1934). Section 177 of the Code, by providing only for amortization of development costs over 60 months or more rather than providing for a current deduction as does I.R.C. § 173, alleviates, but does not eliminate, the allocation problem. To the extent these development expenditures can be allocated to a current expense such as advertising, rather than to capitalized development costs that require amortization, an acceleration of the deduction results, and the taxpayer will attempt to realize that benefit of timing.

123 See supra note 26. The disposition of a trademark or tradename will be denied capital gain treatment pursuant to I.R.C. § 1253 when the transferor retains a significant power, right, or interest in the intangible asset sold.

It appears that I.R.C. § 1245 would not apply to recapture as ordinary income any part of the proceeds of sale of a circulation list if the costs of production were deducted currently under I.R.C. § 173. The asset is not one that is subject to an allowance for depreciation and this result is, therefore, appropriate. See supra notes 83-85 and accompanying text. This applies equally to amortization of the development costs of a trademark or tradename, since a trademark or tradename is not depreciable property in the absence of a determinable life, see supra note 122, and amortization of such costs pursuant to I.R.C. § 177 should not be considered the equivalent of a deduction for depreciation under § 167, see supra note 87 and accompanying text. The trademark or tradename whose costs have been expensed under I.R.C. § 177, thus, does not satisfy the definitional requirement of “Section 1245 Property” as set forth in I.R.C. § 1245(a)(3).
creation of asset values and thus would be recovered on sale of the intangible property. The expenditures would be recaptured by application of the tax benefit rule. But to apply the rule and thereby require classification of development expenses as current or capital would vitiate the very purpose for which sections 173 and 177 were enacted. The tax benefit rule should not be applied to provide such an inappropriate result.

The very fact that there are difficulties in appropriately distinguishing between true current costs and the capital costs of intangible asset development indicates a more attenuated relationship between the developed asset and such costs. Stated otherwise, the integral relationship between the initial deduction and the subsequent recovery or fundamentally inconsistent event necessary to the application of the tax benefit rule does not exist between the costs deducted pursuant to section 173 and section 177 and the sale or other disposition of the resultant intangible asset. This lack of an essential nexus between the prior deduction of these intangible asset development costs and their recovery is perhaps best illustrated by the relationship between goodwill and the costs incurred in its development. Whether goodwill is defined as the ability to generate profits in excess of those of similarly situated businesses or the ability to retain customers, it is created by the totality of the expenditures incurred in the business. If the sale of goodwill were to be considered subject to application of the tax benefit rule, should these expenditures be considered recovered so as to generate ordinary income rather than capital gain and, if so, to what extent? Clearly, any such attempt would be both improbable and impractical. In the same manner and for essentially the same reasons, the tax benefit rule should not be applied in an attempt to recover development costs of intangible assets upon their disposition, even though some nexus may be established.

As in the case of research and development costs, the sale of these intangible assets results in a capital gain greater than it would otherwise have been by the amount of the development

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124 See Estate of Masquelette v. Commissioner, 239 F.2d 322, 325-26 (5th Cir. 1956) (goodwill is value resulting from patronage of habitual customers, reputation for skill, accidental circumstances or historical prejudices); Grace Bros. Inc. v. Commissioner, 173 F.2d 170, 175-76 (9th Cir. 1949) (goodwill is sum total of imponderables that compel patrons to choose one business over another).


126 See I.R.S. Pub. No. 544 (CCH) 9 (1979) (goodwill is every positive advantage that firm acquires in progress of business).
costs expensed or amortized rather than capitalized in the course of development. Thus, the recovery has been subjected to tax, but at capital gains rates. The tax benefit rule should not be extended beyond its traditional function in the recognition of taxable income to recharacterize a portion of that gain from capital to ordinary.

CONCLUSION

From its inception to the present, the tax benefit rule has been applied to provide transactional equity in the recognition of income. This rule should not be administratively extended to recharacterize income recognized by virtue of other provisions of the Internal Revenue Code. That function, if it is to be performed, should be limited to the statutory rules of recapture specifically enacted by Congress to serve that purpose. These statutory provisions are the congressional response to perceived inequities in permitting deductions that affect the basis of property to be offset against ordinary income while the proceeds of sale of that property are taxed at capital gains rates. Extension by the Service of the scope of the statutory rules of recapture would vitiate the benefits specifically granted by Congress in enacting the deductions sought to be recaptured. Such action should be undertaken by Congress and not by administrative extension of the tax benefit rule. Deductions granted as a matter of legislative grace should fall from grace by the same hand.