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Distinction between Capital Expenditures and Expenses for the Conservation of Property Held for the Production of Income

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instituting foreclosure naming the United States as a party defendant. If the United States is not made a party to an action affecting property in which the United States has an interest, judicial sale resulting from that action will have the same effect on the federal lien as state law provides for other liens of similar standing.[21] In other words the federal lien is not effected.

Authority for a suit against the United States in cases where the United States has an interest in the property involved comes from title 28, U.S.C.A. Sec. 2410. The action may be brought in the state district court, or in federal district court. If brought in the state court, the action may be removed to the federal district court upon an appropriate motion by the United States.[22]

If the United States has a lien senior to the one satisfied by the sale, the lien of the United States will not be disturbed by the sale unless the United States consents that the property may be sold free of its lien and the United States gets the share of the proceeds to which it is entitled.[23]

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DISTINCTION BETWEEN CAPITAL EXPENDITURES AND EXPENSES FOR THE CONSERVATION OF PROPERTY HELD FOR THE PRODUCTION OF INCOME

In 1941 a taxpayer was involved with extensive investments in real estate, bonds and stocks. In pursuit of these interests he hired others to assist him in offices rented for that purpose. For the tax years in question, he claimed that salaries and expenses incident to looking after his properties were deductible under Section 23 (a) of the 1939 Internal Revenue Code, which provided for deduction of all ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business. The court held that the taxpayer merely kept records and collected interest and dividends from his securities and could not be considered as carrying on a trade or business, and disallowed the deduction.[1]

Such reasoning by the courts seemed unduly harsh, since a person receiving income was charged with his gross receipts and not allowed to set

21. United States v. City of New Britain, 347 U.S. 81, 74 S.Ct. 367, 98 L.Ed., 520 (1954).
22. 28 U.S.C.A. § 1444.
23. The government's rights to share in the proceedings of a judicial sale are as any other lienor, "first in time, first in right." Supra notes 13, 14, and 23. As between the federal tax lien and the lien of any mortgagee, pledgee, purchaser, or judgment creditor, the priority is to be determined as of the date of first recording. 9 Mertens, Law of Federal Income Taxation, § 54.42. As between the federal tax lien and all other liens, the relative priority of the federal lien is determined as of the date of assessment, and the private liens as of the date of perfection. State law determines what constitutes a perfected lien. 9 Mertens, Law of Federal Income Taxation § 54.40.

1. Higgens v. Commissioner, 312 U.S. 212, 61 S.Ct. 728, 85 L.Ed. 1145 (1941).

off the expenses incurred in obtaining those receipts.[2] To mitigate the harshness of this rule, Congress in 1942 amended Section 23 (a). This amendment was carried over as Section 212 of the 1954 Internal Revenue Code which provides as follows:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year ....
> (1) for the production or collection of income,
> (2) for the management, conservation, or maintenance of property held for the production of income; or
> (3) in connection with the determination, collection, or refund of any tax.

It was not, however, the intention of Congress in drafting this amendment to remove any of the other restrictions and limitations applicable to deductions connected with trade or business which existed prior to the amendment.[3] One such limitation with which we are concerned was set forth in Section 24 (a) (2) and prohibited any deduction under Section 23 (a) for capital expenditures. This limitation was carried forward and now appears as Section 263 of the 1954 Internal Revenue Code and continues to be a limitation on all deductions whether for trade or business or for an individual holding property for the production of income.[4]

With the birth of Section 212, much difficulty arose in distinguishing between a capital expenditure and an expenditure for the conservation of property held for the production of income. The difficulty of making the distinction was apparently due to the literal interpretation of the word "conservation," which resulted in the conclusion that the meaning embraced many expenditures which had theretofore been described as capital expenditures.

The distinction is one of importance. If the expense can be qualified under Section 212, it may be deducted as a whole in the taxable year in which it arose, and this may be an advantage in some instances. On the other hand, classification of the expenditure under Section 263 constitutes a capital charge which in the case of non-depreciable property, must be added to the adjusted basis of the property and taken into account in computing capital gain or loss on subsequent sale.[5] If the property is depreciable, the expenditure can only be recovered through annual depreciation deductions spread over the useful life of the property.[6]

In making a distinction between a capital expenditure and an expense for the conservation of property held for the production of income, it is advisable first to consider the import of the term "capital expenditure"

2. Commissioner v. Heide, 165 F.2d 699 (2d Cir. 1948).
3. S. Rep. 1683, 77th Cong. 2d Sess. 88, H. Rep. 233, 77th Cong. 2d Sess. 75; Bowers v. Lumpkin, 140 F.2d 927 (4th Cir. 1944).
4. Reg. 1.212-2- (n).
5. I.R.C. §§ 1001, 1011, 1016.
6. I.R.C. § 167.

under the Income Tax Regulations. It is stated there that the term generally applies to property owned by the taxpayer with a useful life substantially beyond the taxable year, and includes amounts paid or incurred to (1) acquire, replace, alter, develop, improve, or otherwise add to the value of the property, (2) to substantially prolong the useful life of the property, or (3) to adopt the property to a new or different use.[7] This definition has been supported to a great extent by the courts in their efforts to distinguish between a capital expenditure and an ordinary expense.[8]

Consideration will now be given to the interpretation of the word "conservation" in Section 212 of the Internal Revenue Code. Webster defines "conservation" as preserving, guarding, protecting, or keeping in a safe or entire state. The rule is well established that words of common usage should be given their usual and ordinary meaning of signification according to approved usage.[9] Could it not be considered then, by Webster's definition, that the cost of a new roof upon a building is a cost undertaken for the preservation of the building? If the need of a new roof were ignored, the building itself would probably soon fall into disrepair and the taxpayer would be robbed of its usefulness for the production of income. Is the taxpayer not permitted to preserve this building by adding a new roof and deducting the expense under Section 212? The court in *Georgia Car and Locomotive Co. v. Commissioner,*[10] said that the new roof was a replacement which prolonged the life of the building in excess of one year and the cost thereof should be treated as a capital expenditure. The expenses of rebuilding the stern of a barge, because some of the woodwork has rotted away, seems to be very necessary to keep the barge in a safe or entire state, and to preserve it for further use; however, such an expense was held to have been a capital expenditure.[11] In the case of *Black Hardware Co. v. Commissioner*[12] the court went to extremes in the application of the definition of capital expenditure. The

7. Reg. 1.263 (a) -1 and 2.

8. P. Dougherty v. Commissioner, 5 T.C. 791 (1945), expenses of rebuilding the stern of a barge was a permanent betterment. Page v. Kelm, 128 F.Supp. 14 (D. Minn. 1955), new parts added to an elevator constituted a long range improvement. Nachman v. Commissioner, 12 T.C. 1204 (1949), affirmed 191 F.2d 934 (5th Cir. 1951), premium paid for liquor license held to be an expense for the acquisition of an asset. I.T. 1309, C.B. June 1922, P. 196, where costs of installing machinery and the freight and handling charges thereon were held to be capital expenditures because in acquisition of assets. Rev. Rul. 56-520, C.B. 1956-2, P. 170, where costs of seeking an award of television channel were held to be capital expenditures, because incurred in acquiring an asset. Young v. Commissioner, 59 F.2d 691 (9th Cir. 1932), cost of destroying old buildings to make room for new changed the use of the asset and expenses were for the procurement of the new asset. John G. Bullock v. Commissioner, 27 B.T.A. 440 (1932), where cost of moving dwelling house to a residential area increased the value of the new property and was held to be a capital expenditure.

9. Miller v. Robertson, 266 U.S. 243, 45 S.Ct. 73, 69 L.Ed. 265 (1924); Allen v. Morsman, 46 F.2d 891 (8th Cir. 1931); U.S. v. Burnett, 53 F.2d 219 (D. Mo. 1931).

10. 2 B.T.A. 986 (1925).

11. Supra note 8; P. Dougherty v. Commissioner.

12. 39 F.2d 460 (5th Cir. 1925).

taxpayer lived in Galveston, Texas, which is periodically visited by storms of great violence. In 1919 a committee of businessmen recommended that the entire city level be raised to twelve and one-half feet above sea level. Taxpayer raised the lower floor of his building approximately four and one-half feet which was sufficient to protect it against the highest flood tides. In denying the rehearing the Circuit Court of Appeals admitted that the expenditures did not prolong the life of the building nor increase its value as a building, but that the improvements protected the building against future storms. The court went on to say that because of this protection the building was more valuable and the expense was therefore a capital expenditure.

To say that all of the aforementioned expenditures were incurred for the protection, safe keeping or preservation of property would indeed be the result of a literal application of the word "conservation." It is even more difficult to understand why the courts refuse to apply the term in the case of attorneys' fees incurred in the defense of title to property. In the case of *Lumpkin v. Bowers,*[13] Justice Timmerman expressed his inability to understand just how one could conserve, maintain, and manage property held for production of income, if the title thereto could not be defended from an unwarranted attack made upon it, and held that expenses incurred in the defense of title were deductible under Section 212.

The Circuit Court of Appeals later reversed the decision reiterating that it was not the intention of Congress in amending Section 23 (a) of the Internal Revenue Code to remove restrictions and limitations applicable to deductions under Section 23 (a) prior to the amendment, and prior to the amendment, it was firmly established that legal expenses involved in defending or protecting title to property were not ordinary and necessary expenses, but capital expenditures.

Since the reversal of *Lumpkin v. Bowers,*[14] it has been well settled law that expenses for the defense or perfection of title are capital expenditures for the purposes of Section 212. This position can be reconciled however, by considering the previous definitions of capital expenditures, with particular reference to the fact that all expenses incurred in the acquisition of property are capital expenditures. Learned Hand in *Commissioner v. Field,*[15] indicated that we cannot forget that a disputed right is no right at all. Consequently any expenditures involved in acquiring an undisputable title may be considered costs of acquiring an asset and are therefore capital expenditures.

A contrary position might appear to have been taken in *L. B. Reakirt*

13. 50 F.Supp. 874 (E.D.S.C. 1943), reversed 140 F.2d 927 (4th Cir. 1944), Cert. denied 322 U.S. 755.
14. Commissioner v. Field, 42 F.2d 820 (2d Cir. 1930); Huchings v. Burnett, 58 F.2d 514 (D.D.C. 1932); Browner v. Burnett, 63 F.2d 129 (D.D.C. 1933).
15. 42 F.2d 820 (2d Cir. 1930).

v. Commissioner.[16] There a taxpayer resisted an illegal attempt by a city to condemn and acquire certain of his property. The court held that the litigation was not in defense of title or to perfect petitioner's title; as a matter of fact, the effectiveness of the condemnation, if successful depended on the validity of title. The action was to enjoin the taking of the land itself, hence the expenses of defending the suit were not capital expenditures.

After applying the natural meaning of the word "conservation" to several expenditures which would ordinarily seem to be embraced by that term, it has been found that the court has labelel them capital expenditures and not deductible under Section 212 as expenses for the conservation of income producing property; therefore, we will next consider the interpretation of the meaning given to the word "conservation" under Section 212, by the regulations and decisions of the court.

At the outset it may be advisable to point out that in addition to qualifying the expenditure as one for the conservation of income producing property, it must have been paid or incurred by the taxpayer during the taxable year, and it must be ordinary and necessary. It should also be noted that the expenditure is for the conservation of property *held* for the production of income.[17] Thus the taxpayer must have undisputed title to the property before Section 212 will apply.

Looking further for a legal definition of "conservation" we find that it is to preserve in its *existing state* from *change* or destruction, to oversee, guard or shield.[18] The application of this definition is illustrated very well in the case of *Baer v. Commissioner.*[19] In a divorce settlement the petitioner's wife made a demand for payment in excess of $1,000,000. Petitioner's estate consisted largely of stock in a company of which he had control. To make the payment, petitioner would have had to sell a considerable amount of the stock thereby losing control of the company. The court held that the attorney fees paid in defending the action was for the conservation of property held for the production of income and was deductible in full. Also where the Railroad Commission of the State of

16. 29 B.T.A. 1296 (1934).
17. Edmunds v. U.S., 71 F.Supp. 29 (E.D. Mo. 1947); Helvering v. Stormfeltz, 142 F.2d 982 (8th Cir. 1944).
18. Levin v. Mede, 72 N.Y.S.2d 669 (1947); Hill v. Bank of San Pedro, 107 P.2d 399 (1940); 15 C.J.S. 984.
19. 196 F.2d 646 (8th Cir. 1952); and Northern Trust Co. v. Campbell, 211 F.2d 251 (7th Cir. 1954), where taxpayer sued to prevent the assessment of wrongful estate taxes against his property. Expenses incurred by taxpayer in successfully contesting the government's claim was for the conservation of income producing property. See also Nancy Reynolds Bagley, 8 T.C. 130 (1947). Here the petitioner made loans to executives of a company controlled by the petitioner. If she did not make the loans, the executives would be forced to sell large blocks of their stock in the company, thereby depressing the value of petitioner's stock. The expenses incurred in seeking advice from attorneys, relative to the loans were held to be deductible as conservation expenses. In Straub v. Granger, 143 F.Supp. 250 (W.D. Pa. 1956), attorney fees paid for advice on how to protect taxpayer's interest from existing management were held to be for the conservation of income producing property and deductible.

Texas issued an order regulating production of oil and gas in the producing zones where taxpayers' leases were located, the court said that although the primary purpose of oil and gas restrictions imposed by the State of Texas was the conservation of the natural resources of the state, the effect was to conserve the oil and gas interests of individual owners and lessees, therefore the costs of securing the order were deductible.[20]

In *Fredrick E. Rowe v. Commissioner,*[21] a dispute arose between the executors and the life tenant of a trust with respect to the method of allocating the proceeds of sale of oil and gas runs between income and corpus. The petitioner held a vested remainder in the trust and contends that the executor had properly set aside part of the income as corpus, in the form of reserves for depreciation and depletion of that corpus. The court said the vested remainder was properly held for the production of income and the fees were in conservation of that remainder.

A very curious case is that of *J. H. Collingwood v. Commissioner,*[22] in which a farmer terraced his farm lands to prevent erosion. In the opinion the court stated that nothing new had been added to the soil; the same crops were raised after terracing as before; no new farming areas were developed; no clearing of the land of work to prepare land for cultivation took place; the terracing work did not change the fertility of the soil, or make farming operations easier; nor did it increase the value of the land or its products. Therefore, the expenses were not capital expenditures but were for the conservation of income producing property.

Other expenses said to be for the conservation of income producing property are expenses for the rental of a safety-deposit box where investment securities were kept,[23] and insurance and storage charges for a lot of turpentine bought on speculation.[24]

With exception to the *Collingwood* case the decisions will obviously reveal no relationship to capital expenditures. None of them has increased the life or value of the property under consideration, nor have they been incurred in the acquisition or adaptation of the property; however, they would all bear recognition by application of the accepted legal definition of conservation, i.e., the act of preserving in the existing state from change or destruction.

It is apparent that the court went to great lengths in that case to avoid labeling the costs as capital expenditures, and undoubtedly did so because of the tendency of the tax court to be lenient toward farmers. Their desire to escape the language of Section 263 in the case of farmers probably

20. Campbell v. Fields, 229 F.2d 197 (5th Cir. 1956).
21. 24 T.C. 382 (1955). See Nancy Reynolds Bagley, 8 T.C. 130 (1947), where expenses paid for advice and services in planning an estate were held to be for the conservation of income producing property and deductible.
22. 20 T.C. 937 (1953).
23. Bowers v. Lumpkin, 140 F.2d 927 (4th Cir. 1944), Cert. denied, 322 U.S. 755.
24. Higgins v. U.S., 75 F.Supp. 252 (C.C. 1948).

led to Section 175, first adopted in the 1954 Internal Revenue Code, which allows a deduction to taxpayers engaged in the business of farming for expenditures incurred for soil conservation or for the prevention of erosion of land used in farming.[25]

In conclusion, it would appear that the distinguishing factors between an expense for the conservation of income producing property under Section 212 and a capital expenditure under Section 263 are: (1) an expense incurred for the acquisition of property, with a useful life of over one year is a capital expenditure; whereas an expense deductible under Section 212 must be to conserve property *held* for the production of income, and (2) a capital expenditure under Section 263 must be one which changes the physical structure of the property, which results in an increased value or life of the property, or adapts the property to a different use, whereas, an expense to be deductible under Section 212 does not change in any way the physical state of the property. On the contrary the expenses must be to protect, shield, guard, or preserve the property in its *existing* state.

THOMAS S. SMITH

THE EXPANDING STATE JUDICAL POWER OVER NON-RESIDENTS

The ultimate expansion to date of state judicial power over nonresidents was recently announced by the Supreme Court of the United States in *McGee v. International Life Insurance Co.*[1] The Court upheld a California statute[2] subjecting foreign insurance corporations to suit in California on an insurance contract with a California resident even though the insurer could not be served with process within the state. The insured purchased a life insurance policy from the defendant. He accepted the policy and paid the premiums by mail from California to the defendant's principal office in Texas. When the insured died the defendant refused to pay the claim to the insured's wife as beneficiary. The wife was granted a default judgment in California after serving process upon the defendant by registered mail in Texas. Unable to collect the judgment she filed suit upon it in Texas. The Texas courts refused to enforce the judgment, holding that it was void since the California court had no jurisdiction over the defendant insurance company. The defendant apparently had never solicited or done business in California except for the policy involved here. On certiorari the Supreme Court held that the California Court had acquired jurisdiction over the defendant within the requirements of due process; the judgment was therefore entitled to full faith and credit. It

25. I.R.C. § 174.

1. 355 U.S. 220, 78 S.Ct. 199, 2 L.Ed. 223 (1957).
2. Cal. Insurance Code §§ 1610 to 1620 (1953).