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EVERYTHING OLD IS NEW AGAIN: REACHING THE LIMITS OF *INDOPCO'S* FUTURE BENEFITS WITH THE JUST-IN-TIME MANAGEMENT PHILOSOPHY

Overzealous descriptions of company programs designed to motivate employees may trigger dire tax consequences. The Danaher Corporation ("Danaher") discovered this disturbing fact when the IRS ("the Service") denied the immediate deduction of employee training costs incurred while implementing a Just-in-Time (JIT) manufacturing system.[1] In requiring Danaher to capitalize the costs, the Service relied on Danaher's own description of "long-term benefits" obtained from "New Technician[s]" trained in the JIT philosophy.[2] In actuality, the JIT system used the same factory, machines, and employees to manufacture the same products; only the method of use changed.[3] The descriptions, however, led the Service to conclude that Danaher's extensive training created a new business that would not qualify for an immediate expense deduction otherwise available to existing businesses.[4] This result further complicates the somewhat amorphous expense/capitalization debate.

The difficulties inherent in determining the proper treatment for various expenditures have fueled an endless conflict between taxpayers and the Service. For large corporations, capitalization issues comprise the primary source of contested tax determinations.[5] Even though the Danaher ruling cannot provide reliable

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1. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995).

2. *Id.*

3. *See* Letter from James H. Ditkoff, Vice President, Finance & Tax, Danaher Corporation, to U.S. Senator Joseph Lieberman (Aug. 14, 1995) (on file with the *William and Mary Law Review*) [hereinafter Ditkoff Letter].

4. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995) (noting that the new "process represents a fundamental change in [Danaher's] operations and is a radical redesign of its manufacturing operations"); *see also* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) (allowing immediate expense deductions for employee training costs incurred when teaching employees how to operate new machines in an existing business); Rev. Rul. 96-62, 1996-53 I.R.B. 1 (requiring the capitalization of training costs only when seeking future benefits significantly greater than those traditionally obtained from training).

5. *See Tax Administration, Recurring Issues in Tax Disputes Over Business Ex-*

precedent for other taxpayers,[6] it suggests that many other businesses face the risk of unanticipated adjustments related to their training expenditures.[7] This threat appears realistic in light of recent claims of increasingly aggressive IRS behavior in capitalization issues,[8] despite a denial by the Service of any change in its policy.[9] Regardless of any change in position, the

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pense Deductions, GAO/GGD-95-232 (Sept. 26, 1995) (reporting that of 117 IRS Office of Appeals cases filed by large corporations, capital expenditure issues comprised 42% of the issues contested and $1.1 billion of the $1.9 billion in proposed tax adjustments), *reprinted in GAO Identifies Most Common Business Expense Deduction Issues Between IRS and Taxpayers*, 95 TAX NOTES TODAY 189-39, Sept. 27, 1995, *available in* DIALOG, TNT Database.

6. Section 6110 prohibits other taxpayers from relying on a Technical Advice Memorandum (T.A.M.) issued to another taxpayer as precedent. *See* I.R.C. § 6110(j)(3) (1996). Despite a T.A.M.'s taxpayer-specific application, it may provide valuable rationales for the tax treatment of various expenditures. These rationales may apply to other taxpayers' individual circumstances without rising to the level of precedental authority. *See* Sheldon I. Banoff, *Dealing with the "Authorities": Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties*, 66 TAXES 1072, 1103 (1988) (discussing the authoritative significance of a T.A.M.); *cf.* Treas. Reg. § 1.6662-4(d)(3)(ii) (as amended in 1995) (stating that even when a taxpayer lacks a written determination based on a T.A.M. naming the taxpayer specifically, the "taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision").

7. *See* Albert B. Crenshaw, *IRS Rules Against Danaher on One-Time Tax Write-Off; Conversion Decision Could Affect Other Firms*, WASH. POST, Aug. 19, 1995, at D1, D2 (reporting that during Danaher's dealings with the Service, "[a]n IRS official '[remarked] that there are billions of dollars at stake and [Danaher is] just the first one[ ] up'") (quoting James H. Ditkoff).

8. *See* Laura Saunders, *The Agents Run Riot*, FORBES, Nov. 9, 1992, at 144 (discussing the effect of the Supreme Court's ruling in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), on corporate taxation issues); *see also* Paul M. Barrett & Randall Smith, *High Court Denies Tax Deductions for Takeover Fees*, WALL ST. J., Feb. 27, 1992, at B8 (pointing toward aggressive IRS enforcement and the denial of deductions for takeover fees in *INDOPCO* as the sources for potential tax adjustments for companies involved in mergers and acquisitions during the 1980s).

9. *See* Lee A. Sheppard, *Is the IRS Abusing* INDOPCO?, 56 TAX NOTES 1110 (1992) (citing an IRS official's assertion that "traditional principles still prevail" when deciding capitalization questions); Letter from Stuart L. Brown, Chief Counsel, Department of the Treasury, to Bill Archer, Chairman of the Ways and Means Committee, U.S. House of Representatives (Oct. 1, 1996) ("[T]he service has issued a series of revenue rulings holding that *INDOPCO* does not change the fundamental legal principles for determining whether a particular expenditure may be deducted or capitalized."), *reprinted in IRS Chief Counsel's Response to Archer on FAA-Inspection Costs*, 96 TAX NOTES TODAY 198-44, Oct. 9, 1996, *available in* DIALOG, TNT Database.

ruling adds uncertainty to the treatment of training expenditures at a time when manufacturers implement new processes and procedures almost daily.[10]

This Note examines the Service's position on JIT training expenditures. The first part provides a brief overview of the management philosophy of JIT to assess its implementation and expected results. The second part shifts the focus to the evolving classifications of expenditures requiring capitalization. The third part considers the specific application of these classifications in light of some recent IRS rulings and one case involving an expanding business. This Note then concentrates on the Danaher ruling and concludes that the new business characterization appears inappropriate. Furthermore, the recurring nature of the JIT training expenditures and the lack of a clear association with future benefits requires a current deduction to avoid a distortion of income. The last part of this Note explains that other expenditures with patterns resembling the recurring nature of JIT training, with similarly indeterminable benefits, also require an immediate deduction.

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10. *See* Crenshaw, *supra* note 7, at D2. Some of the uncertainty in the capitalization area may be attributable to the lack of clear guidance from the Service after the Supreme Court decision in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). *See* Lee A. Sheppard, INDOPCO *Redux in the Manufacturing Sector*, 68 TAX NOTES 1154, 1156 (1995) ("[T]he IRS has chosen to deal with the capitalization question through technical advice, resolving taxpayer questions on a case-by-case basis . . . ."). Recently the Service requested comments on whether it should issue general guidance on capitalization principles. *See* I.R.S. Notice 96-7, 1996-6 I.R.B. 22. Some early comments advocated that the Service should continue to provide guidance through revenue rulings. *See* Sheryl Stratton, INDOPCO *Issues Continue To Perplex Practitioners and IRS*, 71 TAX NOTES 992 (1996). Others have urged guidance in the form of regulations. *See, e.g.*, John W. Lee et al., *Restating Capitalization Standards and Rules*, 15 OHIO N.U. L. REV. (forthcoming 1997) (suggesting interpretive regulations that set forth the clear reflection of income standard, a presumption of capitalization when expenditures produce future benefit, and "rough justice" exceptions to capitalization).

Beyond the potential for increased uncertainty as a result of the Danaher ruling lies the concern that the inability to deduct these expenditures will raise manufacturing costs and will harm U.S. competitiveness. *See* Laura Saunders, *How To Fight the IRS*, FORBES, Jan. 22, 1996, at 64 ("Isn't [the ability to deduct Danaher's conversion expenditures] what international competitiveness is all about?"); Ditkoff Letter, *supra* note 3. *But see* Sheppard, *supra*, at 1154 (criticizing attempts to justify an immediate deduction with the rationale that it improves a company's international competitiveness).

THE JUST-IN-TIME PHILOSOPHY

JIT manufacturing represents an approach to decreasing costs and increasing efficiency during the production process.[11] Unlike some production control methods, JIT encompasses an entire "philosophy of manufacturing."[12] At its heart lie two "common sense" aspects: the "elimination of wasteful practices" and the "habit of improvement."[13] The elimination of waste aspect stresses that nothing should remain "in the production process . . . unless it adds value to the product."[14] The habit of improvement complements this elimination of waste by seeking to improve the remaining parts of the process.[15] These aspects appear in the basic JIT components of flow, quality, and employee involvement.[16]

The flow component typically concerns itself with eliminating the waste caused by maintaining large inventories.[17] It focuses on creating reductions in lead time throughout the entire process to avoid delays and the accumulation of inventory at any stage in the manufacturing process.[18] To reduce lead times and inventories within the system, JIT strives to accomplish a continuous materials flow that arrives at the next stage of production at the very moment that it is needed.[19] This streamlined

11. *See* Paul H. Zipkin, *Does Manufacturing Need a JIT Revolution?*, HARV. BUS. REV., Jan.-Feb. 1991, at 40. The JIT philosophy can apply outside of manufacturing settings. Even white-collar "factories" can benefit from JIT's approach to eliminating waste within a system. *See* Joseph D. Blackburn, *Time-Based Competition: White-Collar Activities*, BUS. HORIZONS, July-Aug. 1992, at 96, 99 ("Although we have made great strides in simplifying manufacturing . . . administrative processes still resemble the factories of the 1950s and 1960s.").

12. Shirley A. Hopkins, *An Integrated Model of Management and Employee Influences on Just-In-Time Implementation*, S.A.M. ADVANCED MGMT. J.; Spring 1989, at 15.

13. ANTHONY DEAR, WORKING TOWARDS JUST-IN-TIME 11 (1988).

14. Hopkins, *supra* note 12, at 15. Although definitions of adding value may differ, generally "[o]nly an activity that physically changes the product adds value." EDWARD J. HAY, THE JUST-IN-TIME BREAKTHROUGH: IMPLEMENTING THE NEW MANUFACTURING BASICS 16 (1988).

15. *See* DEAR, *supra* note 13, at 11.

16. *See* HAY, *supra* note 14, at 15.

17. *But see* DEAR, *supra* note 13, at 12 (stressing that JIT seeks to eliminate all waste within a system and not just that associated with inventories).

18. *See* Uday Karmarkar, *Getting Control of Just-in-Time*, HARV. BUS. REV., Sept.-Oct. 1989, at 122, 123.

19. *See id.* Hence the name "Just-in-Time" captures the goal of synchronized pro-

system can reduce capital funds previously held in inventories, while the short lead times can increase the system's flexibility and enable it to respond to specialized customer needs.[20] These potential benefits from a relatively simple concept earned JIT praise as "a return to basics" that offers "a new vision of manufacturing—a purer efficiency than managers ha[ve] ever known."[21]

JIT's apparent simplicity obscures its latent ability to produce calamitous results. Accumulated inventories provide a safety net that can be drawn upon when an unexpected event disrupts the manufacturing process.[22] In addition to introducing unique

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duction. This concept of a continuous flow might be analogized to a fire brigade attempting to extinguish a fire by using buckets of water. *See id.* at 126. By handling one bucket at a time, each person receives the next bucket only after passing the last. *See id.* As buckets are passed along the line, an inventory of buckets will not accumulate as long as each person passes the buckets at approximately the same rate; the whole line reacts to avoid any accumulations so that only the slowest bucket passer restricts the overall pace. *See id.* In a manufacturing setting, work product would replace the buckets, and it would pass between production cells instead of individuals.

Some companies extend the continuous flow concept outside of the factory walls by including suppliers as a key element of the production system along with employees and equipment. *See* Michael A. Cusumano, *Manufacturing Innovation: Lessons from the Japanese Auto Industry*, SLOAN MGMT. REV., Fall 1988, at 29, 32 (presenting a Japanese manager's observation that efficient manufacturing required effective utilization of equipment, workers, and suppliers). These firms often attempt to coordinate delivery schedules with suppliers to avoid an unnecessary accumulation of raw materials. *See id.* at 33. *But see* Dexter Hutchins, *Having a Hard Time with Just-In-Time*, FORTUNE, June 9, 1986, at 64 ("[As a supplier, o]ur people go to meetings where the bastards [purchasing agents] are up there pounding on the table telling you how it's going to be.") (quoting Ken Stork, Purchasing Director of Motorola, Inc.); John H. Sheridan, *Just in Time: Two Perspectives*, INDUSTRY WK., Sept. 18, 1989, at 26, 27 ("[With large customers demanding tight delivery schedules,] small firms tend to see themselves as the 'whipping boys' in the JIT cycle."); Zipkin, *supra* note 11, at 46 (remarking that cooperation rarely occurs and manufacturers often coerce suppliers into complying with new JIT schedules).

20. *See* Karmarkar, *supra* note 18, at 123-24.

21. Zipkin, *supra* note 11, at 40. This vision might not be that new. *See* John F. Krafcik, *Triumph of the Lean Production System*, SLOAN MGMT. REV., Fall 1988, at 41, 42-44. Henry Ford's reason for developing mass production plants was that "the most efficient way to produce a vehicle is to minimize the time that elapses between beginning and completing production." *Id.* at 43. Unlike the JIT approach, Ford developed his concept with volume, standardization, and vertical integration. *See id.*

22. *See* P. Robert Duimering et al., *Integrated Manufacturing: Redesign the Organization Before Implementing Flexible Technology*, SLOAN MGMT. REV., Summer 1993, at 47, 48 ("[I]nventory within a manufacturing system is a buffer that absorbs vari-

problems caused by operating at low inventory levels, JIT reveals problems that previously were masked by the system's ability to continue operating by using the inventory safety net.[23] Without a net, "[s]mall amounts of inventory mean that the wrong part, machine breakdowns, absent workers, nonstandard design components, and sudden schedule changes will rapidly disrupt the manufacturing system."[24] An inability to deal effectively with these common problems may prove disastrous.[25]

JIT's habit of improvement attempts to address these problems by emphasizing quality and the importance of employee involvement. Arguably the most important feature of JIT,[26] quality enhances production flow by "doing it right the first time;"[27] product flow cannot occur when components require continual reworking and inspection.[28] Building quality into products enables the line to keep moving.[29] Implementing this philosophy requires the cooperation and involvement of employees who will endure most of the changes firsthand.[30] Gaining

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ability between interrelated manufacturing processes.").

23. *See* DEAR, *supra* note 13, at 14; Vivian Brownstein, *The War on Inventories Is Real This Time*, FORTUNE, June 11, 1984, at 20, 21 ("With minimal stockpiles at each stage of production, inefficiencies, bottlenecks, and quality problems reveal themselves . . . ."). Exposing latent problems hidden by inventories is like finding rocks in a lake: lower the water level and expose the rocks. *See* DEAR, *supra* note 13, at 12.

24. Duimering et al., *supra* note 22, at 49.

25. *See* DEAR, *supra* note 13, at 12.

26. *See* Jinichiro Nakane & Robert W. Hall, *Management Specs for Stockless Production*, HARV. BUS. REV., May-June 1983, at 84, 88 (asserting that most impediments to achieving a repetitive system are caused by quality defects).

27. HAY, *supra* note 14, at 30.

28. *See* Harold Sirkin & George Stalk, Jr., *Fix the Process, Not the Problem*, HARV. BUS. REV., July-Aug. 1990, at 26, 28-30. Operations will not improve by simply identifying defective products before they go out the door. *See id.* at 30. Improvement results as businesses move through several phases of first preventing defective products by adjusting the system after it malfunctions, second locating and fixing the root cause of the problems, and finally learning to anticipate how this system knowledge can be used to create an unsuspected competitive advantage. *See id.* at 28-32.

29. *See generally* DEAR, *supra* note 13, at 91-92 (discussing an example of a press shop that was forced to stop production constantly so that fitters or quality inspectors could adjust the presses to eliminate defects in the products).

30. *See* HAY, *supra* note 14, at 174 ("JIT . . . requires people to develop different attitudes and behaviors."). Employee involvement in turn requires the support and patience of management as the process undergoes a transformation. *See* Sirkin & Stalk, *supra* note 28, at 32-33.

employees' commitment to improving quality requires employee involvement.[31]

Beyond the general common objectives of eliminating waste and improving the underlying system, JIT develops its particularized character in the individual businesses that adopt it.[32] Although this "fungible concept"[33] lacks a standardized form, the implementation of JIT appears to have taken two distinct courses: the pragmatic and the romantic.[34]

The pragmatic approach simply views JIT as addressing practical problems within the manufacturing system.[35] A pragmatic implementation proceeds slowly, with careful deliberation over minor aspects of the production process, to accomplish small feats that aid in the manufacturing process.[36] Inventory reductions follow this slow pace when the "process-improvement tactics . . . do their work before pushing inventories down further."[37]

The pragmatic implementation of JIT uses continuous improvement to develop the system through an "accumulation of many small gains in efficiency over a sustained period of time."[38] Creating sustainable improvements through a series of

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31. *See* DEAR, *supra* note 13, at 91.

32. *See* Zipkin, *supra* note 11, at 40 (explaining that different managers who have worked with JIT may have different ideas about what it is, and what it does). Although often attributed to "pull" systems, *see* Karmarkar, *supra* note 18, at 122, JIT works with either "pull" or "push" systems. *See id.* at 124. Pull systems respond to a present customer demand by beginning production; push systems prepare production schedules to meet future demand. *See id.* at 123.

Danaher implemented an inventory control method known as *kanban*. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995). All variations of a *kanban* system use cards to communicate between production cells; each card authorizes the manufacture of a set-number of units by a cell. *See* DEAR, *supra* note 13, at 41-42. In general, as a downstream cell needs component parts, it provides an upstream cell with a card and a container intended to hold the desired number of parts. *See id.* Once the upstream cell completes the request, it returns the container and card to the downstream cell. *See id.* As the upstream cell needs to replenish its components, it supplies its own upstream cell with a similar card and container. *See id.* This procedure continues throughout the entire system and, therefore, constitutes a basic pull system. *See id.* For a general discussion of *kanban* systems, see J T. BLACK, THE DESIGN OF THE FACTORY WITH A FUTURE 156-78 (1991).

33. Zipkin, *supra* note 11, at 50.

34. *See id.* at 41.

35. *See id.*

36. *See id.*

37. *Id.* at 44

38. *Id.* at 41. Many Japanese manufacturers realized great improvements in inven-

process refinements provides greater benefits than attempting to address all problems with a one-time change.[39] The proximity of the line-employees to the process makes them ideal sources for most of these improvements; they are positioned to investigate the process, suggest improvements, and monitor the results of any changes instantly.[40] Thus, the improvements within the system occur from "employee experience and creativity" in an environment with a "natural equilibrium [of] constant improvement and change."[41]

In contrast to a pragmatic implementation, a romantic approach seeks a revolution in the workplace.[42] Often motivated by the perceived threat of foreign competition, this approach mandates urgent change toward the goal of simplicity.[43] JIT does not simply improve operations, rather it involves a complete and immediate transformation of the company.[44] Any part of the organization that hinders progress needs to be eliminated.[45] In particular, romantics cut inventory levels in order to drive reform rather than let inventory levels fall as a result of reform.[46] Frequently, this type of reform results from the motivations of senior managers acting without regard for their

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tory levels, lead times, and productivity only after an approximate five-year period. *See* Nakane & Hall, *supra* note 26, at 87. For example, Toyota Corporation spent 25 years modifying a die-changing procedure, reducing the time for this procedure from several hours to several minutes. *See* Zipkin, *supra* note 11, at 41.

39. *See* Cusumano, *supra* note 19, at 38. The process of continuous improvement closely relates to inventory levels:

> All . . . inventory levels . . . come from an inability to solve the technical and organizational problems that keep a plant from reaching its goals of stockless production. Relentless effort to solve them focuses attention on the simple modification of equipment or procedure needed to meet the endless little difficulties that crop up.

Nakane & Hall, *supra* note 26, at 85.

40. *See* Janice A. Klein, *The Human Costs of Manufacturing Reform*, HARV. BUS. REV., Mar.-Apr. 1989, at 60, 61.

41. Dean M. Schroeder & Alan G. Robinson, *America's Most Successful Export to Japan: Continuous Improvement Programs*, SLOAN MGMT. REV., Spring 1991, at 67.

42. *See* Zipkin, *supra* note 11, at 6.

43. *See id.* ("The name of the movement is not, after all, 'Almost-In-Time'.").

44. *See id.* ("Kanban is something that can be installed between any successive pair of processes in 15 minutes, using a few containers and masking tape.") (quoting RICHARD SCHONBERGER, BUILDING A CHAIN OF CUSTOMERS (1990)).

45. *See id.*

46. *See id.* at 42-44.

subordinates' roles on the actual factory floor.[47] Driven by a top-down approach, management seeks the revolution's benefits but fails to consider the real consequences that may be inflicted upon the manufacturing operations; instead of coordinating process improvements and inventory reductions, management unleashes all the problems caused by inventory reductions in the hope that JIT will take hold.[48] These rash acts sometimes produce "gruesome tales of chaotic plants, furious customers, and financial wreckage."[49]

EXPENDITURE CLASSIFICATIONS

Every business expenditure faces two alternate routes that eventually lead to the tax return. The first leads to the inviting immediate deduction as a business expense.[50] Eligibility, however, depends on the "ordinary and necessary" nature of the expense.[51] Ordinary expenses connote a "normal, usual, or customary" character,[52] suggesting a degree of recurrence, in the business operations.[53] The necessity of the expense imposes a minimal hurdle that the expense appear "appropriate and helpful" in the business.[54] Despite the emphasis frequently placed on the terms "ordinary and necessary," other requirements stip-

47. *See id.* at 44; DEAR, *supra* note 13, at 104 ("The blunt truth is that many managers don't know what is happening in the operations for which they are responsible.").

48. *See* DEAR, *supra* note 13, at 14 ("When the building is burning down we don't think of developing a fire prevention system."); Zipkin, *supra* note 11, at 44.

49. Zipkin, *supra* note 11, at 40.

50. *See* I.R.C. § 162(a) (1996).

51. *Id.* ("allow[ing] as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business").

52. Deputy v. du Pont, 308 U.S. 488, 495 (1940) ("[A]n expense may be ordinary though it happen but once in the taxpayer's lifetime. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved.") (citations omitted).

53. *See* Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 216-17 (7th Cir. 1982) ("Most of the 'ordinary,' in the sense of recurring, expenses of a business are noncapital in nature and most of its capital expenditures are extraordinary in the sense of nonrecurring.").

54. Commissioner v. Tellier, 383 U.S. 687, 689 (1966). *But cf.* May v. Commissioner, 71 T.C.M. (CCH) 2498 (1996) (questioning the helpfulness of contributions made to a church by a piano service and sale business).

ulate that the expense be paid or incurred during the taxable year, while carrying on the business.[55] The last requirement prevents the deduction of "start-up" costs.[56]

The alternate route leaves the taxpayer with a nondeductible capital expenditure.[57] These expenditures include the purchase of assets and improvements or restorations that increase the value or life of property.[58] Unlike their expense counterparts, capital expenditures presumably leave the taxpayer with something of value after the end of the tax year. Despite the apparent harshness of denying a deduction, the Internal Revenue Code ("the Code") generally permits the taxpayer to deduct a ratable portion of the asset's cost over its estimated useful life[59] in order to represent the theoretical exhaustion or wear caused by asset use.[60]

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55. *See* I.R.C. § 162(a); Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971) (outlining the statutory requirements of an allowable expense deduction).

56. *See* I.R.C. § 195 (requiring capitalization rather than deduction, but allowing an election to amortize start-up expenditures). Two alternative rationales support the disallowance of a business expense deduction for start-up costs. First, during the period of business preparation, the business has not "begun to function as a going concern and perform[ ] those activities for which it was organized." Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965). Second, expenditures during the preparatory stage might provide benefits in future tax periods and require capitalization. *See* Fishman v. Commissioner, 837 F.2d 309, 312 (7th Cir. 1988); Blitzer v. United States, 684 F.2d 874, 880 (Ct. Cl. 1982); *infra* notes 113-40 and accompanying text (discussing future benefits). These rationales leave open the debatable question of when a business actually begins. *See* John W. Lee, *Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics*, 6 VA. TAX REV. 1, 77-118 (1986).

57. *See* I.R.C. § 263(a). In a limited number of circumstances, taxpayers can immediately deduct expenditures that otherwise fall into the capital expenditure category. *See id.* § 263(a)(1) (listing exceptions); *see, e.g., id.* § 179(b)(1) (permitting a maximum annual $17,500 deduction for certain tangible property used in a business).

58. *See id.* § 263(a).

59. *See, e.g., id.* § 167 (addressing depreciation). The terms depreciation, amortization, and depletion refer to this ratable allocation. Although technically the amortization occurs over a recovery period, *see id.* § 168(a)(2), this Note uses the term "useful life" to simplify the discussion of capitalization.

60. *See* Commissioner v. Idaho Power Co., 418 U.S. 1, 10-11 (1974) (noting that depreciation attempts to match the consumption of an asset with the corresponding income produced in later periods). The asset only needs to be subject to exhaustion or wear, it does not actually need to waste. *See* Liddle v. Commissioner, 65 F.3d 329, 335 (3rd Cir. 1995) (permitting a musician to depreciate a 300-year-old bass viol); Selig v. Commissioner, 70 T.C.M. (CCH) 1125, 1127-29 (1995) (holding a show

These imprecise definitions often leave confused taxpayers on a path without any guideposts. Perhaps the most straightforward example of a capital expenditure is the procurement of a physical asset.[61] The presence of an asset in future tax years gives the appearance of a sustained value that is not consumed immediately. This logic led to the development of a one-year rule of thumb: Treat as capital expenditures any acquisition costs for assets with useful lives or similar secured advantages exceeding one year.[62] Beyond its treatment of the acquisition of physical assets, however, the simplicity of this rule deteriorates quickly, especially for asset-related costs and intangible assets.

Ultimately, the proper classification depends primarily on factual circumstances[63] because both classifications can often describe the same expenditure.[64] As a result, the chosen classification often reflects an overall desire to avoid a distortion of income.[65] Minimal distortion occurs when a deduction—as a nor-

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car that was never driven subject to depreciation due to technological obsolescence).

61. *See* Treas. Reg. § 1.263(a)-2(a) (as amended in 1987) (including as capital expenditures "[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property").

62. *See* Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950). This rule's natural corollary leads to an immediate expense for assets with lives of one year or less. *See* W.B. Harbeson Lumber Co. v. Commissioner, 24 B.T.A. 542, 550 (1931) (holding that where an asset is worn out after less than one year "the entire cost is deductible from the income of that year, whether the expenditure be designated as expense or capital").

63. *See* Deputy v. du Pont, 308 U.S. 488, 496 (1940) (stressing the importance of each case's specific facts).

64. *See* Welch v. Helvering, 290 U.S. 111, 114 (1933) (describing the distinction often as one "of degree and not of kind"). This frequent lack of distinction appears in *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979). In *Wolfsen Land*, a ranch faced a choice of cleaning a drainage ditch annually or performing more substantial work approximately every 10 years. *See id.* at 11-13. Both policies preserved the system and allowed the ranch to remain functional. *See id.* at 11. The court acknowledged that the "maintenance-type expense" incurred every 10 years closely resembled the annual maintenance because it merely returned the ditch to its original condition. *See id.* at 13. Despite the resemblance to the annual repairs, the court concluded that the substantial amount of the 10-year expenditures warranted capitalization with subsequent amortization in order to avoid a distortion of income. *See id.*

65. *See* Lee, *supra* note 56, at 10-28. In fact, the chosen classification scheme represents an accounting method that arguably must "clearly reflect income." *See* I.R.C. § 446(b) (1996) (stating that the computation of taxable income must be made by an accounting method that clearly reflects income); Lee et al., *supra* note 10 (urging the placement of future capitalization regulations under section 446).

mal business expense or as amortization—offsets the revenue it generates.[66] This process attempts to match the expense with the related revenue in the period earned.[67] From these concepts, several doctrines have emerged for distinguishing business expenses from capital expenditures for asset-related costs and intangible assets.

Asset-Related Costs

Repairs

Business expenses generally include repairs to capital assets.[68] Repairs keep property in its ordinary operating condition without adding to either the property's life or its value.[69] As such, a deductible repair amounts to a less substantial modification[70] than typically identified with asset replacements,[71] alterations,[72] or improvements.[73] Arguably, every repair adds

66. *See* Lee, *supra* note 56, at 10-28.

67. *See* Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974) ("[Section 263] serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing.").

68. *See* Treas. Reg. § 1.162-4 (1958).

69. *See id.* ("repairs . . . neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition").

70. *See* Buckland v. United States, 66 F. Supp. 681, 683 (D. Conn. 1946). Substantiality itself is another gray area:

> [T]he distinction between . . . "repair" and "replacement" is one of degree rather than of kind. . . . Most repair[s] would necessarily involve substitution of new parts or ingredients for old. If the substitution is of a major [component] . . . so that the [asset] as a whole may be considered to have gained appreciably in expectancy of useful life, it is a substitution so great in degree that we may well place it on the "replacement" side of the line.
>
> Where the substitutions, though numerous, are of relatively minor proportions of the physical structure and of any of its major parts, even though high in cost, . . . it falls more naturally on the "repair" side of the line . . . .

Id.

71. *See* Treas. Reg. § 1.162-4 (1958) (establishing the capitalization of repairs in the nature of replacements).

72. *See, e.g.*, Popular Dry Goods Co. v. Commissioner, 6 B.T.A. 78 (1927) (capitalizing expenditures for an annex that altered building fronts for the taxpayer's use).

73. *See, e.g.*, Mt. Morris Drive-In Theater Co. v. Commissioner, 25 T.C. 272 (1955)

value or prolongs an asset's life because maintenance often becomes necessary to keep an asset operable.[74] Therefore, testing a potential change in an asset's value or life requires comparing the asset after the repair with the asset during the period just prior to its entering an impaired state.[75] Moreover, replacement parts with long useful lives generally are expensed despite the capitalization suggested by the one-year rule of thumb.[76] As a limitation, however, an overriding judicial concept of a "general plan of rehabilitation" imposes capitalization treatment on repair expenses incurred in a comprehensive scheme designed to increase the value or life of the property.[77]

Origin-of-the-Claim

The broad definition of "cost of acquisition"[78] requires the capitalization of all costs associated with the original acquisition.[79] Expressed another way, this rule capitalizes all costs

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(capitalizing expenditures for a drainage system needed but not installed during the original construction of an outdoor theater), *aff'd per curiam*, 238 F.2d 85 (6th Cir. 1956).

74. *See* Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103 (1926). In *Illinois Merchants*, a building was in danger of collapsing after a wall settled from dry rot. *See id.* at 106-07. The repairs essentially prolonged the building's life by preventing its expected immediate collapse. *See id.* at 107. The court allowed a current repair deduction, however, noting that "the normal, useful, expected life of th[e] building was not increased." *Id.*

75. *See* Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962) ("The proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."), *nonacq. on other grounds*, 1964-2 C.B. 8.

76. *See* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). This one-year rule was intended merely to provide a "guidepost" for characterization without establishing a bright line rule. *See id.* Exceptions to the rule-of-thumb envisioned long-lived benefits from repair "expense[s] incurred in the replacement of a broken windowpane, a damaged lock, or a door, or even a periodic repainting of the entire structure." *Id.*

77. *See id.* at 689-90. Even though when viewed in isolation the expense appears to qualify as a repair, other facts including "the purpose, nature, extent, and value of the work done" in the entirety may establish the existence of a plan of rehabilitation. *Id.* at 690.

78. Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).

79. *See* Estate of Wilbur v. Commissioner, 43 T.C. 322, 327 n.6 (1964) (illustrating the need to capitalize the last coat of paint placed on a building in the course of construction, as opposed to generally expensing the cost of painting an existing building), *acq.*, 1965-2 C.B. 7; Shainberg v. Commissioner, 33 T.C. 241, 251 (1959) (capitalizing cleaning expenses paid to a contractor prior to the grand opening of a

incurred to put an asset into place.[80] Coined the origin-of-the-claim doctrine, this approach examines the underlying reason for incurring the expense; expenditures driven by an otherwise capital transaction rationally are deemed capital themselves.[81] Aside from preventing a current deduction for an expenditure that produces income in later periods, this doctrine preserves the character of the expenditure by disallowing an ordinary deduction for a capital expenditure.[82]

Intangible Assets

Separate and Distinct Assets

The separate and distinct asset approach developed for intangible assets is a parallel to the treatment of tangible assets.[83] Essentially, this doctrine searches for something it can call an asset.[84] The concept of finding a separate and distinct asset de-

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newly constructed building), *acq.*, 1960-1 C.B. 4, 5, *acq.*, 1960-2 C.B. 5, 7.

80. *See* Woodward v. Commissioner, 397 U.S. 572, 576 (1970) ("such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it").

81. *See id.* at 577 (capitalizing litigation expenses incurred to determine an asset's value because "the origin of the claim litigated is in the process of acquisition itself"); *see also* United States v. Gilmore, 372 U.S. 39, 46-48 (1963) (examining the connection of litigation claims with the business activities of a taxpayer); Soelling v. Commissioner, 70 T.C. 1052, 1055 (1978) (inquiring "into the origin and character of the claim giving rise to the expenditure"); *cf.* United States v. Hilton Hotels Corp., 397 U.S. 580, 584 (1970) (*Woodward* companion case) (examining the whole process of acquisition as the origin-of-the-claim and not just events occurring prior to the passage of title). Identifying the origin may prove to be a difficult task. *See* John W. Lee & Ninn R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473, 491-99 (1981) (discussing courts' attempts to apply the origin-of-the-claim doctrine).

82. *See* Sharples v. United States, 533 F.2d 550, 555 (Ct. Cl. 1976) (stating the rationale that when expenses arise from a capital transaction, they must be capitalized rather than deducted to assure that *capital* gains on the property are not offset by *ordinary* deductions). Despite the preservation of character, this doctrine may still produce income distortion through timing. *See* Lee, *supra* note 56, at 29. This timing distortion occurs when the expenditure is added to the basis of an asset with a different useful life than that of the expenditure. *See id.* Subsequent amortization of the asset may spread the cost of the expenditure over periods that it does not benefit. *See id.* at 29-32.

83. *See* John W. Lee, *Doping Out the Capitalization Rules After* INDOPCO, 57 TAX NOTES 669, 674 (1992).

84. *See* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 786 (2d Cir. 1973)

veloped from strong language in *Commissioner v. Lincoln Savings & Loan Association.*[85] *Lincoln Savings* questioned the deductibility of an "additional premium" paid to the Federal Savings and Loan Insurance Corporation (FSLIC) to establish a secondary reserve.[86] Unlike the general primary reserves designated for use by the FSLIC, the pro rata share of each insured financial institution in the secondary reserve accumulated interest and could either discharge that institution's future premium obligation to the primary reserve or it could be refunded to cover the institution's losses.[87] In assessing the deductibility of the secondary premium, the Court stated that "the presence of an ensuing benefit that may have some future aspect is not controlling" because many expenses provide future benefits.[88] Instead, "[w]hat is important and controlling . . . is that the [secondary reserve premium] serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature."[89] The Court then noted the asset-like characteristics of the secondary reserve, including its senior position to the primary reserve to cover insured losses, the insured institutions' pro rata property interests in the reserve, the inclusion of Lincoln's share of the reserve on its balance sheet, and the permanent duration of the reserve.[90]

After the *Lincoln Savings* opinion, the separate and distinct language began to appear in business expansion cases. In *Briarcliff Candy Corp. v. Commissioner,*[91] the Second Circuit considered whether a candy retailer should capitalize expenditures for sales personnel hired to solicit franchise agreements

("[T]he words ['capital asset'] must be taken in their usual and customary business sense as items of ownership of a permanent or fixed nature which are convertible into cash.").

85. 403 U.S. 345 (1971).

86. *See id.* at 345-46.

87. *See id.* at 349-51.

88. *See id.* at 354.

89. *Id.*

90. *See id.* at 354-56. The Court further noted that if the secondary reserve actually satisfied the institution's future primary premium obligations, an expense deduction would become appropriate. *See id.* at 358.

91. 475 F.2d 775 (2d Cir. 1973).

from drugstores outside its traditional sales region.[92] The Second Circuit first determined that the addition of a new corporate division to service the franchise agreements failed to create a new business.[93] The additional division simply represented the sales department that continued to function in the same candy business.[94] The court then cited *Lincoln Saving*'s required "radical shift in emphasis" from examining the duration of the benefits derived from the franchise agreements to searching for the existence of a separate and distinct asset.[95] The court concluded that the franchise agreements were not separate and distinct assets because they failed to provide the franchisor with customary "ownership of a permanent or fixed nature which [is] convertible into cash."[96] Therefore, the salaries were immediately deductible.[97]

The *Briarcliff Candy* decision led to similar holdings in bank credit card[98] and branch expansion cases.[99] The leading credit card case, *Colorado Springs National Bank v. United States*,[100] examined start-up expenditures including costs to add cardholders to the Master Charge system and to perform credit

92. *See id.* at 781. As city residents moved to the suburbs, the candy retailer sought to stem losses from a diminishing consumer population by implementing a market development strategy of soliciting independent outlets in the suburbs. *See id.* at 777.

93. *See id.* at 782.

94. *See id.* at 782-83.

95. *Id.* at 782.

96. *Id.* at 786. These best effort agreements afforded the franchisor "only marginally enforceable" rights. *Id.* at 786 n.5.

97. *See id.* at 787.

98. *See* First Sec. Bank v. Commissioner, 592 F.2d 1050 (9th Cir. 1979) (holding expenditures to implement a credit card operation to be deductible); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974) (holding the same); First Nat'l Bank v. United States, 413 F. Supp. 1107 (D.S.C. 1976) (holding the same), *aff'd per curiam*, 558 F.2d 721 (4th Cir. 1977); Iowa-Des Moines Nat'l Bank v. Commissioner, 68 T.C. 872 (1977) (holding the same), *aff'd*, 592 F.2d 433 (8th Cir. 1979).

99. *See* NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (en banc) (permitting a deduction of market survey expenditures because branch banks simply expand the business without creating identifiable assets). *But see* Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181 (5th Cir. 1984) (requiring capitalization of marketing and licensing expenditures because the branch offices themselves constitute separate and distinct assets).

100. 505 F.2d 1185 (10th Cir. 1974).

checks.[101] In denying the government's argument that the credit cards constituted a new business, the court found that the cards merely represented an extension of the overall banking business.[102] The decision explained that issuing credit cards was analogous to issuing letters of credit through modern means.[103] The court finally concluded that participation in the Master Charge system failed to create an identifiable asset.[104]

The impetus for the courts' willingness to follow the separate and distinct asset doctrine might be explained by a desire to avoid the permanent capitalization of business expansion costs.[105] Prior to the allowed amortization of start-up costs under section 195,[106] *Richmond Television Corp. v. United States*[107] required the capitalization of any start-up costs but left the potential for amortization conditional upon a determination of the asset's limited useful life.[108] In *Richmond Television*, the Fourth Circuit capitalized training expenditures incurred prior to obtaining a broadcasting license[109] by adding the expenditures to the non-amortizable basis of the license.[110] If courts followed this approach, many start-up costs would not be immediately deductible and would become non-amortizable because they would be added to the bases of non-amortizable assets or to the business as a whole.[111] Instead, by following the separate and distinct asset test that often failed to identify a cognizable asset, courts could avoid the harsh result otherwise

101. *See id.* at 1187.
102. *See id.* at 1189-91.
103. *See id.* at 1190-91 ("[Here is] an established bank which adopted a new method, use of cards and computers, to conduct an old business, financing of consumer transactions.").
104. *See id.* at 1192 ("The start-up expenditures produced nothing corporeal or salable.").
105. *See* George B. Javaras & Todd F. Maynes, *Business Expansion and Protection in the Post-*INDOPCO *World*, 55 TAX NOTES 971, 975 (1992).
106. *See* I.R.C. § 195 (1996).
107. 345 F.2d 901 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965).
108. *See id.* at 908-09.
109. *See id.* at 907-08.
110. *See* Richmond Television Corp. v. United States, 354 F.2d 410, 412 (4th Cir. 1965). The court found that the corporation's ability to renew the license created an asset with an unlimited useful life. *See id.*
111. *See* Lee, *supra* note 56, at 45.

suggested by *Richmond Television*.[112]

Future Benefit

The Supreme Court returned to the capitalization issue[113] in *INDOPCO, Inc. v. Commissioner*[114] in order to clarify *Lincoln Savings* and eliminate any confusion in applying the separate

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112. *See, e.g.*, Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) ("The government suggests no way in which [the start-up expenditures] could be amortized. The government's theoretical approach . . . permits a distortion of [the] taxpayer's financial situation.").

Unfortunately, this all-or-nothing approach of either permitting a current deduction or adding the cost to a non-amortizable asset missed the middle ground of amortizing the cost over a fixed period such as the life of another depreciable asset. This middle ground would distort income less than these other alternatives. The Service used this more sensible analysis in some of its rulings. *See, e.g.*, Tech. Adv. Mem. 7509099440A (Sept. 9, 1975) (capitalizing training costs for a new plant to an intangible asset called an "operational electric plant" and permitting an amortization period based on the life of the underlying physical plant); Tech. Adv. Mem. 94-30-003 (Apr. 22, 1994) (capitalizing training costs in a new power plant as a freestanding asset amortized over a 40-year period commensurate with the duration of an operating license). *But see* Tech. Adv. Mem. 96-45-002 (June 21, 1996) (allowing a current deduction for start-up costs, in particular for training costs, due to the recurring nature and short-term benefits provided by these costs in high-turnover retail stores); *cf.* Cabintaxi Corp. v. Commissioner, 63 F.3d 614, 619 (7th Cir. 1995) (explaining that start-up costs traditionally are not incurred on a continuous basis).

113. The Court addressed capitalization one year after *Lincoln Savings* in *United States v. Mississippi Chemical Corp.*, 405 U.S. 298 (1972). In *Mississippi Chemical*, the Court examined the deductibility of bank stock purchased by farm cooperatives as required by their loan terms. *See id.* at 299-300. The loan terms required each cooperative to purchase stock with a par value totaling at least 15% of the cooperative's quarterly interest payment. *See id.* Congress mandated the stock purchase requirement in an attempt to raise private funds to displace public support for farm loans. *See id.* at 302-05. In assessing the deductibility of the stock's cost, the Court focused on the stock's value as part of the capital structure that maintained this type of farm financing. *See id.* at 309-12. Without identifying a separate and distinct asset, the Court concluded that the stock's ability to sustain its value into other taxable years made the security a capital asset. *See id.* at 310.

Arguably, the Court's opinion in *Mississippi Chemical* followed a future benefits analysis and indicated that the separate and distinct asset test was not an exclusive test for determining capital expenditures. If *Lincoln Savings* had announced an exclusive test for capital asset determination, it would have overruled many other decisions without any discussion. *See* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 225 (1985). Furthermore, the decision in *Mississippi Chemical* would indicate that the Court was unaware of its own previous formulation of an exclusive test. *See id.* at 223-24.

114. 503 U.S. 79 (1992).

and distinct standard.[115] The Court explained that *Lincoln Savings* merely suggested capitalization for expenditures that create or enhance a separate and distinct asset; when an expenditure creates a distinct asset, it cannot be ignored.[116] The announced standard did not foreclose other means of determination.[117] In particular, the Court emphasized that *Lincoln Savings* never "prohibit[ed] reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure."[118] The Court stressed that something more than a mere incidental benefit beyond the tax year in which the expenditure is incurred remains "undeniably important" in assessing the proper tax treatment.[119]

Future benefits embodied the long-recognized concept that an expenditure could provide usefulness beyond the taxable year in which it was incurred.[120] These long-term benefits characterize an asset rather than an expense, despite the lack of a corporeal asset.[121] In order to clearly reflect income, these expenditures should be capitalized, and subsequently amortized, over the period benefited.[122]

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115. *See id.* at 83 & n.3.

116. *See id.* at 86-87.

117. *See id.* at 87 ("*Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure.").

118. *Id.*

119. *See id.* (stating that "the mere presence of an incidental future benefit—'*some* future aspect'—may not warrant capitalization").

120. *See* United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957) (characterizing sums paid by a taxpayer to ditch companies as possessing the future benefit of strengthening the financial position of the ditch companies to assure the taxpayer that water would remain available).

121. *See* United States v. Mississippi Chem. Corp., 405 U.S. 298, 310 (1972); General Bancshares Corp. v. Commissioner, 326 F.2d 712, 716 (8th Cir. 1964) ("[I]t is not enough to demonstrate that [the expenditures] possess some characteristics different from the more commonly accepted capital expenditures (such as those directed toward the acquisition of a recognizable and tangible corporate asset).").

122. *See INDOPCO*, 503 U.S. at 83-84; Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974) ("[Capitalization] serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."). Unfortunately, the *INDOPCO* opinion also mentioned that "deductions are exceptions to the norm of capitalization" and that any deduction is a "matter of legislative grace." *INDOPCO*, 503 U.S. at 84. Although some courts apparently have interpreted this language as creating a presumption of capital-

The Court, in *INDOPCO*, required capitalization for banking, legal, and other costs incurred to facilitate a friendly takeover.[123] Without pointing to a well-defined asset, the Court relied on the lower courts' findings of substantial future benefits secured by the merger.[124] These benefits included the potential synergy gained by pooling resources and a reduction of "shareholder-relations expenses" by dealing with only one shareholder.[125]

In contrast to the future benefits obtained by the friendly takeover in *INDOPCO*, questions immediately were raised about the viability of this argument in a hostile takeover context.[126] Some commentators argued that expenditures incurred to resist a takeover bid simply would not produce future benefits.[127] Even the

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ization, *see* United States v. Binstein, No. 94-386, 1996 WL 19132, at *8-*9 (D.N.J. Jan. 3, 1996) (stating that Code provisions granting deductions are construed strictly); Durando v. United States, 70 F.3d 548, 550 (9th Cir. 1995) (holding the same); *cf.* Glenn R. Carrington, *Capitalization After* INDOPCO, *in* 53 INST. ON FED. TAX'N §§ 25.00, 25.02[4][b] (1995) (questioning whether the Code could be read to provide a general rule that business expenses are currently deductible with section 263 supplying exceptions for capitalization), others properly have construed the language to mean that the taxpayer has the burden of proof for any claimed deduction. *See* Kim v. Commissioner, 70 T.C.M. (CCH) 1595, 1595 (1995) (explaining that the taxpayers bear the burden of proving that they should receive any claimed deductions); Georgiou v. Commissioner, 70 T.C.M. (CCH) 1341, 1347 (1995) (holding the same); Stricker v. Commissioner, 70 T.C.M. (CCH) 1192, 1194 (1995) (holding the same); Wise v. Commissioner, 70 T.C.M. (CCH) 1095, 1098 (1995) (holding the same).

123. *See INDOPCO*, 503 U.S. at 88-89.

124. *See id.* at 88.

125. *See id.* (rejecting claims that any benefits acquired were "'entirely speculative' or 'merely incidental'") (quoting Petitioner's Brief at 39-40, *INDOPCO* (No. 90-1278)).

126. *See* J. Phillip Adams & J. Dean Hinderliter, INDOPCO, Inc. v. Commissioner: *Impact Beyond Friendly Takeovers*, 55 TAX NOTES 93, 98-99 (1992) (noting that the outcome of hostile takeover attempts should be irrelevant in permitting the deduction of defense expenses); Richard M. Lipton et al., *Supreme Court Approves Focus on Long-Term Benefit in Takeover Expense Controversy*, 76 J. TAX'N 324, 328-29 (1992) (considering the role of the "long-term benefit" requirement in determining whether costs incurred during takeover attempts should be capitalized); Sarah R. Lyke, Note, INDOPCO, Inc. v. Commissioner: *National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1257-62 (1994) (defending the deductibility of expenses arising from hostile takeover bids).

127. *See* Adams & Hinderliter, *supra* note 126, at 98 ("The avoidance of a detriment should not be a significant benefit—any benefit is indirect and incidental, and not the primary purpose of the takeover expense."); Paul D. Manca, Note, *Deductibility of Takeover and Non-Takeover Expenses in the Wake of* INDOPCO, Inc. v. Commissioner, 45 TAX LAW. 815, 819-20 (1992) ("Expenses that simply repel an at-

Service experienced significant difficulties in determining its stance prior to *INDOPCO*.[128] Likewise, the courts addressed this issue with varied results.[129] As the variety of approaches

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tack do not create a long-term future benefit, they preserve the status quo and allow the business to continue functioning as it had before.").

128.

> To briefly summarize, TAM 8516002 found costs to oppose a hostile takeover were deductible. TAM 8626001 withdrew TAM 8516002, but TAM 8816005 reinstated it. TAM 8927005 confirmed that such costs were deductible. However, TAM 8945003 revoked TAM 8927005 as being inconsistent with the Tax Court's decision in *National Starch* [*INDOPCO*'s case name in the lower courts]. TAM 9043003 determined that costs to resist a hostile takeover were deductible but costs to locate a white knight were not. TAM 9144042 . . . concludes that such costs may be deductible if the taxpayer can show it did not derive a long-term benefit.

Adams & Hinderliter, *supra* note 126, at 98 n.41.

129. In an early decision after *INDOPCO*, the Tax Court indicated that a corporation's initial reluctance to accept a takeover bid would not be considered hostile when the board of directors eventually adopts the merger plan. *See* Victory Mkts., Inc. v. Commissioner, 99 T.C. 648, 661-62 (1992) (emphasizing that the hostile bidder never attempted to circumvent the board of directors by appealing directly to the shareholders). At least one commentator has suggested bifurcating expenditures in these situations between those for the defense (deductible) and those for the agreed-upon acquisition (capitalized). *See* Adams & Hinderliter, *supra* note 126, at 99.

Federated Department Stores, Inc. v. United States, 171 B.R. 603 (Bankr. S.D. Ohio 1994), permitted the deduction of breakup fees incurred while trying to avoid a hostile takeover. *See id.* at 610. In that case, the target corporations incurred breakup fees that compensated potential white knights for their expenses when proposed friendly mergers failed and the targets fell prey to the hostile suitors. *See id.* at 605-07. The court distinguished these hostile takeovers from the benefits obtained in *INDOPCO* by emphasizing the lack of synergies created when a corporation takes over a target without having any experience in the target's business. *See id.* at 609. Although not determinative, the court noted that, in hindsight, the targets' subsequent bankruptcies supported the finding of a lack of future benefit. *See id.* at 610. Responding to the contention that the breakup fees were incurred to change the corporate structures for the benefit of future operations, the court noted that the fees constituted defensive tactics to protect the businesses, and they did not represent attempts simply to change the corporations' structures. *See id.* at 609-10.

A divided Tax Court recently addressed the issue of a hostile takeover in *A.E. Staley Manufacturing Co. v. Commissioner*, 105 T.C. 166 (1995). In *Staley*, a target corporation concerned about the potential of a takeover adopted numerous defensive measures. *See id.* at 170-72. This concern was realized when a hostile suitor began making market purchases of the target's stock and made several tender offers. *See id.* at 172-74, 176-79. Despite the board of directors' attempts to avoid the takeover, it eventually recommended the merger after concluding that it could not provide the shareholders with an alternative plan. *See id.* at 178-80. Relying on the "origin-of-the-claim" doctrine, the Tax Court majority noted that the defensive measures were related to the change in the capital structure of the target. *See id.* at 195-98. Be-

taken by commentators, the Service, and the different courts indicate, the issue of deductibility of expenditures incurred by a target during a hostile takeover is far from settled.[130]

Unfortunately, this confusion could have been avoided if the Court denied the deduction on the basis of the potential distortion of income rather than the potential future benefits. The particular reorganization in *INDOPCO* was designed to facilitate a tax-free transfer to accomplish the estate planning of the majority shareholders.[131] This reorganization deferred the recognition of gain until future tax years. If the reorganization expenditures were deducted immediately, then income distortion would occur when the expenses were not matched with the revenue generated by the transaction.[132] Instead, matching requires capitalizing the expenditures until the future recognition of the gain.[133] Under a distortion of income approach, therefore, the presence of a future benefit is less determinative.[134] The Court, however, deviated from its initial approach of matching[135] and searched

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cause a change in the capital structure produces future benefits that justify capitalization under *INDOPCO*, the related defense expenditures also must be capitalized because they originated from the same transaction. *See id.* at 196-98. A concurring opinion by Judge Beghe emphasized that a change in ownership may not always produce future benefits so that a proper analysis focuses on whether the benefits occur in the current or future years. *See id.* at 202-03 (Beghe, J., concurring). Regarding the *Staley* merger, Judge Beghe concluded that there were future benefits. *See id.* at 203-04 (Beghe, J., concurring).

Judge Cohen dissented, pointing out that the board of directors consented to the merger only reluctantly. *See id.* at 214 (Cohen, J., dissenting). The consent resulted from the board's decision that further resistance would not be successful; even after acquiescing, the board never expected to realize future benefits from the hostile takeover. *See id.* at 214-16 (Cohen, J., dissenting). The only party expecting any benefits was the hostile suitor, not the unwilling target. *See id.* at 215-16 (Cohen, J., dissenting). Another dissent, by Judge Laro, stressed that a hostile takeover itself should indicate a lack of future benefits because expenditures for defensive measures are not intended to produce lasting improvements. *See id.* at 219-20 (Laro, J., dissenting).

130. *See* Richard M. Lipton, *Divided Tax Court Applies* INDOPCO *to Hostile Takeovers*, 84 J. TAX'N 21, 21 (1996).

131. *See INDOPCO*, 503 U.S. at 80-81.

132. *See* Calvin H. Johnson, *Capitalization After the Government's Big Win in* INDOPCO, 63 TAX NOTES, 1323, 1329 (1994) ("[I]t is a sin, the sin of *mismatching*, to deduct expenses immediately, while deferring the gain on the sale.").

133. *See id.*

134. *See id.*

135. *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992) ("[T]he Code

instead for any future benefits from the transaction.[136]

Although *INDOPCO* revitalized the future benefit concept, the decision failed to provide guidance for assessing the minimum benefits necessary for capitalization. The Court provided a standardless basis by concluding that "[a]lthough the mere presence of an incidental future benefit—'*some* future aspect'—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining . . . the appropriate tax treatment."[137] Following this standard literally may require capitalizing almost every business expenditure.[138] The Court clearly sought to avoid that result, however, by affirming its statement in *Lincoln Savings* that an ensuing benefit may not automatically require capitalization.[139] *INDOPCO* rejected subsequent interpretations of *Lincoln Savings*, but did not overrule that decision.[140] With the absence of a clear standard, classification determinations seem to have returned to an uncertain state.

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endeavors to match expenses with the revenues of the taxable period to which they are properly attributable . . . .").

136. *See id.* at 88-89.

137. *Id.* at 87; *accord* Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984) ("While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item."). This style characterized *INDOPCO* and other predominant capitalization cases written by Justice Blackmun. *See* Newark Morning Ledger Co. v. United States, 507 U.S. 546, 566 (1993) ("The significant question for purposes of depreciation is not whether the asset falls 'within the core concept of goodwill,' but whether the asset is capable of being valued and whether that value diminishes over time.") (citations omitted); Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) ("[T]he presence of an ensuing benefit that may have some future aspect is not controlling"); General Bancshares Corp. v. Commissioner, 326 F.2d 712, 716 (1964) ("[In capitalization issues] there is no readily available formula.").

138. *See* Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 217 (7th Cir. 1982) (illustrating the potential for capitalizing a salesperson's salary because sales activities generate future benefits through goodwill).

139. *See INDOPCO*, 503 U.S. at 87.

140. *See* Javaras & Maynes, *supra* note 105, at 973.

A RETURN TO UNCERTAINTY: WRESTLING WITH FUTURE BENEFITS

The potentially broad scope of future benefits created frustration because *INDOPCO* eliminated the supposedly bright-line separate and distinct asset rule.[141] Some practitioners claimed that the decision's breadth produced too much uncertainty and permitted the Service to question otherwise settled areas.[142] The Service countered that *INDOPCO* merely affirmed the Service's long-standing position on capitalization.[143] Subsequent rulings and decisions failed to provide any consistent guidance.

IRS Rulings After INDOPCO

Repair Expenditures

The Service concluded that *INDOPCO* would not alter the treatment of incidental repair costs.[144] It explained that the decision merely clarified that the satisfaction of the separate and distinct asset rule was not a prerequisite to capitalization.[145] Instead, expenditures that produce multiperiod benefits "require[ ] a careful examination of all the facts."[146] A factual examination, therefore, would support the deduction of incidental

141. *But see INDOPCO,* 503 U.S. at 87 n.6 (arguing that even with a "separate and distinct asset" test, the term "'asset' is itself flexible and amorphous").

142. *See* Saunders, *supra* note 8, at 144 (suggesting that *INDOPCO* gave the government license to question previously undisputed deductions whenever they involve "at least some element of future benefit"); Rita L. Zeidner, *Treasury-IRS Business Plan Wins Praise,* 92 TAX NOTES TODAY 112-4, May 29, 1992 ("IRS field agents have been running wild, using [the *INDOPCO* ruling] to deny all manner of deductions.") (quoting Tim McCormally, Tax Counsel for Tax Executives Institute, Inc.), *available in* DIALOG, TNT Database.

143. *See* Sheppard, *supra* note 9, at 1110. The Service contends that *INDOPCO* merely applied existing general capitalization rules without approving a new principle of law. *See id. But see Brown Lists Factors That Could Be Used To See If Cleanup Costs Must be Capitalized,* 1993 DAILY TAX REP. 45 d19, Mar. 10, 1993 (noting that despite the lack of change "we discover[ed] that we don't know what the pre-*Indopco* standard was") (quoting Stuart Brown, IRS Associate Chief Counsel (Domestic)), *available in* WESTLAW, BNA-DTR Database.

144. *See* Rev. Rul. 94-12, 1994-1 C.B. 36.

145. *See id.* at 37.

146. *Id.*

expenditures regardless of some possible future benefit.[147]

Advertising Expenditures

The Service also declined to change its position on the immediate deduction available for advertising expenditures.[148] Although the Service expressly acknowledged their potential "future effect on business activities," especially from institutional or goodwill advertising, it held in light of *INDOPCO* that the amounts remain currently deductible.[149] As a caveat, it added that expenditures must be capitalized when the advertising seeks to "obtain[ ] future benefits significantly beyond those traditionally associated with . . . advertising."[150] To some degree, it seems that the Service will permit a deduction when the future benefits are indeterminable.

Business Programs Aimed at Increased Efficiency

The Service determined that severance payments made to terminated employees during a business downsizing remain cur-

147. *See id.* By citing *INDOPCO,* the Service must assume that the Court's description of "incidental future benefit," INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992), equates with the benefits of an "incidental repair." Rev. Rul. 94-12, 1994-1 C.B. 36. *Cf.* Tech. Adv. Mem. 94-24-002 (Feb. 9, 1994) (denying a repair deduction due to the *substantiality* of more than one billion dollars spent for temporary work performed to raise oil rig platforms and to construct a barrier wall around a storage tank, protecting the equipment from the sinking ocean floor).

148. *See* Rev. Rul. 92-80, 1992-2 C.B. 57.

149. *See id.*; Peter L. Faber, INDOPCO*: The Still Unsolved Riddle,* 47 TAX LAW. 607, 624 (1994) ("The Ruling does not indicate why advertising expenses should be deductible, other than that they always have been.").

150. Rev. Rul. 92-80, 1992-2 C.B. 57; *cf.* Tech. Adv. Mem. 95-41-004 (June 30, 1995) (capitalizing commissions paid on pre-need funeral contracts due to the greater likelihood of generating at-need funeral sales from parties to the contracts than from more traditional advertising attempts). The Service cites *Cleveland Electric Illuminating Co. v. United States,* 7 Cl. Ct. 220 (1985), as its sole support for capitalizing advertising expenditures. Rev. Rul. 92-80, 1992-2 C.B. 57. *Cleveland Electric,* however, involved publicly focused advertising to assist in the acquisition of a license to open a nuclear power plant. *See Cleveland Elec.,* 7 Cl. Ct. at 231. The court found that the generally deductible advertising expenditures needed to be capitalized because the purpose of the advertising was to facilitate the purchase of a capital asset by avoiding public opposition. *See id.* at 231-32. Therefore, the advertising expenditures related to part of the acquisition price and were capitalized with an amortization period over the life of the acquired plant. *See id.* at 233.

rently deductible.[151] After citing *INDOPCO* for the proposition that "the mere presence of some future benefit may not warrant capitalization,"[152] the Service drew an analogy between the costs of repairs or advertising and the severance payments in a downsizing.[153] In each case, it determined that the potential future benefit would not warrant capitalization even though the downsizing may "reduc[e] operating costs and increas[e] operating efficiencies."[154] Echoing the origin-of-the-claim doctrine, the Service found that the severance payments were "principally relate[d]" to employee services in the past.[155]

In Revenue Ruling 95-32, the Service considered expenditures incurred in a utility company's programs designed to achieve increased energy conservation and efficiency.[156] Aside from addressing concerns about the environment and society, the programs enabled the utility to "reduce its future operating and capital costs."[157] In addition to capitalizing the costs on its financial

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151. *See* Rev. Rul. 94-77, 1994-2 C.B. 19.

152. *Id.* at 19-20.

153. *See id.*

154. *Id.* at 20; *cf.* Priv. Ltr. Rul. 92-40-005 (June 12, 1992) (permitting a deduction of settlement costs incurred to cancel a coal supply contract because the ability to reduce operating costs by making spot market purchases produced only speculative future benefits). *But cf.* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 88-89 (1992) (finding substantial benefits in a report stating that "management 'feels that some synergy may exist'" and that the company experienced reduced "shareholder-relations" costs in "reporting and disclosure obligations, proxy battles, and derivative suits . . . and in the interests of administrative convenience and simplicity, to eliminate previously authorized but unissued shares" of stock).

155. *See* Rev. Rul. 94-77, 1994-2 C.B. 19, 20; *cf.* Tech. Adv. Mem. 95-40-003 (June 30, 1995) (concluding that bonus payments made to stock option holders in a merger originated in employment relationships instead of the merger); Tech. Adv. Mem. 95-27-005 (Mar. 15, 1995) (holding the same). This reasoning follows the origin-of-the-claim doctrine by carefully identifying the transaction that gave rise to the payment obligation.

156. Rev. Rul. 95-32, 1995-1 C.B. 8; *cf.* Tech. Adv. Mem. 95-48-004 (Aug. 9, 1995) (allowing an expense deduction for conservation expenditures that are not designed to acquire new customers); Tech. Adv. Mem. 95-13-002 (Nov. 28, 1994) (permitting a deduction for expenditures made by an electrical utility for conservation programs).

157. Rev. Rul. 95-32, 1995-1 C.B. 8. Utilities frequently use these programs to avoid the more expensive construction of additional capacity; to build goodwill through advertising and public relations; or to respond to the encouragement of utility commissions that seek natural resource conservation, consumer electricity rate reductions, and environmental protection. *See* Hal Gann & Roy Strowd, *Demand Side Economics*, 67 TAX NOTES 1249 (1995).

books, the utility received favorable rate structure treatment from the state regulatory commission based on these program expenditures.[158] The rates that the utility could charge its customers included an amount designed to generate a rate of return on the unamortized cost equal to other rate-based investments.[159] The utility also could include a portion of the costs avoided through the program's conservation efforts in its rate base.[160]

The Service permitted a current deduction for the utility company's expenditures.[161] The ruling noted that the programs neither acquired nor retained any asset.[162] Moreover, the ruling stated that despite *INDOPCO*, the "kinds of benefits" obtained from reduced operating and capital costs do not warrant capitalization.[163] Although this ruling may apply only to regulated industries such as utilities, the ruling may also reflect the tacit recognition by the Service that *INDOPCO* permits the deduction of many different costs incurred by businesses in their hopes of generating greater profits through lower operating costs.[164]

Environmental Cleanup Costs

In three technical advice memoranda and a revenue ruling, the Service chartered a shifting course in environmental cleanup expenditures. The first technical advice memorandum re-

158. *See* Rev. Rul. 95-32, 1995-1 C.B. 8, 9.

159. *See id.* at 9.

160. *See id.*

161. *See id.*

162. *See id.* Although assisting customers in designing efficient systems, the utility did not obligate customers to purchase their future power from the utility; therefore, future sales were not assured. *See id.*

163. *Id.*; *cf.* T.J. Enters., Inc. v. Commissioner, 101 T.C. 581, 593 (1993) (allowing deductions for payments to a retiring shareholder that enabled the franchisee to reduce its operating costs by paying lower royalty payments to the franchisor). The ruling tacks on an ambiguous qualification that "these kinds of benefits, *without more*" would not be considered under *INDOPCO*, but it did not indicate what type of circumstances might require capitalization. Rev. Rul. 95-32, 1995-1 C.B. 8, 9 (emphasis added); *cf.* Tech. Adv. Mem. 95-13-002 (Nov. 28, 1994) (permitting a deduction for conservation and load management expenditures because a potential reduction in "operating costs is not in and of itself sufficient to require capitalization").

164. *See* Gann & Strowd, *supra* note 157, at 1251. Read broadly, the ruling suggests that a speculative reduction of operating and capital costs may provide insignificant benefits under *INDOPCO*. *See id.*

quired capitalization of expenditures made to replace asbestos insulation in manufacturing equipment.[165] The magnitude of the benefits obtained by removing health risks and increasing the equipment's marketability belied the taxpayer's characterization that the replacement constituted an incidental repair.[166] One significant factor examined by the Service was the degree of permanence of the expenditure—a repair "remedies immediate consequences," whereas the taxpayer's replacement permanently cured the problem.[167]

In another memorandum, the Service again considered the abatement of asbestos, located this time in a building.[168] Relying on similar reasoning, the costs of removing the asbestos were capitalized, but the costs incurred in encapsulating the asbestos were deducted.[169] The difference in treatment focused on the respective permanent and temporary solutions to the problems.[170]

The final memorandum addressed the remediation of soil contaminated with hazardous waste.[171] The Service focused primarily on the increase in value obtained by owning uncontaminated property.[172] It did not find compelling the taxpayer's arguments that the land was simply returned to its original state, and the Service required capitalization for the expenditures made to increase the property's value.[173] Former Chief Counsel for In-

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165. *See* Tech. Adv. Mem. 92-40-004 (June 29, 1992).

166. *See id.* The taxpayer argued that the value of the property had not increased because the property was returned to its original state. *See id.* The Service denied the taxpayer's reliance on *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq. on other grounds*, 1964-2 C.B. 8, where the Tax Court measured an increase in value by comparing the asset's value before the impairment and after the expenditure. Tech. Adv. Mem. 92-40-004 (June 29, 1992). The Service determined that the *Plainfield-Union* test did not control the present case, and asserted that the test is relevant only when repairs are necessary because of the progressive deterioration of the property. *See id.*

167. *See* Tech. Adv. Mem. 92-40-004 (June 29, 1992).

168. *See* Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993).

169. *See id.*

170. *See id.* ("By removing the asbestos, the taxpayer permanently eliminated the defect . . . . [whereas] the effects of the encapsulation on taxpayer's property are temporary.").

171. *See* Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992).

172. *See id.*

173. *See id.*

come and Accounting, Glenn Carrington later revealed that the costs were capitalized to the basis of a gas pipeline that caused the original contamination.[174] The ability to depreciate the pipeline, as opposed to land, would avoid a distortion of income.

Despite the position taken on soil remediation in its December 1992 memorandum, the Service issued Revenue Ruling 94-38, permitting a deduction.[175] With a similar factual pattern, the ruling explained that the soil treatment failed to produce any permanent improvements.[176] Moreover, the treated land failed to provide any "significant future benefits" under the *INDOPCO* standard.[177] Finally, the land's value was tested prior to the treatment and immediately afterward to assess any change in value, but the Service found no increase in value because the treatment "merely restored" the asset to its original condition.[178] One explanation for this perceived change in position,[179] appears in the ruling's concluding remarks that if the cleanup costs were capitalized to the land, then the costs could not be amortized.[180] An immediate deduction, therefore would create less distortion of income than permanent capitalization.[181]

174. *See* Carrington, *supra* note 122, § 25.03[5][c], at 25-29.

175. 1994-1 C.B. 35.

176. *See id.* at 36. In contrast, the soil and water treatment facilities did provide future benefits and therefore expenditures related to their construction were capitalized. *See id.*

177. *Id.* The lack of future benefits might not be creditable given that the cleanup avoided future environmental liability and the threat of the EPA closing the plant.

178. *See id.* The Service finally applied the *Plainfield-Union* test previously advanced by taxpayers in other environmental expenditure disputes involving progressive deterioration. *See id.*; Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), *nonacq. on other grounds*, 1964-2 C.B. 8.

179. *But see* David G. Coolidge, Note, *A Square Hole for a Square Peg: Section 165 and Environmental Cleanup Costs*, 14 VA. TAX REV. 779, 783-87 (1995) (discussing increased political pressure for a clear deduction scheme for environmental cleanup costs prior to the issuance of Revenue Ruling 94-38).

180. *See id. But see supra* text accompanying note 174.

181. *See* Carrington, *supra* note 122, § 25.03[5][c]; *cf. supra* notes 105-12 and accompanying text (discussing the willingness to permit immediate deductions for start-up costs to avoid permanent capitalization).

Adding in the New Business Complication

Cleveland Electric Illuminating Co. v. United States,[182] considered the future benefits obtainable from employee training during a business expansion.[183] The expansion occurred at an electric utility through the construction of both a nuclear power plant and a conventional fossil fuel plant.[184]

The New Method: Nuclear Power

Cleveland Electric first considered the expansion of a traditionally coal powered electric utility into a nuclear facility.[185] Employees of the company's fossil fuel plants required extensive training and licensing prior to their transfer to the nuclear plant to commence operations at the new facility.[186] The company attempted to deduct the training costs as ordinary and necessary business expenses.[187]

The court compared the different methods of generating electrical power and concluded that the nuclear plant represented a new business for the utility company.[188] Despite the identical end product of electricity, the higher degree of required training and the means used to generate heat distinguished the nuclear plant from a conventional fossil fuel plant.[189] The higher degree of required training reflected the potential dangers to public safety and the additional support systems located in a nucle-

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182. 7 Cl. Ct. 220 (1985).

183. *See id.* at 227-30. Although decided prior to *INDOPCO*, the opinion expressed the reasoning later established by the Supreme Court in rejecting a restricted reading of *Lincoln Savings*. *See id.* at 225 ("[*Lincoln Savings*] does not state . . . that if the separate and distinct asset test is not met the payment is a necessary and ordinary expense."). The Claims Court found the presence of future benefits significant in making a capitalization determination. *See id.* at 224 ("[T]he fact that a substantial expenditure is likely to give long-lived benefit . . . is always an important, if not dominant, factor in the direction of tangible or intangible capital asset treatment.").

184. *See id.* at 222.

185. *See id.* at 225-26.

186. *See id.* at 226-27.

187. *See id.* at 222-23.

188. *See id.* at 228-29.

189. *See id.* ("[T]he means by which heat is produced in a nuclear plant to generate steam for the generators differs from the process in a conventional plant.").

ar reactor.[190] Furthermore, only after completing this training could the facility obtain the license necessary to begin operations.[191] In combination, the method of generating heat, the extensive training, and the need for a license convinced the court that this plant actually represented a new business.[192] As the first nonconventional electric plant in the whole company, the nuclear reactor constituted a new business for which the training costs should have been capitalized as a "one-time" start-up cost.[193]

In support of its capitalization treatment, the court also indicated that the future benefits expected from a trained workforce justified capitalization.[194] The initial training "would obviously add value to the services" provided by the employees beyond the first operational year.[195] These trained employees could then help to train future hires and thereby lower the cost of future training.[196] Moreover, the license obtained after the training provided the future benefit of the "right to do business";[197] therefore, the costs incurred to secure the license, in particular the extensive training, required capitalization.[198]

By combining a characterization of a new business enterprise

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190. *See id.* at 229.

191. *See id.*

192. *See id.*

193. *See id.* at 228-29. The court relied heavily on the construction and operating agreements between the taxpayer and an independent contractor that provided the utility with a completed facility, including trained personnel. *See id.* at 227. The court reasoned that the expenditures, therefore, represented the acquisition price for a "going business" that properly required capitalization. *See id.* at 227-28; *cf.* Estate of Wilbur v. Commissioner, 43 T.C. 322, 327 n.6 (1964) (capitalizing the last coat of paint in the cost of acquiring a completed building), *acq.*, 1965-2 C.B. 7. In dictum, however, the court noted that even without considering the agreements as a purchase of a business, the expenditures still constituted nondeductible start-up costs. *Cleveland Elec.*, 7 Cl. Ct. at 228.

194. *See Cleveland Elec.*, 7 Cl. Ct. at 229.

195. *Id.* The future benefits included the reasonable expectation that the entire trained staff would not leave simultaneously and require the plant to close while training a new staff. *See id.*

196. *See id.*

197. *Id.*

198. *See id.*; *cf.* Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir.) (capitalizing training expenditures made to obtain an FCC license), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965).

with the expectation of future benefits from the training, the court concluded that all of the training expenditures required capitalization.[199]

The Old Method: Fossil Fuel

The court also considered the training costs associated with an expansion into another conventional power plant.[200] Like the nuclear plant expansion, this fossil fuel plant employed workers from preexisting plants after training them to work in the new facility.[201]

The court determined that the expansion into another fossil fuel plant did not constitute a new business.[202] The new plant, despite its larger size and modern pressurized furnaces and computers, was not different in kind due to its fundamentally conventional nature.[203] The limited training needed to commence operations supported the finding of similarity with the utility's other fossil fuel plants, because the additional training matched the amount generally needed for newly hired employees.[204] Finally, the new plant lacked the licensing prerequisite of nuclear plants; therefore, the training costs were not attributable to a portion of a license acquisition cost.[205]

Characterizing this transaction as an expansion of an existing business, the court found appropriate an immediate deduction

199. *See Cleveland Elec.*, 7 Cl. Ct. at 228-29; *cf.* Tech. Adv. Mem. 94-30-003 (Apr. 22, 1994) (defining employee training as a freestanding asset in a factual situation similar to *Cleveland Electric*, and permitting the amortization of that asset over the 40-year term of the nuclear regulatory license); *see, e.g.*, Tech. Adv. Mem. 7509099440A (Sept. 9, 1975) (capitalizing training costs for a new plant to an intangible asset called an "operational electric plant" and permitting an amortization period based on the life of the underlying physical plant). *But see* Tech. Adv. Mem. 96-45-002 (June 21, 1996) (allowing a current deduction for start-up costs, in particular for training costs, due to the recurring nature and short-term benefit provided by these costs in high turnover retail stores).

200. *See Cleveland Elec.*, 7 Cl. Ct. at 233-35.

201. *See id.* at 233.

202. *See id.* at 234.

203. *See id.* at 233-34 ("incorporating modern features not available when the [other fossil fuel plants] were built . . . [failed to make it] essentially different in kind").

204. *See id.* at 234.

205. *See id.*

for the training expenditures.[206] After mentioning the general deduction available for training costs incurred in teaching employees to operate new equipment in the same business, the court indicated that the utility trained its own employees—unlike the nuclear facility that purchased a plant from an agent who trained the utility's employees—and only incurred an insubstantial amount of expenses.[207] Even though the training would provide some future benefit, the court found that "the record does not reflect that immediate benefit was lacking and it is impractical to make any division of the expenditure for such purpose."[208] Therefore, the training expenditures remained ordinary and necessary business expenses.[209]

Attempting a Reconciliation

The opposite conclusions for the plants in *Cleveland Electric* present two fundamental problems. First, the "new business" label attached to the nuclear plant seems awkward in light of the court's discussion of the fossil fuel plant. While discussing the fossil fuel plant, the court stated that the incorporation of modern features into a plant would not change the character of the business, and it cited favorably the bank credit card expansion cases that involved producing the same product through new means.[210] This comparison should not differ when analyzing the means used to generate steam—whether by nuclear energy or coal—because the underlying business never changed. The utility company remained in the electric business simply by incorporating modern techniques into its production methods.

The second problem with the court's reasoning lies in distinguishing the future benefits obtained from the training in both plants.[211] Presumably, the initial training at each plant would

206. *See id.*
207. *See id.*
208. *Id.* at 234-35.
209. *See id.* at 234.
210. *See id.* (citing First Nat'l Bank v. United States, 558 F.2d 721 (4th Cir. 1977); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974)). The credit card cases essentially involved producing the same end-product—consumer loans—through a new process, using credit cards. *See supra* notes 98-104 and accompanying text.
211. The court reasoned that the nuclear facility incurred a one-time training

provide similar future benefits regardless of whether the employees are located in a "new" business or part of an expansion.[212] If the proper classification depends upon the expectation of future benefits, then the training expenditures at both facilities should have received the same treatment.[213] Either they both provide future benefits and invoke capitalization requirements, or they both lack future benefits and warrant an expense deduction.

The capitalization of the nuclear plant training costs might appear more sensible when viewed alongside the decision in *Richmond Television*.[214] Like the nuclear facility, *Richmond Television* involved an expanding business that reimbursed another agent for providing it with a trained workforce prior to its obtaining an operating license.[215] In addition to finding that the corporation incurred the expenditures prior to commencing its broadcasting operations, the Fourth Circuit characterized the training costs as part of the acquisition price of a capital as-

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charge capitalizable as a start-up cost, *see Cleveland Elec.*, 7 Cl. Ct. at 228-29, whereas the fossil fuel plant faced recurring training costs. *See id.* at 233. This reasoning lacks merit in light of the employee turnover and additional training required to maintain a nuclear facility. *See* Lee, *supra* note 83, at 672 (arguing that employee turnover at nuclear plants is high and employee retraining costs are substantial).

212. *See* Lee, *supra* note 83, at 672.

213. The enactment of section 195 produces problems when analyzed along with the future benefit test of *INDOPCO*. Section 195 permits a new business to amortize start-up costs provided that a business in its normal operations could deduct those costs—i.e., the start-up costs of a new venture are the same as expansion costs of an existing business. *See* I.R.C. § 195(b)(1), (c)(1)(B) (1996). *INDOPCO* suggested that start-up costs would provide future benefits once a business began operations; therefore, expanding businesses must capitalize these costs. *See* Javaras & Maynes, *supra* note 105, at 975; *see, e.g.*, Tech. Adv. Mem. 96-45-002 (June 21, 1996) (considering field agent assertions that pre-opening costs of a retail store in an expanding business will create future benefits under *INDOPCO*). If expanding businesses are required to capitalize their expansion costs, section 195 would become meaningless because no start-up costs would qualify for a deduction by an existing business. *See* Javaras & Maynes, *supra* note 105, at 975. Conversely, if expanding businesses are required to capitalize start-up costs because they provide future benefits, section 195 would favor "new" businesses by permitting amortization of the start-up costs of newly created businesses. *See id.*

214. Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965).

215. *See id.* at 903-04. The corporation eventually obtained a three-year broadcasting license from the FCC. *See id.* at 904.

set—the FCC license.[216] Similarly, the nuclear training costs in *Cleveland Electric* appeared to relate to the purchase of an asset—the plant's operating license—rather than to expenses incurred in the business's normal operations. Both *Richmond Television* and *Cleveland Electric* resemble purchased intangible asset cases and not future benefit cases.[217]

JUST-IN-TIME MODIFICATIONS AT DANAHER CORPORATION

Danaher Corporation implemented a JIT system to replace its batch processing system for producing various retail products.[218] The desired processing scheme emulated "flow production" by allowing production units to pass from one stage to the next without interruption.[219] Each production stage used a "cell" that combined several operations that previously had occurred separately.[220] Each cell performed the entire manufacturing process, from start to finish, unlike the prior assembly line process.[221]

The new cell approach required a reconfiguration of the existing plants.[222] To place the needed equipment within a cell, the machines used in the old assembly lines were relocated and connected together in the cells.[223] In completing the conversion to a cell environment, Danaher also painted the cell space, made electrical and plumbing modifications to accommodate the equipment, and rigged the machinery to operate in a continu-

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216. *See id.* at 907-09.

217. *See* Lee, *supra* note 83, at 673.

218. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995). Danaher manufactures truck "Jake Brakes," industrial fasteners, Allen wrenches, fuel leak detection systems, hand tools, and industrial process controls. *See* Ditkoff Letter, *supra* note 3.

219. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995) ("Previously, [Danaher] transported units to the next production stage as soon as they [were] ready. Under the new system each stage is required to go back to the previous stage to pick up the exact number of units needed."); *see also supra* note 32 (discussing Danaher's *kanban* system).

220. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995).

221. *See id.*

222. *See id.*

223. *See id.* ("[Danaher] reengineered its assembly lines to put together operations that have never before been together."). One example of the changes was Danaher's modification of the factory layout to U-line configurations within cells. *See id.*

ous flow.[224]

In addition to reconfiguring the plants, Danaher conducted in-depth training to prepare its current employees for working in the cell environment.[225] The training focused on JIT concepts and the need for continuous improvement in manufacturing production.[226] This training provided a new production-oriented vocabulary and placed the responsibility for decision making within the cells.[227] The training also expanded the employees' skills so that each employee could operate machines that previously remained functionally separated; the multiple operations performed within a cell required each employee to become knowledgeable about all of the machines contained in a cell.[228]

Danaher sought to deduct the training costs associated with this conversion, but the Service issued a Technical Advice Memorandum requiring capitalization.[229] Relying on *Cleveland Electric*, the Service considered the expenditures necessary to establish a workforce trained in JIT and to enable the plant to function in a cell environment.[230] In particular, the Service examined whether Danaher had entered a new business and if it could expect future benefits from the training.[231]

The Service found that the changed production process and the training required to make the system operational constituted a new business.[232] In *Cleveland Electric*, the court had determined that generating electricity by nuclear energy differed from fossil fuel generation because they involved different processes

224. *See id.*
225. *See id.*
226. *See id.*
227. *See id.* The new responsibility included the authority to stop work within a cell upon the discovery of waste and to adjust the cell accordingly to eliminate the waste. *See id.*
228. *See id.*
229. *See id.* Danaher also attempted to deduct the reconfiguration costs, costs of materials and supplies used in making signs for the process, costs for training manuals and videos, and consulting fees. *See id.* The Service required the capitalization of each of these costs. *See id.* This Note concentrates primarily on the training expenditures.
230. *See id.*
231. *See id.*
232. *See id.*

used to produce the same product.[233] The Service reasoned that, like *Cleveland Electric*, Danaher's redesign of its operations represented a fundamental change in manufacturing.[234] Under this analysis, manufacturing the same end product becomes irrelevant because the focus shifts to the new means used to manufacture that product.

The extensive training required to facilitate this new process also provided persuasive support to the new business characterization.[235] *Cleveland Electric* identified the high degree of training required to enable employees from its coal facilities to operate a nuclear plant.[236] Similarly, Danaher's conversion to JIT manufacturing required significant training in the use of unfamiliar machines and required employees to assume greater individual responsibility for the work product.[237] The training was so extensive that Danaher referred to its new processes as requiring a "New Technician."[238] Thus, the extensive operational changes combined with the training required to operate the system provided the basis for concluding that Danaher had started a new business.

The potential future benefits from the initial training complemented the Service's conclusion to capitalize the costs.[239] Despite Danaher's arguments about the continuous evolution of the JIT process, the Service found that these expenditures may have benefitted the current year, but that they also provided future long-term benefits.[240] Without a detailed discussion, the Service relied on Danaher's own statements that JIT provided long-term benefits by reducing capital costs through lower inventory levels, and by creating a more flexible manufacturing opera-

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233. *See* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228 (1985).
234. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995).
235. *See id.*
236. *See Cleveland Elec.*, 7 Cl. Ct. at 229.
237. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995).
238. *Id.* ("[Danaher does] not object to the view that 'the transformation of [the] workforce represented nothing less than the creation of a 'New Technician'.") (quoting Danaher's factual submission to the Service).
239. *See id.*
240. *See id.*

tion.[241] These submissions allowed the Service to conclude that the costs were appropriately capitalized under the *INDOPCO* rationale.[242]

Rethinking Danaher's "New Business"

The Service's new business characterization overemphasizes Danaher's description of the magnitude of change in its plants. Danaher's factual submission to the Service echoed the sentiments of romantic JIT advocates.[243] Marching in step with the JIT revolution, Danaher suggested not only that its facilities had undergone a "radical redesign, [but that it had also implemented] a fundamental change" in its production methods.[244] Danaher used a management driven "top-down" approach to implement the "broad processes and dramatic improvements" involved in the change.[245] As the "cornerstone" of its new philosophy stood the "New Technician," an employee with expanded responsibility and greater flexibility in an environment freed of many former barriers.[246] These statements led the Service to conclude that the new production process no longer resembled the former process.[247]

Unfortunately, this characterization ignores the realities of the conversion. A wholesale conversion never happened. Instead, Danaher continued to operate the plants in their former assembly line fashion while creating operational cells one at a time over a period of several years.[248] Moreover, the "top-down" ap-

241. *See id.* ("[Danaher] also agree[s] that JIT manufacturing has already produced significant long-term benefits for us.") (quoting Danaher's factual submission to the Service).
242. *See id.*; *see also* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992) (stating that a taxpayer's realization of future benefits, although not determinative, is an important factor in deciding whether expenses must be capitalized).
243. *See supra* notes 42-49 and accompanying text.
244. Tech. Adv. Mem. 95-44-001 (July 21, 1995).
245. *Id.*; *see* Sheppard, *supra* note 10, at 1155 (describing conversions from batch manufacturing to JIT manufacturing as a "sea change").
246. Tech. Adv. Mem. 95-44-001 (July 21, 1995).
247. *See id.*
248. *See* Sheppard, *supra* note 10, at 1155 (noting that this piecemeal approach was expected to take place over a eight-year period); Sheridan, *supra* note 19, at 29 (noting that at the Jacobs Vehicle plant, employees received only one hour of training each week over a six-month period).

proach consisted of a decision to adopt the new philosophy and to resequence the production operations.[249] Changes in the actual process were not expected until sometime in the future when the "New Technicians" implemented refinements to the system.[250] Although employees' attitudes may have changed, a dramatic renovation was not obtained immediately. The training taught the employees to perform tasks previously done by others; it did not train employees in methods new to the business itself.[251]

These realities weaken the comparison to *Cleveland Electric*. *Cleveland Electric* considered a newly constructed plant designed to operate with nuclear power rather than with fossil fuel.[252] The court concluded that the methods used to generate heat differed substantially; a nuclear facility requires specific designs that are neither compatible nor interchangeable with those of a coal facility.[253] Conversely, Danaher implemented JIT in existing facilities.[254] The manufacturing processes remained the same; the implementation merely altered the timing of the various stages of production and which employees performed which specific tasks. Making adjustments to the delegation of duties and timing of production fails to constitute a fundamental change in the production process.

The degree of training required to implement JIT also differs from the training needed to make a nuclear plant functional. In *Cleveland Electric*, the court found that a high degree of training became necessary to prepare employees for both safety risks and

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249. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995).

250. *See id.*

251. A potentially broad view of reengineering may force the capitalization of many training costs. Consider the dramatic impact of conversions within law and accounting firms from centralized word processing functions to networked computers in individual offices. *See* American Bar Ass'n Section of Taxation Comm. on Tax Accounting, *Report on Capitalization Issues Raised Under Sections 162 and 263 by* INDOPCO, Inc. v. Commissioner, 50 TAX LAW. 181, 195 n.45 (1996). Viewed broadly, the Service's approach requires capitalizing these training costs of a "new business" even though these costs have been currently deducted in other circumstances.

252. *See* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 225-27 (1985).

253. *See id.* at 229. Arguably, after the heat generated steam, the processes for utilizing the steam could be identical. The fundamental nature of the facilities, however, still might differ.

254. *See* Ditkoff Letter, *supra* note 3.

support systems that were not present in a conventional coal plant.[255] Furthermore, the training enabled the utility company to acquire an operating license to commence its operations.[256] Danaher's operations used the same equipment from its assembly line production without requiring employees to learn processes or equipment that the company never had used.[257] This training may be analogous to new hire training: teaching people to perform tasks foreign to the individual but very familiar to the company. The JIT training itself was geared toward decision-making processes and understanding the overall JIT manufacturing philosophy.[258] The training enriched employees' abilities to make changes in an ongoing process without changing the fundamental features of the production process. Furthermore, no regulatory agency required Danaher to conduct this training to acquire an operating license.

The dissimilarities between the utility company in *Cleveland Electric* and Danaher strongly suggest that a new business was not commenced when Danaher implemented JIT manufacturing. Instead, the Service's new business characterization deferred the need to ultimately address the issue of the deductibility of training expenditures. By characterizing Danaher's new JIT production operation as a new business, the Service could immediately require capitalization because employee training represented start-up costs. This treatment allowed the Service to offer little discussion of the appropriateness of capitalization under *INDOPCO*'s future benefits analysis. If the Service properly examined this training, by considering its future benefits, the Service should have permitted an immediate business expense deduction.

Future Benefits from JIT

The Mode of Analysis

Despite all of the doctrinal approaches to resolving capitaliza-

255. *See Cleveland Elec.*, 7 Cl. Ct. at 229.
256. *See id.*
257. *See* Ditkoff Letter, *supra* note 3.
258. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995).

tion questions,[259] a basic desire to clearly reflect income underlies the ultimate decision regarding deductibility.[260] This concept might be understood by considering that for tax accounting purposes, an "asset" represents capitalized costs rather than property interests; these deferred costs are capitalized because they will be expensed only in the appropriate future period.[261] Even though the doctrines discussed earlier might suggest capitalization,[262] this suggestion should comport with the idea that capitalizing costs must not distort income.[263] In general, deduction of expenditures that provide future benefits, without creating clearly identifiable assets, will produce minimal distortion of income when the expenditures appear insubstantial in amount, are short-lived, recur regularly in approximately equal amounts, or lack a clear association with future tax years.[264]

Insubstantial or short-lived expenditures warrant an immediate deduction because they produce virtually no threat of a serious distortion of income.[265] This approach technically will produce some distortion, but the amount of distortion generally is

259. *See supra* notes 50-140 and accompanying text.

260. *See* Alan Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COM. L. REV. 443, 452 (1974). The clear reflection of income occurs when expenses are matched with the revenues they generate. *See id.* Deducting costs before the revenue is produced understates income in early years and overstates it in later years, whereas denying a deduction until after the revenue is generated overstates income in the early years and understates later years. *See id.*; *supra* notes 65-67 and accompanying text.

261. *See* Gunn, *supra* note 260, at 445.

262. See *supra* notes 68-140 and accompanying text for a discussion of capitalization doctrines.

263. *See* Gunn, *supra* note 260, at 450 ("Recognition that capitalization is a basic principle of income taxation rather than a technical requirement imposed by specific statutory language may help to avoid the error of looking for the answers to close questions concerning capitalization in the words of the Code."); *accord* Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283-84 (1967) (rejecting the contention that section 263 is dispositive on capitalization issues and indicating that the principles of capitalization and clear reflection of income are "inextricably intertwined").

264. *See* Lee, *supra* note 83, at 680.

265. *See, e.g.*, Cincinnati, New Orleans & Tex. Pac. Ry. v. United States, 424 F.2d 563 (Ct. Cl. 1970) (permitting current expense deductions when a company consistently deducts all property valued at less than its internal 500-dollar minimum rule).

immaterial compared to the total overall income.[266] In particular, the accounting burden needed to eliminate the distortion outweighs any advantage gained by a more precise measurement through capitalization and subsequent amortization.[267]

A deduction for recurring expenditures of roughly equal amounts avoids income distortion because the yearly deduction approximates the amount otherwise deductible through amortization.[268] For example, deducting the cost of assets with five-year lives, valued at one hundred dollars and purchased annually, approximates the yearly total deduction representing twenty dollars of straight-line amortization for five one-hundred-dollar assets over each of their five-year lives.[269] Although perfect

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266. *See* Gunn, *supra* note 260, at 456 (accepting accounting methods that produce some income distortion, provided that the distortion is insubstantial in relation to total income).

267. *Cincinnati, New Orleans & Tex. Pac. Ry.*, 424 F.2d at 572. Expressed another way:

> Where the burden on both taxpayers and [the] Service to account for each item of property separately is great, and the likelihood of distortion of income is nil or minimal, the Code is not so rigid and so impracticable that it demands that nevertheless all items be accounted for individually, no matter what the trouble or the onus.

Id. The real difficulty involves determining what amounts are insubstantial in relation to a particular taxpayer and tax year. *See* Lee, *supra* note 56, at 17-18; *compare Cincinnati, New Orleans & Tex. Pac. Ry.*, 424 F.2d at 572-73 (finding $500 insubstantial) *with* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 234 (1985) (finding $15,545 insubstantial).

268. *See* Gunn, *supra* note 260, at 455.

269. *See id.* Professor Calvin Johnson criticized this approach for focusing on the consistency of the income steam after a transition period but failing to account for the larger after tax investment made possible by an immediate deduction. *See* Johnson, *supra* note 132, at 1337. He argued that when a taxpayer makes an investment of I, at a tax rate of t, the taxpayer saves tI in taxes by taking an immediate deduction so the after tax cost of the investment is $I(1\text{-}t)$; a counterpart who capitalizes the investment has no deduction available and can invest only after tax income represented by $I(1\text{-}t)$. *See id.* at 1325 nn.12-13. Although the invested amounts appear equal, the second taxpayer paid Ti in taxes on the invested income first; therefore, holding the taxpayers' net cash outflows equal, the first taxpayer can always invest more—generally by a factor of $\frac{1}{(1-t)}$ —due to the tax savings. *See id.* at 1325. He concluded that this treatment generates *after tax* returns for the larger expensed investment equivalent to the *pretax* returns of the capitalized investment—like a "miraculous exemption" from tax for all subsequent returns on a capitalized investment. *See id.*

consistency rarely occurs, it is not required.[270] This approach explains the present treatment of some expenses. Despite efforts

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Professor Johnson correctly identified but overstated the magnitude of this problem. By premising the invested amount on after tax income, *see* Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019, 1032-33 (defining this premise of tax-sensitive investments as a scope condition), the analysis obscured the combined effects from the expense/capitalization alternatives and the method of finance. To isolate the effects of expensing and capitalization, the initial investments must be equal for the two taxpayers regardless of whether the funds come from income, debt, or other sources. With equal investments, the miraculous exemption disappears, but it becomes apparent that the cash flows from these two alternatives differ. In particular, only the taxpayer who expenses the investment receives tax shields of *Ti* during the transition period to the steady state; both taxpayers have the same net cash flows in the steady state; and only the taxpayer who capitalized the investment receives a benefit of *Ti* from the exclusion of the return of capital once the steady state terminates. As alluded to by Professor Johnson, the expensing alternative is preferred by taxpayers because the tax shields of *tI* occur in earlier years. The additional value of the expensing alternative, therefore, equals the present value of each *tI* cash flow during the transition period less the present value of each *tI* cash flow during the termination period (the present values during the termination period will approximate zero, discounted at a rate of *r* over *n* periods, as the present value factor $\frac{1}{(1+r)^n}$ approaches zero when *n* approaches infinity).

Despite the timing discrepancy, expensing should still be permitted to avoid the rigors of capitalization. The difference in timing indicates that some distortion of income will occur. The elimination of this distortion by following a more theoretically accurate approach, however, requires higher accounting costs. Although arguably tenable for large institutional taxpayers, the limited benefit obtained from capitalization/amortization cannot justify the additional burden for small businesses and individuals. *See* Lee et al., *supra* note 10. Instead, the deductions for steady state expenditures fall into the group of simplified methods that achieve "rough justice." *See id.*

270. *See* Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 215 (7th Cir. 1982). In dicta, Judge Posner considered reasons for allowing authors of books to deduct expenses immediately without capitalizing them as costs of producing a book. *See id.* He concluded that:

> If you are in the business of producing a series of assets that will yield income over a period of years[,] . . . allocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code desiderates, because the taxable income of the author or publisher who is in a steady state (that is, whose output is neither increasing nor decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book—on each book expenses and receipts will be systematically mismatched—but the same on average.

Id. The Service has cited favorably the reasoning of *Encyclopaedia Britannica*. *See, e.g.*, Tech. Adv. Mem. 92-37-006 (Apr. 24, 1992).

to evaluate the degree of asset modification for repair expenses,[271] considerations of insubstantiality and recurrence better justify an immediate deduction: Repairs are inexpensive and recurring whereas improvements are costly and infrequent.[272] Similarly, advertising costs remain deductible despite their future benefits because they occur regularly.[273] As long as the method of accounting avoids a distortion of income, a capitalization doctrine should not mandate an alternate method to produce the same result.[274]

Finally, when the expenditure lacks a clear association with future benefits, an immediate deduction may seem appropriate. In general, when taxpayers can establish a relationship between the expenditure and any benefits, the costs should be capitalized as a freestanding asset and subsequently amortized over the period benefited to clearly reflect income.[275] Accordingly, reasonable approximations of an asset's useful life should suffice to avoid distortion.[276] In cases when even an approximation be-

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271. *See supra* notes 68-77 and accompanying text.

272. *See* Gunn, *supra* note 260, at 458.

273. *See* Lee, *supra* note 83, at 683-84; *see generally* Faber, *supra* note 149, at 625.

274. The emphasis on avoiding income distortion makes it clear that some recurring expenditures may require capitalization when the income production component is absent. For example, in *Black Hills Corp. v. Commissioner*, 73 F.3d 799 (8th Cir. 1996), a mining company attempted to deduct annual payments made to a corporation formed by several mining companies to self-insure for black lung claims filed by employees. *See id.* at 800-01. The mining company made fairly constant annual payments, based on the projected future value of all claims derived from the individual mines. *See id.* at 801-02. In addition, each insured who terminated its policy before the expected date faced an "early termination charge" for premiums that it would have paid had it remained open until its expected closing date. *See id.* at 801. Claims against mines, however, typically occur in the year that the mine closes because many employees continue to work the mines even after contracting black lung disease. *See id.* at 800-01. The Eighth Circuit found that the lack of a correlation between the relatively high payments in the early years and the relatively low risk of loss in these early years indicated that the payments actually constituted prepayment for future claims. *See id.* at 807. In this situation, only the portion of the early payments directly related to the shifted risk of loss—the current benefit of insurance—in the early years was deductible. *See id.*

275. *See* Lee, *supra* note 56, at 38; *cf.* Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1, 13 (1979) (capitalizing substantial and infrequent repair expenditures as separate assets, and permitting amortization during the period prior to the next repair to avoid a distortion of income).

276. *See* Lee, *supra* note 56, at 38-41; *accord* Cohan v. Commissioner, 39 F.2d 540, 543-44 (2d Cir. 1930) (advising courts to approximate the value of expenditures after

comes impractical, however, an immediate deduction will minimize the distortion of income.[277] An immediate deduction seems particularly appropriate for some intangible assets given the potential prohibition on amortization when taxpayers cannot establish the assets' useful lives.[278]

Clear Reflection of Income and JIT Training Expenditures

Following the approach outlined above, Danaher should currently deduct the training expenditures without distorting its income. Although the expenditures themselves may be substantial, the training itself recurs on a regular basis, both in new-hire training and through JIT's objective of seeking continual improvement, and any future benefits cannot be successfully estimated.

Unlike some small expenditures that warrant an immediate deduction because they could not materially distort income, Danaher's training expenditures may be fairly substantial. At issue was approximately $3.2 million in JIT training expenditures incurred over five years.[279] Without attempting to measure the substantiality of this amount in comparison to Danaher's annual sales revenue of more than $800 million,[280] it is *possible* that an immediate deduction might distort income.[281]

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a taxpayer proves that some amount was incurred).

277. *See* NCNB Corp. v. United States, 651 F.2d 942, 961-62 (4th Cir. 1981) (allowing a deduction for current expenditures that cannot be associated practically with any other time period, although they may have future benefits), *rev'd on other grounds*, 684 F.2d 285 (4th Cir. 1982) (en banc). When future amortization is unavailable, a present deduction tends to distort income to a lesser degree than does capitalization without amortization. *See* Lee, *supra* note 56, at 26.

278. *See* Treas. Reg. § 1.167(a)-3 (as amended in 1960) ("No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life.").

279. *See* Sheppard, *supra* note 10, at 1155. The T.A.M. required capitalization of approximately $9 million spent during the conversion, including $3 million for equipment reconfiguration, $.66 million for supplies, $3.2 million for training, and $2.1 million for consulting fees. *See id.*

280. *See* Ditkoff Letter, *supra* note 3; *supra* note 267 (describing problems encountered in defining "substantial amounts").

281. The amount spent on JIT training may be insignificant in comparison to past spending on corporate improvement. Although Danaher's focus on JIT represents a new approach, the funding for the training probably reduced amounts spent on other efforts that also sought to create corporate improvements. *See generally* Hal Gann &

The recurring nature of training, however, strongly suggests that it should be deducted. Like repairs, advertising, and other periodic expenses, training frequently occurs on an ongoing basis. Businesses require this periodic training for updating current employees' skills, introducing new processes, and training new employees. This proposition seems particularly relevant in situations such as Danaher's. As the JIT system continues to evolve and the plant undergoes continuous improvement, additional training becomes necessary.[282] A current deduction, therefore, would represent the same annual expense as amortization spread over each benefited year.

Reliance solely upon the recurring nature of training to justify a current deduction would provide a fairly weak argument for two reasons. First, the Danaher ruling fails to disclose the amount of subsequent training. A deduction for recurring expenditures depends primarily upon the relatively steady state of the incidence of particular expenditures.[283] To the degree that the initial training costs exceeded the expected amounts of future training expenditures, the clear reflection of income doctrine would require capitalizing the excess and amortizing it over its useful life.[284] Second, even if the training expenditures recurred in approximately equal amounts, both an immediate deduction and capitalization with amortization would clearly

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Roy Strowd, INDOPCO—*Time for the Second Shoe to Drop*, 69 TAX NOTES 1045, 1046 (1995) (discussing the reallocation of resources to JIT from the overall corporate improvement budget). Given the fairly constant budget allocation for recurring expenditures in most corporations, it seems likely that JIT replaced programs that had attempted to accomplish similar feats using different methods. *See id.* Thus, a current deduction for the training expenditures would distort income only to the extent that these expenditures represented outlays that were not available in any other year. *See id.* (noting that the sudden capitalization of otherwise recurring expenses may distort income particularly if that pattern is not disrupted uniformly in all industries and for all taxpayers).

282. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995); *supra* notes 30-31, 38-41 and accompanying text (discussing JIT's habit of improvement).

283. *See* Gunn, *supra* note 260, at 455.

284. Consideration of only formal training costs may view this issue too narrowly. Formal training should be considered part of the broader learning costs incurred throughout implementation. These costs occur when the process evolves through continuous improvement efforts. For example, down-time costs, incurred when a line is stopped to investigate and revise procedures that contain waste, will occur on a regular basis.

reflect income. As long as a method does not distort income, it appears justified. In that situation, neither expensing nor capitalizing the expenditures seems preferable. In situations like Danaher's, however, capitalizing the costs appears to create a potential distortion of income, creating a preference for an immediate deduction.

INDOPCO's future benefit inquiry ensures that expenses will closely match the revenue generated by those expenses. The *INDOPCO* decision never encouraged the blind capitalization of expenditures with future benefits; instead the Court stated that the existence of future benefits would remain "undeniably important" in assessing the proper tax treatment.[285] In this light, the proper tax treatment would be to foreclose options that distort income.

In Danaher's situation, a high potential for distorting income exists if training costs are capitalized because the expenditures lack a clear association with any future benefits. The goal of matching expenses with the corresponding revenue is circumvented when the income or benefits themselves cannot be identified. This result becomes clear when considering the future benefits obtained from employee training in JIT manufacturing principles.

Undoubtedly, Danaher anticipated receiving some future benefits from a JIT program. Danaher's own submission to the Service indicates that JIT could significantly reduce the capital invested in an inventory stock and could permit modifications of a manufacturing line to meet customer specific needs.[286] Although the expectation of future benefits suggests capitalization, the expectation of benefits alone seems to indicate a business purpose for the expenditures. The expectation of future benefits closely resembles the expense requirement that an expenditure be "necessary"; both merely suggest that an expenditure be "appropriate and helpful."[287] Businesses incur almost every expen-

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285. *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992).

286. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995); *cf. supra* notes 151-64 and accompanying text (discussing rulings that permitted the deduction of expenditures made to decrease future operating costs).

287. *See* Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (construing the term "necessary" as requiring simply that expenses be "appropriate and helpful").

diture with the hope of achieving some benefit.

The distinction between the benefits requiring capitalization and those supporting an expense deduction depends more on the likelihood of eventually realizing these benefits. The Court in *INDOPCO* referred to an "incidental future benefit" that could justify an immediate expense.[288] This reference presumably indicates that insubstantial benefits can be measured by their probable occurrence.[289] To the extent that expected benefits appear remote, the justification for an immediate deduction gains strength. According to this reasoning, the potential benefits expected from employee training are uncertain and the related expenditures should be deducted.

The training in the JIT philosophy failed to provide assurance of any benefits. Understanding the philosophy is just the beginning of the process. The real improvements in the system do not happen until employees identify waste and successfully eliminate it.[290] This process does not occur overnight. The training only provided employees with the mindset for working in the JIT environment[291]—it prepared them to use their existing knowledge and skills to change the production process. The training alone did not solve problems.

Training costs' lack of association with future benefits appears in the current treatment of employee training costs.[292] The Ser-

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288. *See INDOPCO*, 503 U.S. at 87. The Court noted that the Code's language "envisions an inquiry into the duration and extent of the benefits realized . . . ." *Id.* at 88.

289. *See* Adams & Hinderliter, *supra* note 126, at 96 (identifying contradictory language in *INDOPCO* that first required the "presence" of future benefits, implying certainty and existence, but later discussed "availability," "opportunities," and "anticipated" future benefits, suggesting only potential or contingent benefits).

290. *See supra* notes 35-41 and accompanying text (discussing JIT's focus on continuous improvement).

291. For example, at Jacobs Vehicle Equipment Co., a subsidiary of Danaher, the first hurdle for implementing JIT was internal resistance. *See* Sheridan, *supra* note 19, at 28. The company president got "into a shouting match with [his] manufacturing management" who feared change. *Id.* (quoting George Koenigsaecker). Overcoming this resistance, therefore, required a large amount of training and coaching just to mentally prepare employees for the change. *See id.* at 29.

292. Unfortunately, the Service's guidance on the treatment of training costs provides little insight into the factors that it encourages taxpayers to consider. The Service states that:

> Amounts paid or incurred for training, including the costs of trainers and

vice itself stated in the Danaher ruling that ongoing employee training costs generally are deductible.[293] This deduction for ongoing training costs tacitly admits that the potential of future benefits does not require capitalization.[294] Presumably, training provides the same type of future benefits regardless of whether it occurs on the first day of a program or on subsequent days.[295] The similarity of the benefits obtained during any training schedule strongly supports the notion that all training should receive the same expense or capitalization treatment.

Expense treatment of training expenditures seems to accord with rulings issued in other areas. The Service has acknowledged future benefits but permitted expense treatment for advertising[296] and programs designed to cut costs and improve efficiency.[297] In each instance, the expenditures are incurred

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> routine updates of training materials, are generally deductible as business expenses under . . . section [162] even though they may have some future benefit. Training costs must be capitalized only in the unusual circumstances where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business.

Rev. Rul. 96-62, 1996-53 I.R.B. 1 (citations omitted). Aside from indicating that the treatment of training costs have not changed, *see id.*, this guidance fails to address why JIT training must be capitalized whereas other training costs remain deductible.

293. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995) (citing Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 234 (1985)).

294. *See* Rev. Rul. 96-62, 1996-53 I.R.S. 1 ("Amounts paid or incurred for training . . . are generally deductible . . . even though they may have some future benefit."); *cf.* Tech. Adv. Mem. 95-13-002 (Nov. 28, 1994) (permitting a deduction for conservation and land management expenditures because a potential reduction in "operating costs is not in and of itself sufficient to require capitalization").

295. Arguably, greater benefits might occur when employees first learn about the JIT system than when their learning is refined in the later stages of JIT implementation. Early benefits might include discovering and solving the "easy" manufacturing problems during the initial period, while refinements to the JIT system deal with less consequential or less obvious changes; i.e., there is a diminishing marginal return. This pattern, however, supports the argument for an immediate deduction because the primary benefits occur in the years of the early training. Any residual benefit to future periods is fairly insubstantial.

296. *See* Rev. Rul. 92-80, 1992-2 C.B. 57; *supra* notes 148-50 and accompanying text (discussing advertising expenditures).

297. *See* Rev. Rul. 95-32, 1995-1 C.B. 8 (allowing deduction for programs cutting consumer use of electricity); Rev. Rul. 94-77, 1994-2 C.B. 19 (allowing deduction for severance pay in downsizing); Tech. Adv. Mem. 95-48-004 (Aug. 9, 1995) (allowing deduction for electricity conservation program); Tech. Adv. Mem. 95-13-002 (Nov. 28, 1994) (allowing deductions for the same); *supra* notes 150-64 and accompanying text

with the expectation of receiving benefits beyond the current period. Yet each received an immediate expense deduction.

Danaher essentially has sought only to create a sustainable competitive advantage though manufacturing excellence. It remains impossible to determine what aspect of JIT may produce an advantage for Danaher's manufacturing operations. Without an ability to assess the duration of expected benefits or what those benefits may be, the costs should be currently deducted to avoid a distortion of income. With the recurrence of training within the business, a present deduction will not distort income as would capitalizing the costs.

Aside from lacking a clear association with future benefits, a reasonable estimation of a beneficial period seems improbable.[298] Apparently, the Service tried to estimate the period of expected benefits from Danaher's training.[299] This attempt included bifurcating the annual training costs into their present and future benefit.[300] Unfortunately, the training costs were included in the basis of an "asset" that also included the reconfiguration, supply, and consulting costs.[301] The connection between the useful life of training and the other costs seems extremely weak because training and supplies, for example, that are lumped together in the capitalized asset lack a strong correlation in their respective useful lives.[302] Subsequent adjustments to the period of expected future benefit also raise questions about the estimate's reliability.[303] In the end, the Service's

(discussing business programs aimed at increased efficiency).

298. The lives of intangible assets are particularly difficult to estimate due to the frequency of technical obsolescence, operational and enterprise changes, managerial turnover, and alternative managerial techniques (like JIT) that replace older methods. *See* Gann & Strowd, *supra* note 281, at 1047; *cf.* Newark Morning Ledger Co. v. United States, 507 U.S. 546, 566 (1993) (stating that even when taxpayers can demonstrate the value of intangible assets, the demonstration of a useful life creates a "burden [that] often will prove too great to bear").

299. *See* Sheppard, *supra* note 10, at 1155.

300. *See id.* The Service permitted an immediate deduction of 10% of the costs in the first year as the present benefit and decreased the capitalized portion, as the future benefit, an additional 10% in each subsequent year. *See id.*

301. *See id.*

302. *Cf.* Tech. Adv. Mem. 94-30-003 (Apr. 22, 1994) (distinguishing the normal inability to ascertain a workforce's useful life from the situation in which the life can be measured against another asset such as an operating license).

303. Initially, the Service permitted Danaher to expense the capitalized costs over

efforts lacked any degree of accuracy.[304]

The lack of a clear association between the future benefits and the training expenditures indicates that these expenses should be deducted immediately. Attempts to allocate the deductions arbitrarily over a period of years provide a great potential for

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an eight-year period. *See* Saunders, *supra* note 10, at 64. Later, Danaher demanded a $600,000 tax refund based on its eligibility for a research and development credit. *See id.* Arguably, if the change to JIT represented a radical departure from traditional manufacturing, Danaher's JIT venture should qualify as research and development. *See id.* Apparently in an effort to compromise on the credit, the Service permitted a five-year amortization period. *See id.*

It is not clear why a five-year amortization period was not selected originally. The Service seemed to argue that Danaher entered into a new business and that the training costs were start-up expenditures. *See* Tech. Adv. Mem. 95-44-001 (July 21, 1995). Under section 195, start-up expenditures qualify for a five-year cost recovery period. *See* I.R.C. § 195(b)(1) (1996). Thus, the amortization period for the training expenditures should also occur over five years, to maintain symmetry. Apparently the Service agreed and an IRS representative indicated that the compromise on five years was intended to place Danaher in the same position as if it had acquired a new business. *See* Ada Rousso & Ron Schiel, *Life After* INDOPCO*: Are Business Expansion Costs Deductible?*, 27 TAX ADVISER 399, 401 (1996).

304. Assuming arguendo that the benefitted period could be estimated, the training costs should be capitalized as a freestanding asset, but this would distort income because the asset could not be amortized. *See* I.R.C. § 197(c)(2) (1996) (excluding from amortization self-created going concern value and a workforce in place). The training costs should be amortized over their useful life, and not simply tacked on to the basis of some other asset and amortized over that asset's useful life. *But see* Ithaca Indus. v. Commissioner, 17 F.3d 684, 689 (4th Cir. 1994) (noting that even though amortization is theoretically possible "there can be no defensible estimation of the duration of any one person's employment, nor of the useful life of the workforce of which he or she is a part"). As a freestanding asset, however, the training costs would represent either self-created going concern value—the increase in value of the company with "knowledgeable" employees—or a trained workforce. Both of these intangibles are ineligible for amortization under section 197. *See* I.R.C. § 197(c)(2).

The denial of amortization for self-created intangibles is premised on the fact that the business already has deducted the costs to produce the asset. A workforce in place, for example, was created by deductible training expenditures incurred over time. If *INDOPCO* requires capitalization of the training expenditures because they create the intangible workforce in place, then the taxpayer's only hope to recover the costs is through amortization. As mentioned *supra*, section 197 forecloses amortization for self-created intangibles. *See id.* Therefore, the costs only could be recovered upon the liquidation of the business. This failure to match expenses and revenue would produce income distortion, and it would create a preference for companies that purchase intangibles such as a workforce in place, because they can amortize those assets even though the same assets cannot be amortized by a company that created them through its own efforts. *See id.* § 197(c)(1).

income distortion.[305] Although in some situations an immediate deduction also would distort income, the recurring nature of employee training generally, and training connected with a continuous improvement philosophy specifically, provides reasonable assurance that income distortion will not occur.

RECURRING EXPENDITURES WITH POTENTIAL FUTURE BENEFITS

By emphasizing the need to match expenses with benefits when assessing capitalization, a practical solution for identifying the limited scope of *INDOPCO* can be obtained. It seems clear that the *INDOPCO* decision never intended for all expenditures generating any future benefits to require capitalization; instead, the existence of potential future benefits only suggests capitalization.[306] When those benefits cannot be identified clearly, however, the purpose of capitalizing the costs to avoid a distortion of income seems defeated. Using the need to clearly reflect income as guidance, recurring expenditures should be characterized as deductible expenses despite the potential for benefits in other tax years. Although exact matching will not occur, the results will "on average" produce the right results without undue administrative difficulties.[307]

This method of permitting a current deduction for recurring expenditures lacking an association with future benefits can support well-established deductions questioned by the *INDOPCO* decision. In addition to employee training, other expenses fall into the same pattern. The broad scope of these other examples has raised concerns that capitalizing all expenditures that provide future benefits might be too expansive a rule. Other

305. Note that the arbitrary 15-year amortization period for intangible assets under section 197 reflects an attempt by Congress to maintain revenue neutrality rather than an attempt to approximate the useful lives of the assets. *See* Gann & Strowd, *supra* note 281, at 1046.

306. *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992) (finding the presence of future benefits "undeniably important," but not determinative, in assessing capitalization treatment).

307. *See* Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 215 (7th Cir. 1982) (noting that revenue and expenses on each individual transaction would be "systematically mismatched," but that they would, on average, produce the desired results).

examples include various forms of advertising; salaries of corporate executives working on both present and future projects;[308] salaries of sales personnel that enhance the company's goodwill;[309] board of director fees for considering corporate guidance; routine business and tax planning;[310] and labor relation expenditures that develop positive working relationships with unions.[311] Each of these expenditures remains functionally recurring for most businesses. They are not extraordinary. These types of expenditures can be deducted currently without distorting income.

CONCLUSIONS

The definitions of an expense and a capital asset continue to evolve. Gradually their outlines have been shaped into recognizable forms. Capital assets carry with them the characteristic normally attributed to a tangible asset, that of providing future value to the holder. Conversely, expenses provide little prospect of value and warrant an immediate deduction. Despite the difficulties inherent in assessing future benefits, this distinction remains important and requires separate tax treatment.

Although most considerations of the capitalization issue focus on the "asset," an attempt to clearly reflect income should actually guide the ultimate determination. For many expenditures, income distortion is avoided if the amount of the expenditure is insubstantial, if the expenditure is recurring, and if no association with future benefits can easily be ascertained.

Employee training that accompanies the implementation of a JIT manufacturing system requires an immediate deduction. Companies that implement JIT merely change their operating philosophy without entering into a new business. Any anticipated benefits resulting from the change remain too contingent to

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308. *See* NCNB Corp. v. United States, 651 F.2d 942, 962 (4th Cir. 1981), *rev'd on other grounds*, 684 F.2d 285 (4th Cir. 1982) (en banc).

309. *See Encyclopaedia Britannica*, 685 F.2d at 217; *cf.* Cabintaxi Corp. v. Commissioner, 63 F.3d 614, 620 (7th Cir. 1995) (considering selling expenses incurred to generate a business's first sale).

310. *See* Faber, *supra* note 149, at 639.

311. *See* Saunders, *supra* note 10, at 64.

justify capitalization. Given the recurrence of training in most companies, the costs should be deductible.

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