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Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More-Trouble-Than-It's-Worth?

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CAPITALIZING AND DEPRECIATING CYCLICAL AIRCRAFT MAINTENANCE COSTS: MORE-TROUBLE-THAN-IT'S- WORTH?

John W. Lee, Glenn Walberg,** and Darryl D. Whitesell****

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* Professor of Law, School of Law, College of William and Mary; B.A., University of North Carolina, 1965; LL.B., University of Virginia, 1968; LL.M. (Taxation), Georgetown University, 1970. Professor Lee is grateful for interchanges with members of the Virginia Tax Study Group at the Spring Symposium held at the University of Virginia School of Law on March 21, 1997. Lee presented the ideas contained in this article as part of a panel discussion on "Life After *INDOPCO*: Which Future Benefit?" The other members of the panel were Glenn Carrington and Kenneth Kempson. Both are former high Chief Counsel officials with extensive experience then and now in, and have published significant articles on, capitalization tax issues. Their comments and those of retired Tax Court Chief Judge Samuel Sterrett were invaluable and are reflected throughout this article. Of course, any errors are our own and not attributable to the Virginia Tax Study Group. Additionally, discussions with Virginia Tech Business School Professor Eugene Seago, his advice and comments on this piece and on many fields of mutual interest for the past two decades, and his friendship have enriched Lee beyond measure. Of course, without Professor Alan Gunn's inspiration in scholarship and later his direct inspiration, Lee probably would not have explored capitalization policy as well as doctrine or rules and standards. And without his large family's forbearance he could not have done his portion of this work. He is especially grateful to them and his co-authors and students.

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I. INTRODUCTION

Recently the Internal Revenue Service (the "Service") was strafed¹ by the congressional leadership and the airline industry, both sharply criticizing it for requiring an airline to capitalize its costs of cyclical major inspections and complete overhauls of aircraft engines.² As a result of Federal Aviation Administration (FAA) safety mandates, the airline incurred maintenance costs of \$90,000 to \$122,000 for each of its aircraft engines approximately every four years.³ With these inspections and proper routine maintenance, such aircraft engines have estimated average aggregate service lives of more than twenty-two years.⁴ The Service issued a Technical Advice Memorandum (T.A.M.) requiring the capitalization of the costs under the rationale that the expenditures produced substantial improvements by increasing the values and

¹ According to Webster's Seventh New Collegiate Dictionary, "strafe", meaning to rake ground troops with machine gun fire from low-flying aircraft, comes from *Gott strafe England* (God punish England), a World War I (German) propaganda slogan. We do not mean to imply that these interests act like or have the popular attributes then or now of Huns, much less Nazis. There appears in the recent political anti-income tax rhetoric, however, in Professor Lee's populist eyes trained by an educated understanding of German culture in the early Twentieth Century, at least a faint similarity of conviction as to the righteousness of the cause and perhaps an undertone of long-resented subordination in the case of some of the congressional leadership interested in this tax issue, probably more justified than in the case of the World War I German folk. The Nazis were considerably less self-righteous but infinitely more vengeful and above all opportunistic, unprincipled, and treacherous. We cheapen the lessons of history to apply World War II terms to the prevalent American political factions.

² See T.A.M. 96-18-004 (Jan. 23, 1996). The airline also performed "hot section inspections" of the air intake systems of its aircraft on a one to two year cycle at $\frac{1}{3}$ to $\frac{2}{3}$ the cost of a major engine inspection and overhaul. See *id.* The auditing agent did not challenge the airline's immediate deduction of these costs. See *id.*

³ See *id.* Actually every six to seven thousand flight hours (turning more on number of landings than anything else) triggered an inspection. This article like the Technical Advice Memorandum uses the rough equivalent of four years. See *id.* The purpose for such inspections and resultant overhauls was to ensure aircraft reliability and passenger safety—"airworthiness." See *id.* We thank the many who have educated us as to the mechanics of replacing and reconditioning aircraft engines as part of such safety inspections and the applicable tax accounting methods for rotatable parts. In particular the aid of Eric Smith, a second-year law student at the College of William and Mary, Ken Kempson, and Professor Gene Seago was invaluable.

⁴ See *id.*

useful lives of the engines.⁵ The airline could recover the so capitalized costs through depreciation over an eight-year period.⁶

The airline industry feared that this conclusion would raise the after-tax costs of inspections because the standard industry practice deducted them currently. The airlines collectively spend about nine billion dollars each year on inspections and maintenance with one-third attributable to major engine inspections.⁷ The airline industry asserts that a change from the practice of deducting these costs to capitalizing them would increase the industry's tax cost by one billion dollars over eight years.⁸ Such an increase would significantly raise the industry's cost of complying with the FAA required inspections.

House Ways and Means Committee Chairman Bill Archer, R-Tex., wrote former Commissioner Margaret Milner Richardson requesting reversal of the T.A.M.'s treatment of these safety efforts.⁹ He argued that these costs were deductible incidental repairs and that the Service was using ambiguous interpretations of the Supreme Court's decision in *INDOPCO, Inc. v.*

⁵ *Id.*

⁶ See I.R.C. § 168(e)(3)(C)(ii) (providing a seven-year recovery period for the general residual class of items of personal property into which aircraft fall). The recovery period for aircraft would be used instead of the period for an engine specifically because section 168 does not permit taxpayers to depreciate structures on a component-by-component basis. See I.R.C. § 168(i)(6). Depreciation deductions for property with a seven-year recovery period would be taken over eight tax years due to the half-year convention that treats all property acquired during the year as being placed in service on the mid-point of that tax year. See I.R.C. § 168(d). Depreciation not taken during the first half of the first tax year is taken in the eighth year.

⁷ See Matthew L. Wald, *An I.R.S. Ruling Ruffles Airline Industry Feathers*, N.Y. Times, Oct. 5, 1996, at 1-38.

⁸ See *id.* (citing Air Transport Association Lawyer Richard A. Janis) (reporting that the one billion dollars consists of interest on additional payments due for past years plus the higher tax cost of depreciating the expenditure over longer periods rather than deducting the total all at once); accord David Field, *IRS Rule Change Upsets Airlines: Repair Deduction a Safety "Penalty"*, USA Today, Oct. 8, 1996, at B6; A New Tax Burden on Crucial Airline Safety Check-ups Draws Fire, Wall St. J., Sept. 25, 1996, at A1.

⁹ Letter from Rep. Bill Archer, R-Tex., Chairman of House Ways and Means Committee, to Margaret Milner Richardson, Commissioner of the Internal Revenue Service (Sept. 19, 1996) [hereinafter Archer Letter], reprinted in *Archer Letter to Commissioner About FAA-Inspection Costs*, 96 Tax Notes Today 198-43 (Oct. 9, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 198-43).

Commissioner¹⁰ to expand the capitalization doctrine.¹¹ More importantly, however,

[a]t a time when we should be doing everything possible to improve aviation safety, I am concerned that the Internal Revenue Service position represents a new tax burden on critical airline safety inspections and repairs. Moreover, funds potentially available for additional safety efforts could instead be claimed by the Internal Revenue Service. I believe this Internal Revenue Service position is inconsistent with the views recently expressed by Vice President Gore as a result of his commission's review of airline safety issues and with President Clinton's even more recent call for increased spending on airline safety.¹²

¹⁰ 503 U.S. 79 (1992). In *INDOPCO*, the Court addressed "whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that corporation as 'ordinary and necessary' business expenses." *Id.* at 80. The Court capitalized the expenses on the grounds of the long-term benefits that accrued to the target from the acquisition. *See id.* at 88-90.

¹¹ Archer Letter, *supra* note 9.

¹² Archer Letter, *supra* note 9. The reference to "funds . . . claimed by the Internal Revenue Service" echoes the Republican rhetoric of the debate over whom does income belong to—the government or the taxpayer. *See, e.g.,* Michael Wines, *House Votes to Cut Taxes by \$189 Billion Over 5 Years as Part of G.O.P. "Contract,"* N.Y. Times, Apr. 6, 1995, at A1, B10 (quoting House Ways and Means Committee Chairman Bill Archer, R-Tex.) ("I have a simple message for the Democrats: it's not your money; it's the taxpayers' money."); *cf.* 142 Cong. Rec. H5338 (daily ed. May 21, 1996) (Remarks of Rep. Bill Archer) ("Congress treated the public's money as if were Congress' own."). What Chairman Archer appears to really oppose is progressivity. Representing one of the half-dozen most affluent congressional districts, *see* David E. Rosenbaum, *With a Passion for Tax Cuts, and in Power*, N.Y. Times, Apr. 4, 1995, at A1, he naturally wants to take care of high income individuals. A signature Archer metaphor is providing "fuel for the engine that pulls the train of economic growth," Wines, *supra*. In other words, "affluent taxpayers must receive tax breaks because they are mainly the ones who invest money and create jobs for others." Rosenbaum, *supra*. Chairman Archer's more recent signature phrase involves tearing the Code out by its roots. *See Archer Announces Hearing on Replacing Federal Income Tax and Its Impact on Small Business, reprinted in W&M Schedules Hearing on Effect of Tax Reform on Small Business*, 96 Tax Notes Today 65-19 (Apr. 2, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 65-19). The two goals seem related: tearing the progressive income tax out by its roots would provide fuel for the engine. We presume that Chairman Archer is sincere in his belief that cutting taxes at the top will trickle down through general increase in productivity and standard of living (or at least its maintenance). We read the record as showing to the contrary that the trickle down experiments of the 1978 and 1981 tax cuts failed in that respect—any trickle down was from the top 1% to the top 5% or so of families. *See* John W. Lee, *Current Congressional Capital Gains Contentions*, 15 Va. Tax Rev. 1, 53-55 (1995) [hereinafter *Capital Gains Contentions*]. Certainly Bill Clinton, then-governor of Arkansas, played the populist rhetoric of failed trickle down economics with much skill and success in his 1992 Presidential Campaign. *See* John W. Lee, *President Clinton's Capital Gains Proposals*, 59 Tax Notes 1399, 1400 (June 7, 1993). That is why Lee defended President Clinton's then-

Chairman Archer's letter broached the idea that the deductibility of the inspection costs was supported by the FAA safety policy rather than by federal tax policy. Thirty-one bipartisan members of the House Ways and Means Committee drafted a second letter to Treasury Secretary Robert Rubin concurring with Chairman Archer's conclusions.¹³ They asserted: "Clearly the IRS is overstepping its authority in attempting to impose this tax penalty on air safety."¹⁴

IRS Chief Counsel Stuart Brown, on behalf of Commissioner Richardson, replied to Chairman Archer.¹⁵ Brown insisted that the Service has consistently issued rulings "holding that *INDOPCO* does not change the fundamental legal principles" of capitalization.¹⁶ Accordingly, Brown concluded that the T.A.M. properly characterized the costs as capital expenditures for the

populist reputation against a right wing knock-off of the scurrilous, populist "Mellon Ditty" from the 1920's. John W. Lee, *"Death and Taxes" and Hypocrisy*, 60 Tax Notes 1393 (Sept. 6, 1993).

¹³ Letter from Mac Collins et al., Representative, U.S. House of Representatives, to Robert E. Rubin, Secretary of the Treasury (Sept. 26, 1996), reprinted in *Reps' Letter to Rubin on IRS's New Capitalization Position*, 96 Tax Notes Today 196-51 (Oct. 7, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 196-51).

¹⁴ *Id.*

¹⁵ Letter from Stuart L. Brown, Chief Counsel, Internal Revenue Service, to Bill Archer, Representative, U.S. House of Representatives (Oct. 1, 1996) [hereinafter Brown Letter], reprinted in *IRS Chief Counsel's Response to Archer on FAA-Inspection Costs*, 96 Tax Notes Today 198-44 (Oct. 9, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 196-51).

¹⁶ *Id.*; cf. T.A.M. 96-41-004 (June 25, 1996) (citing various rulings asserting that *INDOPCO* confirmed, without changing, capitalization principles); Letter from Thomas J. Smith, Internal Revenue Service, to William F. Clinger, Chairman of the House Committee on Government Reform and Oversight, U.S. House of Representatives (Aug. 8, 1996), reprinted in *IRS Response to Clinger on FAA-Inspection Costs*, 96 Tax Notes Today 200-13 (Oct. 11, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 200-13). In fact, *INDOPCO* did not change the fundamental legal principles governing capitalization; however, most people had not understood those principles but had instead been applying the erroneous "no separate asset" test to deduct many future benefit expenses. See John W. Lee, *Doping Out the Capitalization Rules After INDOPCO*, 57 Tax Notes 669, 669 (Nov. 2, 1992) [hereinafter *Capitalization Rules*] (quoting Ecclesiastes' observation that what appears to be new actually occurred before). Brown himself acknowledged that the Service discovered while setting "standards in the aftermath of *INDOPCO* [that] 'we . . . don't know what the pre-*INDOPCO* standard was.'" *Brown Lists Factors That Could be Used to See if Cleanup Costs Must be Capitalized*, Daily Tax Rep. (BNA), Mar. 10, 1993, at G-11 (quoting Associate Chief Counsel Stuart Brown). This confusion is amply manifested in the twists and turns of the Service's approach to capitalization rules. See John Lee et al., *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations (Part One)*, 23 Ohio N.U. L. Rev. 631 (1997) and *(Part Two)*, 23 Ohio N.U. L. Rev. (forthcoming) [hereinafter *Rough Justice*] (outlining the various approaches in the Service's rulings).

improvement of property instead of adopting Archer's characterization as incidental repairs.¹⁷ In particular, "[t]he major inspections involve the replacement or reconditioning of a large portion of the engine's component parts; upon completion of these procedures, the engine's value was materially increased and its service life was substantially prolonged."¹⁸ Finally, Brown assured Archer that the Service shared Congress' concern for airline safety; however, Brown asserted that the T.A.M. merely applied current tax law to an airline¹⁹ without addressing any safety issues.²⁰

Chairman Archer expressed disappointment with Brown's response,²¹ complaining that IRS disapproval of the airline industry's long-standing practice of deducting the costs not only failed to provide any rationale for its new interpretation of capitalization standards but even failed to acknowledge that this was a new interpretation.²² Moreover, Archer asserted that the Service's position contradicted the Clinton Administration's support for airline safety by imposing a "new tax burden" on the airlines.²³

¹⁷ Brown Letter, *supra* note 15.

¹⁸ Brown Letter, *supra* note 15.

¹⁹ Brown Letter, *supra* note 15. Brown insisted that a T.A.M. is taxpayer specific—it is based on one taxpayer's specific factual circumstances and cannot be cited as precedent by other taxpayers. *Id.* Others assert "[t]hat's not the real world" because agents will rely on the reasoning of the T.A.M. to support its conclusions when auditing other airlines. Tom Herman, *Airlines Decry IRS Move as Threat to Safety, Broader Than Apparent*, Wall St. J., Oct. 10, 1996, at B4 (quoting former IRS Commissioner Donald Alexander); accord Letter from Bill Archer, Chairman of House Ways and Means Committee, to Margaret Milner Richardson, Commissioner of the Internal Revenue Service (Oct. 8, 1996) (noting that agents already were using the T.A.M. in audits of other airlines) [hereinafter Archer Reply], reprinted in *Archer Letter to Commissioner About IRS Refusal to Change Inspection Cost Policy*, 96 Tax Notes Today 198-45 (Oct. 9, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 198-45). As discussed below, the fact that the IRS National Office of Appeals put aircraft engine inspection costs on the "significant issues" list in 1992, *List of Significant Issues in the Internal Revenue Service Industry Specialization Program, Accompanied by Explanation by John Monaco, Executive Director, IRS Coordinated Examination Programs*, reprinted in *Daily Tax Rep.* (BNA), Dec. 23, 1992, at L-29, is far more relevant than the holding of the T.A.M.

²⁰ Brown Letter, *supra* note 15.

²¹ Archer Reply, *supra* note 19.

²² Archer Reply, *supra* note 19.

²³ Archer Reply, *supra* note 19. Archer has vowed that income taxes will not be raised during his tenure. See *Unofficial Transcript of June 8 W&M Hearing on Tax Reform*, 96 Tax Notes Today 116-54 (June 15, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit. 95 TNT 116-54) ("Well, I would contemplate that as long as I'm chairman of this committee that none of these plans will raise taxes."). He may mean that taxes will not be raised by the IRS as well as by new Congressional enactments.

Simultaneously, the House Budget Committee Report expressed dissatisfaction with the Service's refusal to take into account FAA safety policies.²⁴ Such late 1996 Congressional disapproval of the Service's position forewarns of potential Congressional interference aimed at preserving the government's policy on air safety. It appears unlikely at this time that Congress will address this issue with *substantive* legislation due to the pay-go rules that would require it to find a revenue raiser to offset the Joint Committee on Taxation computed *hypothetical* revenue loss created by subtracting, pursuant to statutory authorization, these costs immediately (as they currently do in the real tax world)²⁵ from a *hypothetical* baseline in which these costs are properly capitalized and amortized. This absurdity suggests that the pay-go rules should be modified to allow enactment of simplification rules codifying a widespread but conceptually incorrect practice without creating a hypothetical revenue loss.

²⁴ H.R. Conf. Rep. No. 104-863, at 1149 (1996) 142 Cong. Rec. H11644, H12009 (daily ed. Sept. 28, 1996) ("[T]he conferees urge the IRS to reverse its recent position on [the] tax treatment of aircraft inspection and safety costs.").

²⁵ The "pay-go" procedures of the Omnibus Budget Reconciliation Act of 1990, as extended by the Omnibus Budget Reconciliation Act of 1993, require estimated revenue decreases under federal tax legislation to be offset by increases in revenues or decreases in spending to produce no net increase in the estimated federal deficit. See Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 Colum. L. Rev. 609, 611-12 (1995); Barbara Kirchheimer, *Reconciliation Perspective: A Look Back to See Where We're Headed*, 59 Tax Notes 158 (Apr. 12, 1993); *Capital Gains Contentions*, *supra* note 12, at 57; Alexander Polinsky, *What is the Deficit Trust Fund?*, 60 Tax Notes 1295, 1296 (Sept. 6, 1993). Revenue decreases usually come from "tax expenditures," defined as "reductions in individual and corporate income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers. These special tax provisions can take the form of exclusions, credits, deductions, preferential tax rates, or deferrals of tax liability." Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1997-2001* 2 (Nov. 26, 1996), reprinted in *JCT Releases Five-Year Forecast of Tax Expenditure Costs*, 96 Tax Notes Today 231-6 (Nov. 27, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 231-6). "Special income tax provisions are referred to as tax expenditures because they are considered to be analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives. Tax expenditures are most similar to those direct spending programs that have no spending limits, and that are available as entitlements to those who meet the statutory criteria established for the programs." *Id.* For an enlightening sampling of the literature, see Paul L. Caron et al., *Federal Income Tax Anthology* 296-312 (1997). Under the pay-go rules, the ideal rule of capitalization/depreciation as to cyclical safety aircraft engine overhauls is included in the base line so that a new statute allowing expensing would be counted as a revenue loser. In actuality, this provision would not increase the deficit because the taxpayers already were expensing the costs and not paying tax on the hypothetically correct income.

Rather than adopting such a sensible bookkeeping reform, congressional tax leadership appears more likely to resort to *procedural* legislation, generically known as “limitation riders” even when appearing in Committee bills rather than in a floor amendment, that would bar the Service from requiring the capitalization of overhaul costs until the Service takes account of FAA safety policies.²⁶ Although the limitation riders might entail an explicit ban on the Service’s enforcement of capitalization standards in this area, the placement of a statement of disapproval of the Service’s position in the 1997 appropriations bill hints that Congress might simply refuse to finance the Service’s enforcement activities.²⁷ (Professor Lee understands, primarily from conversations with former Treasury Deputy Tax Legislative Counsel and Chief of the Joint Committee Staff (and, in between, Professor of Law at the Universities of Virginia and Pennsylvania) Harry Gutman, that given the current institutional “culture” of Congress refusal to fund is less viable than a ban on enforcement of a particular tax policy.) Curiously, the motivation for this congressional micromanagement of tax regulation ostensibly derives from safety concerns and not the Service’s administration of the tax laws. (The no new tax increase notion appears the driving force for some.)

In particular, the congressional leadership states that it seeks to achieve a policy coordinated between the Service and those

²⁶ See, e.g., Archie Parnell, *Congressional Interference in Agency Enforcement: The IRS Experience*, 89 Yale L.J. 1360, 1370-75, 1371 n.77, 1372 n.85 (1980) (cataloging instances during 1975-80 when Congress prohibited the IRS from executing certain aspects of the tax law in the areas of (a) salary reduction plans, (b) oil production-sharing contracts, (c) employee tips paid by credit card, (d) publishers’ prepublication costs, (e) travel expenses, (f) private non-qualified deferred compensation plans, (g) fringe benefits, (h) employee and independent contractor classifications, (i) losses of tax-exempt status for racially discriminating schools, and (j) contributions to tax-exempt religious schools for educational purposes). At the Virginia Tax Study Group’s [hereinafter VTSG] Spring 1997 Symposium the father of the VTSG as well of so much else in the Code, Emeritus Professor Edwin Cohen (former Under Secretary of Treasury who most notably designed and presented the Tax Reform Act of 1969 to the tax writing Committees and co-authored the 1954 American Law Institute Corporate Tax Proposals and whose hands-on experience with income taxes begins with the Revenue Act of 1936) noted that the “limitation rider” which he had fashioned for the publishers was in a regular tax act (section 2119 of the Tax Reform Act of 1976) and remained in effect for a decade as to publishers (until section 263A of the 1986 Code was enacted). See *infra* note 88.

²⁷ See *supra* note 24.

agencies concerned with safety.²⁸ This raises the question of when and how the Service should consider non-tax policies affected by the tax laws. Ultimately, this issue turns more on tax politics than on tax policies. If the Service simply reversed the cyclical aircraft engine maintenance T.A.M. with a tersely worded ruling—as it did with the soil remediation T.A.M.,²⁹ every other industry faced with a new post-*INDOPCO* ruling would tend to challenge it politically.³⁰ Conversely, if the Service did not consider FAA policy and/or hold public hearings to consider cyclical safety overhauls, then Congress might use limitation riders to suspend the application of the T.A.M.'s reasoning. Either way, the Service might well find its whole post-*INDOPCO* strategy of incrementalism, described immediately below, much more trouble than it ever could have been worth.

This article elaborates on the open letter written by Professor John Lee to Commissioner Richardson in partial support of the cyclical aircraft engine safety inspection T.A.M.'s conclusions³¹ and offers negotiated rule making as a defusing technique to address the above problems. The article recommends that the Service abandon its apparent strategy of establishing capitalization rules incrementally through audit, litigation, and occasional rulings. As described more fully in *Rough Justice*, Political Science Professor Charles Lindblom, aptly dubbing that approach "Muddling Through,"³² recommends it where an administrative agency is

²⁸ See H.R. Conf. Rep. No. 104-863, *supra* note 24, at 1149 ("The conferees are also concerned that this policy change, which affects the entire airline industry and critical airline safety policies, was implemented without apparent input from and coordination with other interested parties such as the Department of Transportation and the FAA.").

²⁹ See Rev. Rul. 94-38, 1994-1 C.B. 35 (reversing T.A.M. 93-15-004 (Dec. 17, 1992)); *infra* notes 225-29 and accompanying text.

³⁰ Cf. Art Pine, *Congress Stirs Up IRS Enforcement*, Wash. Post, Dec. 22, 1978, at E1 (describing congressional action inspired by constituents upset by an IRS ruling).

³¹ See Letter from John Lee, Professor, William and Mary Law School, to Margaret Milner Richardson, Commissioner of the Internal Revenue Service (Sept. 30, 1996) [hereinafter Lee Letter] (agreeing with the need to capitalize the overhaul costs but suggesting a four-year recovery period for the capitalized costs as a freestanding depreciable intangible, much like a financial accounting "deferred charge"), reprinted in *Professor Says IRS Shouldn't Change Position on Capitalizing Costs of Airplane Engine Overhauls*, 96 Tax Notes Today 204-11 (Oct. 18, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 204-11).

³² Charles E. Lindblom, *The Science of "Muddling Through"*, 19 Pub. Admin. Rev. 79 (1959).

unsure of the best rules or, as appears to be the instant case, where there are conflicts inside the agency.³³ Such intra-agency conflicts appear to exist in the Service between (a) the higher levels of Chief Counsel, and (b) the National Office of Appeals as reported by the tax press³⁴ and, according to comments at the Virginia Tax Study Group by Glenn Carrington and Ken Kempson, regional chief counsel as well who are eager to establish the boundaries of capitalization/expensing through litigation. We strongly recommend in *Rough Justice* and again here that the Service utilize instead the medium of more global structured discretionary justice regulations as conceptualized by University of Chicago Law School Administrative Law Professor Kenneth Culp Davis in his landmark *Discretionary Justice, a Preliminary Inquiry*.³⁵ Such regulations should set forth (a) the clear reflection of income standard for capitalization versus expensing, (b) rough justice rules for implementing such standard, and (c) directions for applying those rules under fully articulated balancing tests. Going beyond the advice in the open letter,³⁶ this article advocates that the Service formulate such structured discretionary rough justice regulations through negotiated rulemaking with other agencies appropriately represented during the discussions of certain topics affecting non-

³³ See *Rough Justice*, *supra* note 16.

³⁴ See *Minutes of Tax Executives Institute-Internal Revenue Service Liaison Meeting November 19, 1996*, [hereinafter *TEI-IRS Liaison Minutes*] (Remarks of Chief Counsel Stuart Brown) reprinted in *TEI Releases Minutes of IRS, Treasury Liaison Meetings* 97 Tax Notes Today 20-46 (Jan. 30, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit. 97 TNT 20-46).

³⁵ Kenneth Culp Davis, *Discretionary Justice, A Preliminary Inquiry* 103 (LSU Press 1969); cf. John W. Lee, *The Art of Regulation Drafting: Structured Discretionary Justice Under section 355*, 44 Tax Notes 1029, 1032 (Aug. 28, 1989).

³⁶ See Lee Letter, *supra* note 31. This initial reaction to avoid deciding tax treatment on non-tax policy grounds at least put Professor Lee in good company—i.e., the Treasury and Service officials responsible for reviewing the soil remediation T.A.M. See Andrew J. Hoerner, *Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, 93 Tax Notes Today 102-10 (May 12, 1993) (LEXIS, FEDTAX lib., TNT file, elec. cit. 93 TNT 102-10) (“The denial of deductibility was not based on environmental policy, and the current review of the treatment of environmental costs will not consider environmental policy ‘Environmental impact is an issue for legislators and policymakers. My job is to only interpret the law’” (quoting Associate Chief Counsel Glenn Carrington); cf. *Treasury Official Sees Environmental Clean-up Guidance This Year as Warranted*, Daily Tax Rep. (BNA), May 10, 1993, at G-14 (considering environmental guidance that promotes both public policy and tax policy goals). The reaction of members of the VTSG at the Spring 1997 Symposium was much the same.

tax policies.³⁷ This approach should seek to replicate the best of the prior collegial tax reform experiences. Following these recommendations, the Service could take major steps toward simplifying the capitalization rules and reducing the tax law's interference in business decisions.

Part II advances a rough justice concept that seeks fair results through easy-to-apply rules. These rules create a minimal distortion of income when compared with their capitalization-cum-depreciation counterpart. This part explains the rationales behind rough justice, puts forth four rough justice exceptions to capitalization, and advocates promulgating structured discretionary justice regulations incorporating these exceptions. Part III applies these rough justice exceptions in the context of the aircraft maintenance T.A.M. Finally, part IV presents considerations of public policy important to interpretation of the tax laws. This part first demonstrates that the Service previously has considered the impact on non-tax policies in several areas when interpreting the Code. Then this part advances a two-prong test that looks to a congressional or judicial identification of a policy overlap and requires a severe frustration of the non-tax policy before the Service considers the non-tax policy. This part concludes that in the case of the airline maintenance T.A.M., the Service should use a negotiated rulemaking strategy to take into account the safety policies of the FAA.

³⁷ See generally Administrative Conference of the United States, *Negotiated Rulemaking Source Book* (1990); Daniel J. Fiorino, *Dimensions of Negotiated Rule-making: Practical Constraints and Theoretical Implications*, in *Conflict Resolution and Public Policy* 141 (Miriam K. Mills ed., 1990); Philip J. Harter, *Negotiating Regulations: A Cure for Malaise*, 71 Geo. L.J. 1 (1982); Henry H. Perritt, Jr., *Administrative Alternative Dispute Resolution: The Development of Negotiated Rulemaking and Other Processes*, 14 Pepp. L. Rev. 863 (1987); Lawrence Susskind & Gerard McMahon, *The Theory and Practice of Negotiated Rulemaking*, 3 Yale J. on Reg. 133 (1985).

II. "ROUGH JUSTICE" OR "MORE-TROUBLE-THAN-IT'S-WORTH EXCEPTIONS"³⁸ TO CAPITALIZATION OF FUTURE BENEFIT EXPENDITURES

Sections 162³⁹ and 263⁴⁰ intend to more accurately calculate net income⁴¹ by generally matching⁴² expenses with revenue in the taxable period in which the expenses actually generate that revenue.⁴³ Justice Blackmun advanced this conceptually sound idea recently in *INDOPCO, Inc. v. Commissioner*⁴⁴ and two decades

³⁸ *NCNB Corp. v. United States*, 651 F.2d 942, 953 (4th Cir. 1981) [hereinafter *NCNB II*, *rev'd en banc*, 684 F.2d 285 (4th Cir. 1982), *overruled*, 503 U.S. 79 (1992)]; *see NCNB I*, 651 F.2d at 961 (noting "situations involving considerations of pragmatism and uncertainty").

³⁹ I.R.C. § 162(a) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .").

⁴⁰ I.R.C. § 263(a) (denying deductions for most capital expenditures).

⁴¹ Taxing net annual income is a fundamental policy of the Code. *See* 50 Cong. Rec. 3849 (1913) (remarks of Sen. Williams). Today the keystone is section 446's mandate that a taxpayer's method of income tax accounting must clearly reflect income. *See* I.R.C. § 446(b). A taxpayer's practice of expensing or capitalizing an expenditure is a method of accounting. *See* Rev. Rul. 95-74, 1995-2 C.B. 36; Rev. Rul. 95-32, 1995-1 C.B. 8; G.C.M. 39,328 (Jan. 23, 1985) ("A material item is defined as any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Clearly, the taxes, interest and loan fees at issue constitute material items since the decision whether to capitalize or expense such items involves the appropriate time for taking a deduction.") (citation omitted).

⁴² That match is by no means exact. Rather capitalized costs are "added" to the basis of an asset, *see* I.R.C. § 1016, and then depreciated over the estimated useful life or recovery period at varying rates of depreciation. *See* I.R.C. §§ 167, 168. Capital recovery often occurs over a much shorter period than the actual useful economic life. Only by pure chance would the depreciation deductions actually match the resulting income.

⁴³ *See generally* Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 Va. Tax Rev. 1 (1984); *cf.* H.R. Rep. No. 104-586, at 140 (1996) (referring to sections 167(g) and 263A for which "in theory, the income forecast method is an appropriate method for matching the capitalized cost of certain property with the income produced by such property"); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. Penn. L. Rev. 1179, 1184 n.15 (1987) ("A current fad in tax policy is . . . the financial accounting notion of 'matching.'").

⁴⁴ 503 U.S. 79 (1992). In espousing the matching notion, Justice Blackmun stated that: [t]he primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.

Id. at 83-84 (citations omitted).

earlier in *Commissioner v. Idaho Power Co.*⁴⁵ to explain that when an expenditure offers benefits in future periods, the expenditure should be capitalized instead of expensed to accurately reflect net income.

Why should the doctrinal and tax policy analysis not stop with future benefit? Arguably, the cyclical overhauls yield substantial future benefit for a *four*-year period and therefore should be capitalized and amortized over that period. (Of course depreciation over an eight-year period of an expenditure repeated every four years distorts the taxpayer's income. Judge Sterrett provided the answer in *Wolfsen Land & Cattle Co. v. Commissioner*,⁴⁶ which Glenn Carrington introduced into the Chief Counsel's quiver of capitalization precedent and doctrine.)⁴⁷ Treasury, as well as some academics, advocates capitalization and depreciation for all multi-period costs.⁴⁸ Otherwise, as a *Tax Notes Today* article put it, airlines receive tax advantages and preferences over other forms of transportation that must capitalize their overhaul and reconditioning costs.⁴⁹ The short answer to the above question is

⁴⁵ 418 U.S. 1 (1974). Focusing on the purpose of depreciation in tax accounting, the Court stressed that depreciation serves to allocate the cost of an asset to the various periods that benefit from the asset use. See *id.* at 10-11.

When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income.

Id. at 11.

⁴⁶ 72 T.C. 1 (1979).

⁴⁷ For the Carrington-Lee-Wolfsen Land & Cattle story, see *Miscellaneous Revenue Issues: Hearings before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means (Part 2)*, 103d Cong., 1689, 1702 (1993) [hereinafter 1993 *Hearings*] (Prepared Statement of Professor Lee).

⁴⁸ See 2 U.S. Dep't Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth—General Explanation 202-11* (1984).

⁴⁹ John Godfrey, *Bipartisan Group Says Reverse IRS Decision on Plane Inspections*, 96 Tax Notes Today 196-3 (Oct. 7, 1996). See, e.g., *LaSalle Trucking Co. v. Commissioner*, 22 T.C.M. (CCH) 1375 (1963) (capitalizing the costs to overhaul truck engines); Rev. Rul. 88-57, 1988-2 C.B. 36 (capitalizing substantial costs for cyclical overhauls of freight-train cars). Some commentators distinguish Revenue Ruling 88-57 from the aircraft engine overhauls because the railway car overhauls take place at the otherwise end of their service life. See William L. Raby & Burgess J.W. Raby, *Capitalizing the Costs of Aircraft Engine Overhauls*, 71 Tax

that courts, Congress, and the Service always have tempered the absolute rule that future benefit requires capitalization with a host of exceptions.⁵⁰ The story of these exceptions, which essentially make the rule, provides the rationales and tax policies supporting the judicial and administrative results.

The Supreme Court implicitly has recognized the role of these exceptions. In *Commissioner v. Lincoln Savings & Loan Association*⁵¹—properly read for the general proposition that expenditures should be capitalized when incurred to enhance or create an asset producing substantial future benefit⁵²—Justice Blackmun warned that “the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.”⁵³ Similarly in *INDOPCO*, Justice Blackmun acknowledged that the mere presence of an incidental future benefit may not warrant capitalization.⁵⁴ After sanctioning the use of exceptions, however, the Court left to others the task of explaining and cataloging the exceptions.

Notes 1221, 1222 (May 27, 1996).

⁵⁰ See *NCNB I*, 651 F.2d at 953 (noting that these exceptions allow a taxpayer “currently to recognize some expenses even though theoretically nicety would suggest capitalization and subsequent recognition. They may be called the ‘more-trouble-than-it’s-worth exceptions.’”).

⁵¹ 403 U.S. 345 (1971).

⁵² See *Black Hills Corp. v. Commissioner*, 73 F.3d 799, 805-06 (8th Cir. 1996); Rev. Proc. 90-63, 1990-2 C.B. 664, 665; Rev. Rul. 89-23, 1989-1 C.B. 85; G.C.M. 39,606 (Feb. 27, 1987); T.A.M. 96-41-004 (June 25, 1996); T.A.M. 96-38-002 (June 3, 1996); T.A.M. 90-24-003 (Mar. 2, 1990).

⁵³ *Lincoln Savings*, 403 U.S. at 354. This statement served as the peg for the development of the separate asset doctrine. See John W. Lee & Nina R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. Rich. L. Rev. 473, 475-84 (1981) (discussing the development of the separate asset doctrine). Several commentators showed that the separate asset doctrine was unsound and was not mandated by *Lincoln Savings*. See, e.g., Alan Gunn, *The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C. Indus. & Com. L. Rev. 443 (1974); Lee & Murphy, *supra*, at 481-84. By and large, the doctrine developed in reaction to IRS overreaching in requiring capitalization without allowing any or only inadequate depreciation. See *NCNB I*, 651 F.2d at 959; 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, 51-56 (1986) [hereinafter *Start-up Costs and Clear Reflection of Income*].

⁵⁴ See *INDOPCO*, 503 U.S. at 87.

A. *The Rationales Underlying the Exceptions*

Several rationales explain why exceptions generally temper the otherwise absolute rule of capitalizing all costs producing future benefit. These rationales consider costs that produce incidental future benefits, a balancing of the benefits and burdens of capitalization, and the role of administrative convenience in applying the tax laws.

1. *Incidental Future Benefit*

The potential capitalization of all costs that generate future benefit presents an overly expansive rule never intended for income tax accounting.⁵⁵ The Supreme Court recognized this limitation in *INDOPCO* by stating that *incidental* future benefits may not require capitalization.⁵⁶ Tax Court Judge Tannenwald explored this incidental future benefit limitation in *Sun Microsystems, Inc. v. Commissioner*.⁵⁷ In *Sun Microsystems*, the taxpayer, a new high-tech company, argued that the issuance of stock warrants to a new major customer—with the exercise rights contingent upon the volume of future purchases—constituted sales discounts, whereas the Government argued that under *INDOPCO*'s “new look” the warrants should be capitalized as an investment made to develop

⁵⁵ See 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 20.4.1, at 20-67 (1st ed. 1981). Professor Bittker explained:

[I]f the IRS seriously endeavored to disallow every cost contributing to the profits of future periods, it would be necessary to divide almost every salary and advertising expense between its immediate impact on the customer and its contribution to the company's long-lived goodwill. Recognizing this fact of business life, the Supreme Court has said that “the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.”

Id. (quoting *Lincoln Savings*, 403 U.S. at 354); cf. *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982) (same reasoning and example); John W. Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 Tax L. Rev. 347, 462 (1974) (“[An] increase in earning power or benefit to future years is not alone sufficient [for capitalization], otherwise all ordinary and necessary business expenditures resulting in greater profit would have to be capitalized, which is not the law.”).

⁵⁶ See *INDOPCO*, 503 U.S. at 87 (“[T]he mere presence of an incidental future benefit—‘some future aspect’—may not warrant capitalization.”).

⁵⁷ 66 T.C.M. (CCH) 997 (1993).

a long-term relationship with a customer.⁵⁸ Judge Tannenwald responded:

We find it unnecessary to refine this claimed “new look” for the purpose of our decision herein. . . . [T]he Supreme Court recognized that, while realization of future benefits is important in determining existence of a capital expenditure, “the mere presence of an incidental future benefit—‘some future aspect’—may not warrant capitalization.” *INDOPCO* “[T]he anticipated long-term benefits to [the taxpayer] from the relationship with [the customer] were ‘softer’ and were speculative, compared to the immediate benefits to [the taxpayer] of the anticipated sales of computer workstations to [the customer] under the Purchase Agreement.”

We conclude that the instant situation falls within the “incidental future benefit” category reflected in *INDOPCO*. . . . Indeed, the long-term benefits herein appear to be no different than those present in stock options given to employees which were held not to impair their compensatory character even before the enactment of the statutory framework that now exists.⁵⁹

Judge Tannenwald thus ruled that costs predominately benefiting the current period justify an immediate deduction when the remaining future benefit is incidental. Also he catalogued as coming within the currently deductible/incidental future benefit category authorities permitting current deduction of author’s prepublication costs, job seeking fees, and advertising costs.⁶⁰

⁵⁸ *Id.* at 1002.

⁵⁹ *Id.* at 1005 (citations omitted).

⁶⁰ *Id.* We conclude that the instant situation falls within the “incidental future benefit” category reflected in *INDOPCO*. *Cf. Snyder v. United States*, 674 F.2d 1359, 1365 (10th Cir. 1982) (author’s expenses in connection with a book to be published in future held deductible); *Primuth v. Commissioner*, 54 T.C. 374 (1970) (fee in order to secure employment held deductible); Rev. Rul. 92-80, 1992-2 C.B. 57 (*INDOPCO* does not preclude deduction of advertising expenses having a future benefit); see Lee, “Doping out the Capitalization Rules after *INDOPCO*,” 57 Tax Notes 669 (Nov. 2, 1992); Note, “Deductibility of Takeover and Non-Takeover Expenses in the Wake of *Indopco*,” 45 Tax Law. 815 (1992). Indeed, the long-term benefits herein appear to be no different than those present in stock options given to employees which were held not to impair their compensatory character even before the enactment of the statutory framework that now exists. See *Commissioner v. LoBue*, *supra*; *Union Chemical & Materials Corp. v. United States*, 155 Ct. Cl. 540, 296 F.2d 221 (1961). *Sun Microsystems*, *supra*, 66 T.C.M.(CCH) at 1005.

Judge Tannenwald's *Sun Microsystems* list surely intentionally echoes his citing of educational and advertising costs as currently deductible despite future benefits over two decades earlier in his concurring opinion in *Primuth v. Commissioner*.⁶¹ Judge Tannenwald's concurrence was the genesis of Professor Lee's interest in doctrine permitting current deduction of expenses with some future benefit (or profit).⁶² When Professor Lee told this story to retired Tax Court Judges Samuel Sterrett and Lapsley Hamblen at the Virginia Tax Study Group [hereinafter VTSG] Spring 1997 Symposium, Judge Sterrett proudly, and deservedly so, noted his authorship of *Primuth*, a sea change permitting deduction of employee job seeking fees (which at that time appeared to have more future benefit than they perhaps do today, with downsizing and job uncertainty in the air). Judge Sterrett also was the author of *Wolfsen Land & Cattle* treating a recurring maintenance cost itself as a freestanding intangible (much like a deferred charge) depreciable over the period of recurrence rather than associating it with some much longer lived tangible asset. Thus he joins distinguished jurists, such as Judge Tannenwald, Seventh Circuit

⁶¹ 54 T.C. 374 (1970).

I am in full agreement with the result reached by my colleagues in the majority and with much of the reasoning in Judge Sterrett's careful and lucid analysis and his apparent rejection of the subtle distinctions which seem to be developing in this area. To me, the drawing of distinctions based upon the difference between "seeking" and "securing" employment, upon whether the fee of the employment agency is contingent or payable in any event, or upon whether the agency's efforts are successful or unsuccessful simply adds unnecessary confusion and complexity to a tax law which already defies understanding even by sophisticated taxpayers. I would similarly reject any attempt to import a capitalization of expenditure concept into a situation such as is involved herein. That concept has generally been confined to cases of acquisition of tangible assets or intangible assets, such as a license or goodwill of a going business, or preparation for engaging in a new field of endeavor. Compare *Morton Frank*, 20 T.C. 511 (1953) (prospective acquisition of newspaper businesses); *with Manhattan Co. of Virginia, Inc.*, 50 T.C. 78 (1968) (goodwill); and *Arthur E. Ryman, Jr.*, 51 T.C. 799 (1969) (admission to the bar of a second State); and *Nathanial A. Denman*, 48 T.C. 439 (1967) (preparation for a new field of endeavor). By way of contrast, current deductibility has normally been permitted for advertising expenditures and for educational expenditures to improve one's skills utilized in existing employment, even though there were indications that some general benefit would in all probability last beyond the year of expenditure. E.g., *Consolidated Apparel Co.*, 17 T.C. 1570, 1582 (1952), *affirmed in part and reversed in part on other issues*, 207 F.2d 580 (7th Cir. 1953) (advertising expenses); *Cosimo A. Carlucci*, 37 T.C. 695, 701 (1962) (educational expenses). Compare *Harold Haft*, 40 T.C. 2 (1963).

Primuth, *supra*, 54 T.C. at 381-82 (Tannenwald, J., concurring).

⁶² See Bittker, *supra* note 55.

Judge Richard Posner, and Justice Harry Blackmun, who have shaped the capitalization/expensing doctrine.

Glenn Carrington indicated at the VTSG Spring 1997 Symposium that agents argue that *Sun Microsystems* is just a discount case. We believe that Judge Tannenwald, while indicating that such narrow analysis resolved the controversy in front of him, deliberately pointed to the precedent and surely the analysis (minimum distortion of income) that he at least would use to give meaning to "incidental" future benefit. In any event, the Service followed *Sun Microsystems*' incidental benefit reasoning in a T.A.M. extensively discussing deductibility of pre-opening costs incurred by a retailer opening new stores in the same field.⁶³ During the weeks prior to opening a store, this retailer incurred costs for employee hiring and training, inventory stocking, and initial functioning such as postage, supplies, repairs, utilities, communications, and security.⁶⁴ These costs were typical of those incurred during the retailer's normal operations.⁶⁵ The T.A.M. stated that not all expenditures that produce future benefits must be capitalized.⁶⁶ Instead, the T.A.M. focused on whether the benefits were short-lived such that the future benefit was incidental.⁶⁷ In this case, the Service concluded that the need to incur these costs again shortly, in the normal course of business, indicated that these pre-opening costs provided only short-term benefits.⁶⁸ Expenditures with incidental future benefit, like these pre-opening costs, provide ample justification for an immediate deduction: when the benefits are realized in the current period, the expenditures should be immediately deductible to match the expense with the resulting revenue.

⁶³ See T.A.M. 96-45-002 (June 21, 1996).

⁶⁴ See *id.*

⁶⁵ See *id.* (noting that the recurring nature of these costs provides support for a current deduction because recurring costs resemble operating expenses whereas non-recurring costs resemble capital expenditures).

⁶⁶ See *id.* ("Capitalization is *not* required for *every* expenditure that produces a future benefit.").

⁶⁷ See *id.*

⁶⁸ See *id.*

Rough Justice lauds this pre-opening T.A.M. and laments that the “published” version in Revenue Ruling 96-62⁶⁹ is narrowly limited to job “training provided in the ordinary course of the taxpayer’s business” with no other indication of rationale and not addressing the business expansion issue.⁷⁰ Tax Executives Institute, Inc. [hereinafter TEI] which had been the prime private sector mover behind the Notice 96-7⁷¹ request for comments finds the ruling more helpful than not.⁷² Glenn Carrington pointed out at the VTSG Spring 1997 Symposium, however, that the facts of the recent business expansion T.A.M. disclose an abnormally high annual employee turnover rate of 60% at many of taxpayer’s stores.⁷³ He indicated that revenue agents have sought to discount the business expansion T.A.M.’s reasoning due to such high turnover rates and even argue that because Revenue Ruling 96-62 was derived from this T.A.M., it too was distinguishable from more usual business expansion with much lower turnover rates. Ken Kempson flatly stated that when a T.A.M. or other ruling is reviewed at a higher level and a ruling is then published by the Service, the underlying T.A.M. is dead and buried for purposes of analysis of the ruling. This is surely so for purposes of “substantial authority,”⁷⁴ but we believe less so as to the reasoning itself.

2. *Balancing Benefits and Burdens*

The Fourth Circuit panel in *NCNB Corp. v. United States* [hereinafter *NCNB I*] described these exceptions as “situations involving considerations of pragmatism and uncertainty in which, with the blessing of the Commissioner, taxpayers may deduct currently certain expenditures, notwithstanding the presence of

⁶⁹ 1996-53 I.R.B. 6.

⁷⁰ *Rough Justice*, *supra* note 16.

⁷¹ 1996-1 C.B. 359.

⁷² Timothy J. McCormally, *Rev. Rul. 96-62: A Lump of Coal or a Nicely Wrapped Present?*, 74 Tax Notes 797 (Feb. 10, 1997).

⁷³ See T.A.M. 96-45-002 (June 21, 1996) (“Thus, the stores must continually hire and train new employees to replace those that have resigned or have been terminated or promoted, and train the employees that have been promoted or transferred for their new positions.”).

⁷⁴ See Reg. § 1.6662-4(d)(3)(ii) (1996).

probable future benefit.”⁷⁵ The panel majority dubbed these “more-trouble-than-it’s-worth exceptions.”⁷⁶ Although the author of the *NCNB I* majority opinion probably intended a disparaging import to the “more trouble” description, the phrase hits the nail squarely on the head. It accurately captures the balancing process of weighing the burdens of capitalization/depreciation with the benefits of a more clear reflection of income resulting from that capitalization. The Court of Claims’ landmark pre-*INDOPCO* decision *Cincinnati, New Orleans & Texas Pacific Railway v. United States*⁷⁷ elucidates the proper role for such balancing test:

Where the burden on both taxpayers and 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 onus.⁷⁸

The Eighth Circuit implicitly endorsed such a balancing approach by ruling in a pre-*INDOPCO* opinion that “[w]here the prospective benefit is

⁷⁵ *NCNB I*, 651 F.2d at 961. The court further elaborated:

The Commissioner allows current deductions for some repair and educational expenditures which will benefit a taxpayer during subsequent tax years Finally, there is a residuum of current expenditures which will have some future benefit but which “cannot, as a practical matter, be associated with any other period” and allocation of which “either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.” These are also currently deductible. An example might be the salary of a high corporate officer whose time is not practically allocable between present operations and future projects.

Id. at 961-62 (quoting *Accounting Principles Board Statement No. 4*, §§ 155, 160 (American Inst. of Certified Pub. Accountants 1970)) (footnotes omitted).

⁷⁶ *NCNB I*, 651 F.2d at 953.

⁷⁷ 424 F.2d 563 (Ct. Cl. 1970).

⁷⁸ *Id.* at 572. The court found the distortion insignificant by comparing “both on a year-to-year basis and on a 17-year overall basis, the disallowed minimum rule expenses [i.e., current deduction of all items costing less than \$500] are fairly similar to the amount of depreciation that would have been allowed under the defendant’s [capitalization and depreciation] method.” *Id.* at 571-72. (Moreover, the after tax revenue would be even closer if the additional administrative costs of capitalizing and depreciating were taken into account). Professor Gunn pointed to the immediate deduction available for tools, professional books and equipment, and work uniforms, concluding that

[i]n none of these cases will a current deduction reflect income more clearly than would capitalization and depreciation, but the burden on the taxpayer of accounting for such costs through capitalization and depreciation would not justify the small increase in the accuracy of determining taxable income that would result from capitalization.

Gunn, *supra* note 53, at 456-57.

very slight, capitalization is not easily supported.”⁷⁹ Similarly, Judge Posner relied in the landmark, oft-cited *Encyclopaedia Britannica* on a balancing approach to rationalize the current deduction of steady-state recurring expenditures when “the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.”⁸⁰ While we understand from Glenn Carrington that revenue agents may attempt to distinguish such authorities as decided prior to *INDOPCO*, such a tack should not succeed in the courts. These authorities all rest on the flexibility of the clear reflection of income standard.

3. Administrative Convenience

The Service has never explicitly adopted a balancing approach to resolving expensing versus capitalization issues.⁸¹ From time to time, however, the Chief Counsel’s Office has recommended the adoption of one or another of the rough justice exceptions to capitalization under the rubric of “administrative convenience.”⁸²

⁷⁹ *Iowa-Des Moines Nat’l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979).

⁸⁰ *Encyclopaedia Britannica*, 685 F.2d at 215. Congress has approved of a balancing approach for exceptions to the uniform capitalization rules. See S. Rep. No. 99-313, at 142 (1986) (“The [section 263A] regulations may adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits.”); *id.* at 140 (permitting “appropriate exceptions where application of the rules might be unduly burdensome”). This approval provided the basis for Notice 88-62, sec. 3.02, 1988-1 C.B. 548.

⁸¹ Two recent rulings contain oblique indications that some in the Service may be starting to balance the benefits and burdens of capitalization/depreciation in assessing the desirability of a current deduction. See T.A.M. 96-38-002 (June 3, 1996) (citing *Iowa-Des Moines* for the proposition that expenditures to produce current income are deductible currently even though some incidental future benefit may result); T.A.M. 96-45-002 (June 21, 1996) (same proposition).

⁸² See, e.g., Rev. Proc. 90-63, 1990-2 C.B. 664, 665 (providing safe harbor amortization procedures for package design costs explicitly for “administrative convenience” to “minimize disputes”); Rev. Proc. 89-17, 1989-1 C.B. 827 (same); cf. G.C.M. 36,074 (Nov. 11, 1974) (“In view of the lack of any demonstrable legislative purpose or legal reason, we think it appropriate to consider questions of administrative convenience.”); see also *IRS Environmental Cleanup Guidance May be Out by July, Official Says*, Daily Tax Rep. (BNA), May 11, 1993, at G-8 (“Asked whether IRS believes it has regulatory authority to ‘arbitrarily’ require capitalization over a fixed period, such as five or [ten] years, [Associate Chief Counsel Glenn] Carrington responded, ‘It would be arbitrary, but we’ve done arbitrary—reasonably arbitrary—things in the past.’”). Commentators referred to Revenue Procedure 90-63 as “administrative grace.” Hal Gann & Roy Strowd, *INDOPCO—Time for the Second Shoe to Drop*, 69 Tax Notes 1045, 1047 (Nov. 20, 1995). Hopefully, the atypical situation involved recommendations grounded in administrative considerations but urging the Service to avoid a published ruling. See, e.g., G.C.M. 35,044 (Sept. 20, 1972) (accepting a position based on

Unlike the balancing test, the administrative convenience rationale focuses only on the excessive accounting burden necessary to achieve conceptual purity.⁸³

For example, General Counsel Memorandum (G.C.M.) 33,968, dealing with writers' prepublication costs, extensively discussed the concept of administrative convenience.⁸⁴ The G.C.M. pointed out that there was ample *legal* precedent for capitalizing prepublication costs because they yield future benefits in the form of a manuscript intended to produce royalties.⁸⁵ Nevertheless, it concluded that a published ruling should permit a deduction for these costs based on administrative considerations.⁸⁶

While there would thus appear to be a sound legal basis for requiring authors to capitalize all of their expenses, such a requirement gives rise to considerable practical difficulty Particularly where such an author works on several projects during a taxable year, . . . it would be most difficult for him to capitalize and allocate to particular projects all of his recurring-type costs, such as rent, supplies, and secretarial assistance. To make such an allocation with any degree of accuracy would in many cases require the use of a rather complex cost-accounting system, based on careful records of time spent on various projects. And in many cases the actual tax effect of recovering expenses through capitalization would be little different from

administrative considerations that allowed a federal employee to include a payroll check—dated January 1, 1971—in the employee's 1971 taxable income even though the employee deposited the check in 1970 but suggesting that a published ruling be avoided to prevent problems in defending this position).

⁸³ Cf. *Encyclopaedia Britannica*, 685 F.2d at 217 ("The administrative costs of conceptual rigor are too great.").

⁸⁴ See G.C.M. 33,968 (Nov. 18, 1968).

⁸⁵ See *id.* The G.C.M. noted that

[t]he principal published rulings . . . indicate a Service position to the effect that an author may never currently deduct expenses incurred in writing books, but must capitalize all expenses by allocating them to his basis in particular manuscripts. This position would appear to have a sound legal basis in section 263(a), since it can be said that expenses incurred by an author in writing a book are costs of improving the value of property, i.e., the manuscript, within the meaning of section 263(a).

Id.

⁸⁶ See *id.* ("The ruling to be published should make clear that the decision to permit current deduction of overhead-type expenses is based on administrative, rather than legal considerations, so that the Service will not be prejudiced in litigating cases . . . in which it is deemed appropriate to take a [legally based] position.").

recovering them through current deductions, since a professional author may be expected to have continuing income from his writing over the years, as well as continuing expenses of an overhead nature In view of the foregoing considerations, we believe the Service should adopt an administrative policy of permitting professional writers to deduct currently their expenses of a continuing nature, and we recommend publication of a ruling to state such a policy.⁸⁷

The Service never issued such a ruling. Instead, the Government lost in a refund suit where a professional writer asserted a current deduction for prepublication costs.⁸⁸

In addition to practical considerations, the Chief Counsel expressed some concerns about problems with litigation that might be avoided through administrative determinations. First, revenue rulings and procedures that permitted deductions based on administrative convenience could avoid the unpredictable results of litigation.⁸⁹ Courts were likely to reach inconsistent conclusions under the *Cohan* doctrine⁹⁰ which would require a court to estimate

⁸⁷ *Id.* (citation omitted); cf. G.C.M. 38,410 (June 18, 1980) ("While we believe our position [requiring capitalization for costs with future benefit] has substantial merit, we accept your [immediate deduction under a separate asset] approach . . . in view of the practical considerations involved, including the lack of sympathetic appeal of our position due to the total denial of deductions and the continued losses in the circuit courts."). Note the emphasis on an increased burden to the taxpayer and minimal increase in revenue to the Treasury.

⁸⁸ See *Stern v. United States*, 71-1 U.S.T.C. ¶ 9375 (C.D. Cal. 1971) (permitting a current deduction for a professional writer because the author is engaged in the trade or business of writing and is not attempting to create an asset). Revenue Ruling 73-395, 1973-2 C.B. 87, rejecting *Stern*, held that a publisher's prepublication costs incurred in creating, publishing and distributing textbooks and visual aids did not constitute research and developmental expenditures deductible under section 174 but instead should be capitalized under section 263 because part of the publisher's cost of producing and copyrighting a manuscript of a literary composition thus resulting in the creation of an asset having a useful life extending substantially beyond the close of the taxable year. This ignited a firestorm of criticism ultimately resulting in section 2119 of the Tax Reform Act of 1976, which directed the Service to administer sections 162, 174 and 263 as to publishers' prepublication expenditures without regard to Revenue Ruling 73-395 and "in the same manner as they were consistently applied by the taxpayers prior to the issuance of [such ruling]." See H.R. Rep. No. 94-658, at 338 (1975); *Certain Committee Amendments to H.R. 10612: Hearings before the Sen. Comm. on Fin. (Part 2)*, 94th Cong., 475-76 (1976) (statement of Townsend Hoopes, President, Association of American Publishers, Inc., representing the Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry).

⁸⁹ See G.C.M. 34,262 (Jan. 30, 1970), considering Rev. Rul. 74-456, 1974-2 C.B. 65.

⁹⁰ *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) (George Cohan was a famous Broadway director who claimed astronomical entertainment expenses.).

the useful life of a depreciable asset if it believed that the asset declined in value or became obsolescent.⁹¹ By adopting one administrative determination of a class useful life or classes of such lives, the inconsistent estimations resulting from litigation could be avoided. Alternatively, a *Cohan* approximation of *class* lives for depreciation of self-created intangibles would avoid the unadministrability of varying depreciation periods for employee training according to what surrogate assets the IRS or the taxpayer can use to approximate the life of the business, e.g., nuclear regulatory license, natural gas pumping license, plant building in which the trained workforce works.⁹² When Lee recited these authorities at the VTSG Spring 1997 Symposium, Ken Kempson observed that such a case-by-case approach to depreciation of self-created intangibles is unadministrable. Certainly the history of purchased intangibles in taxable corporate acquisitions prior to the enactment of section 197 so suggests.⁹³ Moreover, the more conceptually accurate approach would treat the workforce itself as a freestanding depreciable intangible, which compounds the administrative problems.

Second, the unpredictability of litigation might lead to excessive litigation.⁹⁴ Taxpayers believing that they might benefit from courts' short estimations of useful lives under *Cohan* may choose to

⁹¹ See *id.* at 543-44 (noting that once a taxpayer shows that some amount was spent, a court should fashion an estimation of the amount, otherwise "to allow nothing at all appears to us inconsistent with saying that something was spent").

⁹² See *Rough Justice*, *supra* note 16.

⁹³ General Accounting Office, *Report to the Joint Committee on Taxation: Tax Policy, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (Aug. 9, 1991), reprinted in *GAO Report on Tax Treatment of Intangible Assets is Available*, 91 Tax Notes Today 169-1 (Aug. 13, 1991) (LEXIS, FEDTAX lib., TNT file, elec. cit. 91 TNT 169-1); *Tax Treatment of Intangible Assets: Hearings before the House Comm. on Ways and Means*, 102d Cong., 48 (1991) (prepared statement of Commissioner Fred Goldberg) ("From a tax administrator's perspective, the present situation [as to amortization of purchased intangibles] is untenable because it embroils the government in endless factual inquiries that are made more difficult by unsettled case law. Some courts are sympathetic to arguments that certain intangible assets can be distinguished from goodwill and therefore can be amortized. These decisions are dependent on the facts of the particular case, and results may differ from court to court depending on the legal principles considered controlling. What this means in practical terms is that both taxpayers and the system suffer intolerable inequities, costs, and other burdens.").

⁹⁴ See G.C.M. 34,262 (Jan. 30, 1970), considering Rev. Rul. 74-456, 1974-2 C.B. 65.

litigate more often.⁹⁵ Or even worse as a matter of tax administration and horizontal equity, their advisers may feel more comfortable in "preparing" the return claiming a current deduction of such self-created intangibles without fully disclosing the issue. Nevertheless, the contradistinction between administrative convenience and conceptual purity may have encouraged the Commissioner to frequently ignore the Chief Counsel's recommendations of simple solutions to the tax treatment of expenditures benefiting present and future tax years.⁹⁶ Although administrative considerations certainly lie at the heart of tax policy, future solutions to the expensing/capitalization puzzle should not be couched in terms of "administrative convenience" given the historical lack of acceptance by the Service, as evidenced in never-implemented G.C.M.'s. These solutions should be articulated as rough justice or equitable solutions: easier to administer and fairer on average in lieu of more theoretically correct rules.⁹⁷ In particular when the theoretical standard is the clear reflection of income, rough justice rules implement a more practical and minimal distortion of income gloss.

B. *Rough Justice Rules*

For purposes of this article, the core idea of rough justice is the use of simple administrative rules that work well enough on average⁹⁸ in lieu of either detailed rules pursuing theoretical purity or case law uncertainty. The principal virtue of these rules is the reduction of administrative costs to the taxpayer, to the Service,⁹⁹

⁹⁵ See *id.*

⁹⁶ See *Rough Justice*, *supra* note 16.

⁹⁷ Former Commissioner Fred Goldberg was a leading proponent of a rough justice approach over more theoretically correct but administratively difficult approaches. See *Rough Justice*, *supra* note 16.

⁹⁸ The core concept of rough justice is the use of rules that entail simple application, eliminate expensive factual inquiry, and achieve rational or just results in *most* cases. For an extensive discussion of rough justice, see generally *id.* The ideas in the accompanying paragraph in text are distilled from *Rough Justice*, *supra* note 16.

⁹⁹ As a proponent of rough justice, Commissioner Goldberg was particularly concerned about the transaction costs to the Service/Treasury of establishing rules by litigation in the capitalization arena. See *id.*

or to both¹⁰⁰ while avoiding a distortion of income. Aside from reducing compliance and enforcement costs, rough justice connotes an approximation of the just result. In some cases, rough justice is a “second best” surrogate or proxy tax; however, it generally seeks to effect better rather than unjust results—fair on average for a class of taxpayers but not necessarily just as to each affected taxpayer. Jurisprudentially, rough justice may be viewed as equity versus rule (equity versus law in the Anglo-American lexicon) or as substance versus form—an age-old battle between the spirit and the letter of the law. Under this view, rough justice envisions equity overcoming the rule of law.

The Chief Counsel’s analyses of rough justice expensing/capitalization rules in several G.C.M.’s support the Commissioner’s use of these rules with the broad enforcement authority granted by the clear reflection of income standard. The clear reflection of income standard, embodied in section 446,¹⁰¹ goes to the heart of capitalization.¹⁰² Basically stated, income is clearly reflected when expenses are matched with related revenue. Expensing/capitalization rules that avoid a distortion of income, therefore, should come within the Commissioner’s authority to adopt those rules. For example, in General Counsel Memorandum 34,959, the Chief Counsel’s Office recommended a “minimum capitalization rule” as a practical guide to taxpayers with small items used in a trade or business.¹⁰³ This rule automatically would have expensed purchases under \$100 and permitted expensing of larger amounts benefiting future years if that method of accounting “is generally accepted by the accounting profession for that industry and

¹⁰⁰ See *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 5-6, 6 n.8.

¹⁰¹ I.R.C. § 446(b) (“[T]he computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”).

¹⁰² See *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283-84 (1967) (“[S]ections 263 and 446 are inextricably intertwined. A contrary view would encase the general provisions of section 263 with an inflexibility and sterility neither mandated to carry out the intent of Congress nor required for the effective discharge of [the Service’s] revenue-collecting responsibilities.”); accord *Cincinnati*, 424 F.2d at 569 (“This court agrees that the capitalization and depreciation provision[s] . . . and the method of accounting provision . . . are ‘inextricably intertwined’ and must be utilized in conjunction in deciding the ultimate success of the taxpayer’s method in clearly reflecting income.”).

¹⁰³ See G.C.M. 34,959 (July 25, 1972).

produces no distortion of income.”¹⁰⁴ The G.C.M. bottomed its recommendation of this rule on the clear reflection of income standard.

The scheme of the Internal Revenue Code of 1954 is to tax income in the year it should properly be taxed pursuant to appropriate accounting methods and standards. Thus, the accounting provisions (e.g., Code §§ 446 and 461) generally operate to override the more specific deduction or nondeduction provisions. A deductible item is to be deducted in the year paid or incurred unless a proper application of the accounting provisions requires or permits a different result.

Code §§ 446 and 461 provide the general authority to prohibit deductions in the year the expense item is paid or incurred if to allow the deduction in that year would not clearly reflect income. However, Code § 446 (b) and (c) provides the Commissioner with very broad authority to determine (1) whether a particular taxpayer's method clearly reflects income, and (2) whether particular methods of accounting generally may be used by various taxpayers even though such methods may deviate in certain respects from traditional tax accounting methods. Thus, while we believe those provisions provide authority for the Commissioner to prohibit deductions where such is necessary to prevent a distortion of taxable income, we also believe they provide authority for the Commissioner to permit certain deductions where a deduction is seemingly proscribed by a particular provision of the Code.

We recognize that by regulations and long-standing ruling practice the Service has definitely limited the Commissioner's discretion in this area. However, we are unaware of any such limits that would prevent the exercise of the discretion we now propose [W]e believe section 461 gives the Commissioner authority to direct the timing of deductions in a manner that will clearly reflect income. Although the exercise of this authority has generally been aimed at proscribing methods that fail to

¹⁰⁴ *Id.* This minimum capitalization rule resembled the minimum expensing rule approved in *Cincinnati* that enabled railroads to expense any expenditures under \$500 in accordance with the accounting system imposed by the Interstate Commerce Commission. *Cincinnati*, 424 F.2d at 572. Professor Gunn noted that the 1954 ALI Draft Code contained a \$500 minimum capitalization rule. See Gunn, *supra* note 53, at 457 n.61.

clearly reflect income, there is little doubt that it is broad enough to permit the recognition of additional methods that allow a clear reflection of income, even though such methods may appear to be a variance with a narrow interpretation of specific language of the Code.¹⁰⁵

The G.C.M. concluded that a "small item carve-out" was permitted under regulations that allowed expensing for both small items actually consumed and those not consumed but consistently expensed under the taxpayer's accounting method where the consistency avoided income distortion.¹⁰⁶ The use of rough justice rules, therefore, is authorized by the Commissioner's broad authority to avoid a material distortion of income.¹⁰⁷

At the VTSG Spring 1997 Symposium Ken Kempson pointed out that a recurring cost exception with a two or three year interval could be readily abused by high income taxpayers just as a timing mismatch of three years was attempted in *ACM Partnership v. Commissioner*.¹⁰⁸ Lee responded that the rough justice expensing

¹⁰⁵ G.C.M. 34,959 (July 25, 1972) (citation omitted).

¹⁰⁶ See *id.*

¹⁰⁷ See *id.* ("[These] provisions are recognition that there is no absolute rule that capital expenditures, in the strict traditional sense, must in all cases be capitalized. Rather the rule is that such expenditures may be currently deducted if such treatment does not materially distort income.").

¹⁰⁸ 73 T.C.M. (CCH) 2189 (1997). There the attempted transaction was as follows:

Three parties form a partnership to acquire a liquid fixed-income security that is not publicly traded. It may even be a security created just for this purpose by the investment bank; the point is that it is liquid and readily valued. The partners have shares of income and loss of 90 percent, 9 percent, and 1 percent, which match their initial capital contributions. The 90 percent partner is either not subject to U.S. tax liability, or may be a U.S. taxpayer that needs to replenish its net operating loss carryovers. The 9 percent partner is the one in need of tax losses. The third partner is the investment bank, there to keep the partnership going when the 90 percent partner leaves.

Shortly after its formation, the partnership sells the security in an installment sale; there may be no economic gain. The partnership receives most of the proceeds immediately, and the remainder, which is contingent, three years later. The contingent part of the price could be calculated according to a formula that factors in interest. In the second year, the 90 percent partner is redeemed out of the partnership for cash, presumably equal to the remainder of its capital account.

The key to this arrangement is temporary reg. section 15A.453-1(c)(3)(i). If property has been sold for a fixed-term installment obligation with a contingent total price, the regulation requires that the seller recover basis ratably over the term of the obligation. Temporary reg. section 15A.453-1(c)(3)(i) states that in a year when no payment is

of expenditures with future benefits entails simplified accounting methods generally denied to large taxpayers and, above all, to shelters. Our Submission in response to Notice 96-7¹⁰⁹ asserted that as a matter of tax policy rough justice rules based on considerations of simplicity from the taxpayer's perspective should be limited to small taxpayers.¹¹⁰ Under present law, examples of such limitations of simplified tax rules appear in the restriction of the cash method of accounting¹¹¹ and the treatment of farm preparatory and livestock raising costs for small taxpayers.¹¹² However, retaining complexity for tax shelters is desirable. Assistant Secretary of Treasury (Tax Policy) Buck Chapoton articulated in a 1984 House Ways and Means Committee Hearing on proposed tax accounting changes that complexity in tax rules dealing with complicated tax shelters was acceptable.¹¹³ There the

received or the amount of the payment is less than the basis allocated to that year, no loss will be allowed unless that particular year is the final payment year. If no loss is permitted, then the unrecovered basis allocated to that year is carried forward to the next year.

In the Merrill-designed partnerships, the literal application of temporary reg. section 15A.453-1(c)(3)(i) allows the partners to recognize a large artificial gain in the first year, 90 percent of which is allocated to the partner who will owe no tax on it. In the second and third years, the partnership recognizes large artificial losses, which will be allocated 90:10, respectively, to the two remaining partners, the original 90 percent partner having departed.

Lee A. Sheppard, *"Hero of the Day" is a Thankless Job*, 74 Tax Notes 1382, 1382-83 (Mar. 17, 1997).

¹⁰⁹ 1996-1 C.B. 359 (seeking comments on the need for guidance on capitalization principles, the desired approaches of such guidance, and any safe harbor amortization periods for certain expenditures). The final version of our Submission is being published as *Rough Justice*, *supra* note 16.

¹¹⁰ See *Rough Justice*, *supra* note 16. Professor Lee's work-in-progress, *"Still Chewing on That Old Rag?": Writer's Prepublication Expenses Revisited After INDOPCO and New Section 167(g)*, develops this thesis further.

¹¹¹ See I.R.C. § 448 (limiting the cash method of accounting to individuals and non-shelter entities with gross receipts averaged over a three-year period of less than five million dollars). The scope of current section 448 allowing *all* individuals to use the cash method is somewhat questionable on the basis of simplicity. Furthermore, permitting all personal service corporations to use it clearly indicates political pressure and an origin of tradition rather than simplicity.

¹¹² See I.R.C. § 263A(d) (permitting the deduction of direct and indirect costs of producing livestock or plants in cash basis farming businesses).

¹¹³ *Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms: Hearings before the House Comm. on Ways and Means*, 98th Cong., 32-33 (1984) (statement of John "Buck" Chapoton, Asst. Sec. (Tax Policy), Dep't of the Treasury) (stating that time value of money rules contain exceptions for "normal transactions and apply principally to large tax

complexity itself served as a transaction cost to retard tax shelter use. Additionally by limiting rough justice rules to small taxpayers, the retained complexity for large income individual and corporate taxpayers might be justified as increasing the progressivity of the effective tax rate on economic income, with regard to the high income individual taxpayers (directly or as shareholders), via higher compliance costs.¹¹⁴ This increased progressivity—in addition to achieving horizontal equity by treating airlines the same as other large corporate taxpayers with multi-period costs—is the best classic tax policy answer to House Ways and Means Chairman Bill Archer's rhetoric of a tax on airline safety.

Descending from the grove at Academe to the rocky agora of practicable tax ideas, administrative convenience from the Service's perspective may militate in favor of extending rough justice rules to large corporations as well as small businesses. Certainly this is the Commissioner's judgment call. (But even in that event, high income taxpayers should not be permitted to use such simplified accounting methods to offset unrelated income, i.e., shelter other income, as was attempted in *ACM Partnership*. Such a schedular income rule would not be that different from the old *Libson Shops* doctrine.)¹¹⁵ The General Accounting Office reports that the biggest section 162 issue on audit is capitalization versus expensing and that this single Code section generates the largest dollar amount in controversy for business taxpayers.¹¹⁶ Rough justice rules might serve to reduce or eliminate much of this controversy.

transactions, tax shelters, and otherwise, where very sophisticated planning is involved . . . I do not think we need to apologize when we complicate the Tax Code for very complicated transactions, and that is the intent here.”)

¹¹⁴ This assumes that corporate earnings are allocated to shareholders in the short-run and owners of capital in general in the long-run, both of whom in the case of individuals are mostly high income. See John W. Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process*, 8 Va. Tax Rev. 57, 102 n.178 (1988).

¹¹⁵ *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957) (restricting use of a net operating loss carryover after a statutory merger to the “same business” that generated the loss under a “continuity of business enterprise” test.)

¹¹⁶ General Accounting Office, *Tax Administration Recurring Issues in Tax Disputes Over Business Expense Deductions* (Sept. 27, 1995) (reporting that of 117 IRS Office of Appeals cases filed by large corporations, capital expenditure issues comprise 42% of the total number 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) (LEXIS, FEDTAX lib., TNT file, elec. cit. 95 TNT 189-39).

Unlike many other big corporation capitalization issues, however, four-year cyclical expenses seem to raise minimal administrative problems for the Service or the taxpayer. An Industry Specialization Program [hereinafter ISP] coordinated issue paper (rather than merely listing as a "significant issue")¹¹⁷ probably would pick up most, if not all, of the cases in the airline industry and, assuming Congress permits the establishment of capitalization boundaries through audit and litigation to continue, direct litigation costs would probably be minimal.¹¹⁸ In general, however, the Service might well follow the lead of courts that have extended rough justice rules to large taxpayers.¹¹⁹

¹¹⁷ The first step identifies a significant issue as widespread and complex. If a significant issue remains significant and becomes more widespread, the industry specialist is involved in the development of the significant issue into a coordinated issue paper. If the issue is coordinated, an Industry Specialization Program [hereinafter ISP] coordinated issue paper is written thus becoming the method by which the IRS examines the cases, procedures, processes and techniques used to audit the particular issues. *Deposition of IRS National Director of Corporate Examinations Addresses FSA and ISP Programs* (Nov. 29, 1994) 95 Tax Notes Today 67-84 (Apr. 6, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit. 95 TNT 67-84). John J. Monaco, Executive Director Coordinated Examination Programs, stated that "significant issues" differ from ISP "coordinated issues" in that only the latter are governed by precise mandatory guidelines; the former might develop into coordinated issues, but they might not. John J. Monaco, *Industry Specialization (ISP): Opportunities to Relieve Corporate Tax Burden* (Dec. 22, 1992), 92 Tax Notes Today 256-17 (Dec. 24, 1992) (LEXIS, FEDTAX lib., TNT file, elec. cit. 92 TNT 256-17).

¹¹⁸ Establishing tax rules through litigation is a risky and inefficient venture due to the plethora of fora and the tendency to establish an endless cycle of conflicting precedents. See *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 5-6. Before the Service embarks on litigating the tax treatment of cyclical airline repairs, however, it should consider the special hazards of litigation here. House Ways and Means Chairman Bill Archer's reported advice that the airline industry "may not be the most appropriate area in which the Internal Revenue Service should be seeking to expand . . . [INDOPCO]'s application," Sindhu G. Hirani, *Archer Urges IRS to Continue Deductions for Mandated Aircraft Safety Inspections*, Daily Tax Rep. (BNA), Sept. 26, 1996, at G-7 could well be sound even beyond the simple hint of a "limitation rider." Some court decisions reflect a tendency to distort doctrine to ameliorate the hardships of economically distressed taxpayers or, perhaps more narrowly in bankruptcy cases, to direct the few remaining assets to claims other than the Government's newly assessed tax claims. See, e.g., *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991). This tendency might be particularly relevant in challenging some financially distressed members of the airline industry.

¹¹⁹ Courts fashioning simplifying rough justice rules have usually done so for larger corporations—who else can afford to litigate these issues, particularly in refund suits? Cf. *NCNB Corp. v. United States*, 684 F.2d 285, 296 (4th Cir. 1982) (en banc) (Murnaghan, J., dissenting) (criticizing a rough justice deduction under the since discredited (no) separate asset doctrine for a large business' expansion costs because "[t]he taxpayer here, and others, preeminently banks, who will benefit from the decision of the *en banc* majority, can by no means merit description as 'economically deprived.' The benefit heaped upon them further

The rough justice exceptions to future benefit capitalization provide immediate expensing for several categories: (1) costs with de minimis (insubstantial) or short-lived benefit, (2) costs recurring in a steady state, (3) costs with temporally limited benefit, but lacking a depreciation deduction if capitalized, and (4) costs when the burdens of capitalization/depreciation outweigh the benefit of a more clear reflection of income. Although the rationale of the last category underlies the other three, it supports an independent category for those costs that can not come under the other three categories, but where the capitalization of these costs is still more-trouble-than-it's-worth. Each of these rules are explored briefly below and in greater detail in *Rough Justice*.¹²⁰

1. De Minimis or Short-Lived Benefit

Achieving rough justice under a minimum distortion of income standard requires an exception from strict capitalization requirements for items of relatively small cost and for items with short-lived benefits. Items of insubstantial cost present no realistic threat of a material distortion of income if they are expensed immediately despite the presence of future benefit. The courts¹²¹ and Chief Counsel's Office¹²² have approved the use of minimum capitalization rules that permit taxpayers to deduct any expenditures falling below a certain dollar threshold.¹²³ The problem with this de minimis exception is determining what amounts are insubstantial for a particular taxpayer for a particular tax year.¹²⁴ At the VTSG Spring 1997 Symposium Ken Kempson suggested that the section 179 election to expense a set annual amount (\$17,500 to increase gradually to \$25,000) could serve as a model for an annual maximum deductible amount. We agree and discuss the exceptions to future benefit capitalization as small business provisions in *Rough Justice*.

contributes to the deserved description of our income tax system as a disgrace.").

¹²⁰ See generally *Rough Justice*, *supra* note 16.

¹²¹ See *Cincinnati*, 424 F.2d 563.

¹²² See G.C.M. 34,959 (July 25, 1972).

¹²³ See *supra* notes 103-07 and accompanying text.

¹²⁴ Compare *Cincinnati*, 424 F.2d at 563 (finding \$500 insubstantial), with *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 234 (1985) (finding \$15,545 insubstantial).

Expenditures with short-lived benefits require expensing in order to match the expenditure with the current income it produces. Generally, these expenditures are deducted immediately because any future benefit is considered insubstantial in relation to current income.¹²⁵ As with de minimis expenditures, the burden of capitalizing and then amortizing items with short-lived benefit outweighs the benefit of less income distortion that might be possible under the capitalization method.¹²⁶

2. Steady State Recurring Costs

Current deductions for steady state recurring costs tend to produce the same result on average that could be obtained by capitalizing and depreciating these costs over their useful lives. Steady state—fairly constant—costs that recur on a regular basis will produce technical mismatching with the income they generate when deducted currently; however, only minimal income distortion occurs. Viewing each expenditure individually, they should be deducted because a recurring expenditure typifies an ordinary business expense under section 162 whereas capital expenditures generally are extraordinary and non-recurring.¹²⁷ Furthermore,

¹²⁵ See, e.g., *Sun Microsystems*, 66 T.C.M. (CCH) at 1005 (permitting a current deduction for stock warrants issued to a major customer to induce the purchase of workstations because the benefit from long-term customer relationship was incidental in comparison to the immediate benefit of the sale); Rev. Rul. 92-80, 1992-2 C.B. 57 (allowing immediate deductions for most advertising costs despite their potential to generate future sales); Reg. § 1.162-6 (1958) ("Amounts currently paid or accrued for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted.").

¹²⁶ See *Sharon v. Commissioner*, 66 T.C. 515, 527 (1976) (suggesting that a deduction of a \$25 licensing fee might be deductible), *aff'd*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979); *Southland Royalty Co. v. U.S.*, 582 F.2d 604, 618 (Ct. Cl. 1978) (useful life of petroleum reserves survey subject to change at any time (due to effect of any nearby petroleum pumping), which has to be updated every few years to take account of subsequent developments. "In those circumstances, it is not compulsory to amortize such a recurring item over a fixed time-interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort Southland's income.").

¹²⁷ See *Encyclopaedia Britannica*, 685 F.2d at 217 (using the recurring and non-recurring nature as "a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be"); *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614, 619 (7th Cir. 1995) (noting that selling expenses occur continuously to justify an immediate deduction); *Davee v. United States*, 444 F.2d 557, 567 (Ct. Cl. 1971) (distinguishing start-up costs by their non-recurring nature from ordinary expenses that recur regularly); T.A.M. 96-38-002 (June 3, 1996) (finding the recurring nature

considering the aggregate of the recurring expenditures, annual current deductions will approximate the total depreciation that otherwise would be taken in each benefited year.¹²⁸

The inherent difficulty with this approach is defining how often the expenditures must recur to qualify for an immediate deduction. On an individual basis, substantial authority supports expensing costs recurring every one to three years—the classic example is repainting a structure every three years.¹²⁹ The Ninth Circuit reasoned in *Moss v. Commissioner*¹³⁰ that since costs of repainting hotel rooms every three to five years would be currently deductible, doubling up maintenance to paint two-thirds of the rooms in one year to catch up on deferred maintenance was deductible as a “minor variation” in the pattern of annual maintenance. Conversely, costs recurring every five to ten years certainly seem

an important factor to consider in assessing capitalization); P.L.R. 92-36-021 (June 8, 1992) (permitting current deductions for recurring short week benefits paid to laid-off employees).

¹²⁸ See *Encyclopaedia Britannica*, 685 F.2d at 217; T.A.M. 96-38-002 (June 3, 1996); *Cincinnati*, 424 F.2d at 571-72 (“compared with total operating expenses, total depreciation deductions claimed, or the total net income . . . , the differences between depreciation the deductions computed . . . [under an expensing of \$500 dollars or less and under capitalizing and then depreciating such items] are so minute as to become unfathomable”); T.A.M. 96-45-002 (June 21, 1996); *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 18-20. In addition to the costs remaining in a steady state, the income or benefit of these costs must also recur regularly. See *Black Hills Corp. v. Commissioner*, 73 F.3d 799 (8th Cir. 1996) (denying current deductions for steady state insurance premiums paid in anticipation of employees’ black lung disease claims because the premiums were building up a reserve to meet a substantial future liability when the mine closed and the no longer employed miners then filed black lung claims).

¹²⁹ See, e.g., *Estate of Wilbur v. Commissioner*, 43 T.C. 322, 327 n.6 (1964) (distinguishing final coat of paint in construction from currently deductible repainting, which usually recurs no more frequently than every three years). Although the Service has required capitalization of dredging costs incurred every three years in Revenue Ruling 68-483, 1968-2 C.B. 91, some in Chief Counsel only lukewarmly concurred and seemed to prefer an immediate deduction. See G.C.M. 34,102 (Apr. 17, 1969).

[W]e fully realize that characterization of expenditures incurred in a silting removal operation as either “expense” or a “capital improvement” is not free from doubt. Of course we still feel that an expense characterization is the only proper classification where complete dredging is accomplished on an annual basis. However, classification becomes suspect where silt is removed every three years . . . or one-third of the operation is accomplished every year In either case, whether the removal of silt accumulated during the prior three years benefits the current year or benefits the succeeding three years conjures visions in legalistic semantics and often as not the barnyard may wear an entirely different hue when interpretative chickens come home to roost. In either event both sides of the coin have merit.

Id.

¹³⁰ 831 F.2d 833 (9th Cir. 1987).

under *Wolfsen Land & Cattle* to require capitalization.¹³¹ These generalities leave a gray area¹³² for cyclical costs incurred between three and five years, such as airline maintenance costs incurred every four years. The ultimate dividing line will take time to develop. Amortization safe harbors would be much more administrable. Notice 88-62¹³³ providing safe harbor "amortization" of writer's prepublication costs at 50% / 25% / 25% over three years is a useful model in general for amortization or depreciation of irregularly recurring expenditures with substantial future benefits.

Aggregating all of a taxpayer's related costs on a year-by-year basis may indicate that the costs recur annually. For example, even though a taxpayer may repaint individual structures every three years, when that taxpayer repaints a structure each year the aggregate repainting costs recur annually. In most cases, the annual costs will be roughly in a steady state and some variation in amount should not preclude a current deduction.¹³⁴ Instead, the current deductions will properly reflect income on a basis commensurate with capitalization/depreciation¹³⁵ without creating unnecessary burdens to account for each expenditure individually.¹³⁶

¹³¹ See *Wolfsen Land & Cattle*, 72 T.C. 1 (capitalizing the costs to repair drainage gates every five years and dredging costs incurred every ten years; depreciation as a freestanding intangible was then allowed over the recurrence interval). Beginning with the 1954 Code, a congressional pattern has developed for providing a sixty-month amortization period for self-created intangible assets where case law did not readily provide a deduction or depreciation, such as formation costs, see I.R.C. §§ 248, 709, and start-up costs. See I.R.C. § 195. Purchased intangibles received a much longer amortization period of fifteen years due to pay-go revenue neutrality constraints. See *id.* at § 197.

¹³² See *Official Gives Update on Series of Guidance on Tax Accounting Issues*, Daily Tax Rep. (BNA), Mar. 11, 1993, at G2-G3 ("As *Wolfsen* pointed out, if [done] . . . every year, it would have been deductible. But if you've waited four or five years, it's not. I gotta draw the line. I've got to say, 'If you do it every second year, you're fine. If you wait six years, it's not.'") (quoting Assistant Chief Counsel Glenn Carrington).

¹³³ 1988-1 C.B. 548.

¹³⁴ See *Moss*, 831 F.2d at 842 (holding that minor variations in expenditure patterns should not drastically alter the tax consequences); T.A.M. 81-36-001 (Feb. 27, 1980) (finding recurring costs when there are no "disproportionate changes"). But see T.A.M. 74-01-31-140A (Jan. 31, 1974) (holding that sharp decreases indicate a non-recurring nature).

¹³⁵ See *Encyclopaedia Britannica*, 685 F.2d at 215 ("[E]xpenses and receipts will be systematically mismatched—but the same on average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.").

¹³⁶ Cf. *Cincinnati*, 424 F.2d at 572 (considering a current deduction when the burden from

3. Costs With Temporally Limited Benefit When Depreciation Remains Unavailable

When a taxpayer's only options are a current deduction or capitalization without amortization for expenditures with temporally limited benefits, a current deduction is preferable because it creates less income distortion than capitalization without depreciation. To assess the success of a method of accounting, the analysis must first recognize that capitalization, depreciation, and clear reflection of income are "inextricably intertwined."¹³⁷ Income distortion, therefore, occurs when capitalized costs cannot be amortized to effectively match the expense with the associated income. Income distortion also occurs when the costs are deducted immediately but they provide benefits beyond the current period. Given the choice between these two methods, a current deduction is better because it produces less income distortion by at least matching some of the expense with the revenue produced in the current period—permanent capitalization never matches any expense with revenue.¹³⁸ Both the courts¹³⁹ and the Service¹⁴⁰ have allowed current deductions for this reason when faced with this narrow choice.

capitalization "to account for each item of property *separately* is great") (emphasis added).

¹³⁷ *Id.* at 569 (quoting *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283-84 (1967)).

¹³⁸ See *Gunn*, *supra* note 53, at 492 ("In the absence of a feasible method of amortizing costs . . . a current deduction may be preferable to capitalization as a method of clearly reflecting income.").

¹³⁹ See, e.g., *Southland Royalty Co.*, 582 F.2d at 618 ("In those circumstances, it is not compulsory to amortize such a recurring item over a fixed time-interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort Southland's income."). This rationale undoubtedly led courts to adopt the separate saleable asset rule that permitted an immediate deduction when no separate, transferable asset was created by an expenditure. See *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 51-57. By adopting this rule, courts could avoid the harsh result of capitalizing non-amortizable expansion costs by claiming that no identifiable asset was present. See *supra* note 53, at 51-57; 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.").

¹⁴⁰ See, e.g., Rev. Rul. 94-38, 1994-1 C.B. 35 (reversing a T.A.M. requiring the capitalization of soil remediation costs, in part on the rationale that "since the land is not subject to an allowance for depreciation, amortization, or depletion, the amounts expended to restore the land to its original condition are not subject to capitalization").

Unfortunately, this all-or-nothing dichotomy ignores the more desirable option of capitalizing the costs as a freestanding asset and amortizing that asset over its useful life.¹⁴¹ Instead of settling for one of the two options that distort income, several courts have pursued this alternative concept that once again attempts to match expenses with related income.¹⁴² For example, in *Wolfsen Land & Cattle*,¹⁴³ Judge Sterrett capitalized the costs incurred to maintain a drainage system as a freestanding asset depreciable over the ten-year period until the next anticipated maintenance operation (where the repair cycle was five years, the court adopted a five-year amortization period).¹⁴⁴ This approach relieved the pressure to currently deduct a substantial expenditure or to capitalize the costs to the land, a non-depreciable asset. The focus, therefore, should remain on how the costs can be treated to avoid income distortion without placing undue emphasis on capitalizing the costs to a particular asset.¹⁴⁵

4. *More-Trouble-Than-It's-Worth*

The final rough justice rule encompasses any situation where the burdens of pursuing capitalization outweigh any potential benefit obtained from this method's more clear reflection of income. Although intertwined throughout the previous three rough justice rules, this notion justifies a current deduction for any expenditures that do not fall within the specific limits outlined above, but where

¹⁴¹ See *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 32-38; *Gunn*, *supra* note 53, at 445-46.

¹⁴² See, e.g., *NCNB I*, 651 F.2d at 954-55, 962-63.

¹⁴³ 72 T.C. 1.

¹⁴⁴ See *id.* at 13.

¹⁴⁵ For example, in reconsidering a T.A.M. that required the capitalization of soil remediation costs, see T.A.M. 93-15-004 (Dec. 17, 1992), the Service concluded that a current deduction was preferable to capitalizing the costs to the non-depreciable land. See Rev. Rul. 94-38, 1994-1 C.B. 35. Unfortunately, this approach focused too heavily on the land without considering the costs as a freestanding depreciable asset. See Juliann Avakian-Martin & Marlis Carson, *Environmental Cleanup Issue: A Repeating Theme at ABA Meeting*, 60 Tax Notes 925, 927 (Aug. 16, 1993) ("[I]f the costs . . . in that T.A.M. should be capitalized, they should be capitalized to the land. The IRS was trying to be 'nice' in reaching the conclusion that costs were not capitalized . . . yet the IRS still was criticized.") (quoting Treasury official Robert Kilinskis).

"the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization."¹⁴⁶

The benefits of capitalization may be analyzed on several levels. First, by its ability to match expenses with related revenue, capitalization may obtain a more accurate reflection of income than other accounting methods. Second, by treating alike all costs benefiting several tax years, capitalization satisfies the goal of horizontal equity. This effectively assures that the tax system remains neutral and encourages economic efficiency by avoiding a taxpayer preference for immediately deductible items over similar items that require capitalization—Judge Richard Posner's good point in *Fishman v. Commissioner*.¹⁴⁷ Third, capitalization might yield more revenue to the Treasury than expensing. Following the tax policy of adequacy of revenues, capitalization must be a preferred method of accounting if expensing threatens to significantly decrease tax revenues.¹⁴⁸ For a given expenditure, the *dollar amount* of tax deductions would remain the same under both capitalization with depreciation and expensing. The immediate deduction from expensing, however, would decrease tax revenues in present value terms in comparison to the spreading of the deductions over a period of years.

Similarly, the burdens of capitalization can be analyzed on several levels. First, considering only the taxpayers, administrative burdens are at their greatest for small taxpayers for whom record keeping is difficult. Many small taxpayers lack the ability to track their expenditures and accurately depreciate the capitalized amounts over their useful lives. Second, considering both the Service and the taxpayers, the administrative burdens increase when frequent disputes arise during audits and litigation. For example, if litigation typically is required to resolve disputes over useful life estimations, then the costs of capitalization

¹⁴⁶ *Encyclopaedia Britannica*, 685 F.2d at 215.

¹⁴⁷ 837 F.2d 309, 312 (7th Cir. 1988).

¹⁴⁸ See Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567, 569-72 (1965); Edward Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 Fordham L. Rev. 1255, 1263 (1985) ("In its narrower sense, the adequacy criterion refers to the aggregate revenue effect If a proposed change in the Internal Revenue Code will result in a significant loss in revenues, the criterion is badly served. If the proposal will generate additional revenues, the criterion is satisfied.") (footnotes omitted).

increase. Minimizing these administrative burdens would help to satisfy the tax policy of simplicity in the tax system.¹⁴⁹ In the ultimate assessment of whether capitalization is more-trouble-than-it's-worth, the revenue benefits must exceed the increase in administrative burdens.

Together, these four rough justice rules provide effective means for discerning the exceptions to the otherwise harsh rule of future benefit requires capitalization. Their application avoids a material distortion of income and supplies a degree of fairness to the system with simple rules that produce the "right" result on average. In sacrificing theoretical purity, these rules allow taxpayers—particularly small taxpayers—to clearly reflect income without incurring any undue burdens.

C. *Structured Discretionary Justice Regulations*

As developed more thoroughly in *Rough Justice*,¹⁵⁰ these rough justice rules should be incorporated into structured discretionary justice regulations. Administrative guidance normally consists of general standards, detailed rules, examples and conclusions, or some combination of these features. General standards set forth the principle or policy of the substantive law—such as the clear reflection of income standard in taxation—that enables a decisionmaker to assess whether the facts of a particular situation merit the desired treatment, i.e., discretionary justice.¹⁵¹ Conversely, rules are definitional and can generate precise and predictable answers.¹⁵² These two approaches are not mutually exclusive; often "safe harbor" rules are combined with a facts-and-circumstances test subjected to the underlying standard. This combination format provides certainty in the safe harbor for anyone

¹⁴⁹ See Sneed, *supra* note 148, at 572-74 (describing this goal as "practicality"); Yorio, *supra* note 148, at 1256-57 ("Like the [taxpayers'] costs of compliance and planning, the government's expense in administering the law produces no efficiency gains: What the government gains from a successful audit or lawsuit, the taxpayer loses.").

¹⁵⁰ See generally *Rough Justice*, *supra* note 16 (exploring this notion more thoroughly in response to the IRS request for comments on the need and nature of guidance for capitalization issues).

¹⁵¹ See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 Harv. L. Rev. 1685, 1688 (1976).

¹⁵² See *id.* at 1687-88.

who can read the Code and “an area for those who want to venture into it where, if you really understand the cases, you can advise your client intelligently.”¹⁵³ Such a combination of safe harbor and fact-and-circumstances permits too much abuse by generally high income taxpayers, however, and is now disfavored.¹⁵⁴ The better combination is to provide rules for implementing the standard and directions for applying such rules. Expanding on Professor Daniel Shaviro’s illustration of rules and standards with speed limits,¹⁵⁵ (1) a rule would be, “do not exceed 65 miles per hour”; (2) a standard would be, “do not exceed a safe speed under the circumstances”; and (3) structured discretionary justice would additionally provide factors to use in determining safe speed, e.g., (a) time of day or night or dusk; (b) weather conditions; (c) condition of highway; (d) condition of car; (d) skill/training of driver; (e) distractions—radio, eating, cellular phone; and (f) prior accident or speeding records, and how to weigh and apply combinations of these factors.

Ideally, the evolution of regulations incorporating structured discretionary justice progresses from: first, considering one fact pattern at a time without announcing generalized principles; second, fashioning the generalized principle or standard based on this prior experience; and third, formulating regulations that incorporate the generalized standard and implementing balancing rules, consistent with that standard, for achieving some certainty and structured discretionary justice.¹⁵⁶

In the capitalization area, the doctrine is sufficiently evolved to promulgate structured discretionary justice regulations. These regulations should set forth the general principle of a minimum distortion of income through the timing of deductions. In addition, they should contain a presumption of capitalization when the expenditure provides future benefit along with the rough justice

¹⁵³ *Income Tax Revisions: Panel Discussions Before the House Comm. on Ways and Means*, 86th Cong., 883 (1959) (colloquy between Chairman Wilbur Mills, D-Ark., and Hugh Calkins, Esq.).

¹⁵⁴ *Cf. Business Plan 1992*, reprinted in *Treasury-IRS Business Plan*, 92 Tax Notes Today 104-50 (May 18, 1992) (LEXIS, FEDTAX lib., TNT file, elec. cit. 92 TNT 104-50).

¹⁵⁵ Daniel N. Shaviro, *Compliance and Enforcement under the Passive Loss Regulations*, 4 Tax Mgmt. Real Est. J. 107 (May 1988); accord, Lee A. Sheppard, *Kohl Discusses Forthcoming Guidance, Anti-Abuse Rules*, 73 Tax Notes 399 (Oct. 28, 1996) (Kohl uses similar speed limit metaphor).

¹⁵⁶ See Davis, *supra* note 35, at 60.

exceptions for de minimis or short-lived benefits and recurring expenditures. Furthermore, a safe harbor amortization period should be provided for taxpayers with expenditures of temporally limited benefit when amortization otherwise is unavailable. Reasonable approximations of the expenditures' useful lives would provide necessary relief from the otherwise harsh treatment of permanent capitalization. Thus, the regulations would provide safe harbors based on prior ruling and case law experience. In addition, they would supply the general principle behind capitalization for discretionary determinations of facts that fall outside the safe harbor provisions.

III. CYCLICAL AIRCRAFT MAINTENANCE COSTS

A. *Conclusions of the Aircraft Maintenance T.A.M.*

The airline in the T.A.M. currently deducted the costs of major engine inspections and complete overhauls performed approximately every four years on its aircraft fleet used in its passenger and freight transport business.¹⁵⁷ Each major inspection cost between \$90,000 and \$122,000, equivalent to 1/10 the cost of a new engine and 1/100 the cost of a new aircraft.¹⁵⁸ A properly serviced engine had an estimated service life in excess of twenty-two years.¹⁵⁹

The T.A.M. required the airline to capitalize these inspection costs and depreciate them as seven-year recovery property.¹⁶⁰ Chief Counsel commenced its analysis with the conceptually sound notion of using capitalization to achieve a more accurate calculation of net income by matching expenses with related income.¹⁶¹ Acknowledging that the demarcations between current expenses and capital expenditures are those of degree and not kind, the T.A.M. rested on the *INDOPCO* precept that the duration and extent of any future benefits are important considerations in

¹⁵⁷ See T.A.M. 96-18-004 (Jan. 23, 1996).

¹⁵⁸ See *id.*

¹⁵⁹ See *id.*

¹⁶⁰ See *id.*

¹⁶¹ See *id.*

determining the appropriateness of expense or capitalization treatment.¹⁶² The T.A.M. concluded that the costs of major engine inspections were capital expenditures because they

result in substantial improvements to the overall condition of the engine that are not merely incidental and . . . have the effect of adding materially to the then value of the engine while at the same time prolonging the engine's useful life. Furthermore, these expenditures generate significant future benefits to [the airline], not the least of which is the fact that without them, the FAA would not permit [the airline] to continue to operate its aircraft. Finally, in the case of engines owned by [the airline], the major inspection costs restore exhaustion for which an allowance has been made.¹⁶³

Once capitalized, the costs were recoverable through depreciation over the recovery period of the aircraft.¹⁶⁴

Ken Kempson, former aide to Chief Counsel Brown, explained at the VTSG Spring 1997 Symposium that in fact T.A.M.'s are quite taxpayer specific due (a) to the facts of the particular taxpayer's case, and (b), often more importantly, to the presentation to the Service of those facts. Ken first illustrated this concept with the example of the well-publicized Danaher Corp./Just-in-Time T.A.M.¹⁶⁵ That T.A.M. turned on the taxpayer's internal communications lauding the retraining and restructuring as a new

¹⁶² See *id.* Unfortunately, this precept seems to lead agents to presume capitalization whenever an expenditure is expected to produce future benefits, whether "substantial" or "incidental." In part this is because, as yet, "incidental" is more of a conclusion than a test.

¹⁶³ *Id.* The taxpayer argued that the expenditures "merely restored the aircraft to the operating condition that was required by the FAA," *id.*, to come within the before-the-need vs. after-the-repair test of *Plainfield-Union Water Co. v. Commissioner*. 39 T.C. 333 (1962). That case used a before-the-condition and after-the-repair comparison of property values to determine if the expenditure constituted an incidental repair. See *id.* at 338 ("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."). The T.A.M. rejected this contention for a number of reasons, the most significant being the ability to distinguish the aircraft maintenance from the sudden casualty-like occurrence of the condition necessitating a repair in *Plainfield-Union*. See T.A.M. 96-18-004 (Jan. 23, 1996).

¹⁶⁴ See T.A.M. 96-18-004 (Jan. 23, 1996).

¹⁶⁵ T.A.M. 95-44-001 (July 21, 1995). See Matthew A. Melone, *The Information Revolution: Organizational Knowledge and the Capital Expenditure Question*, 50 Tax Law. 73, 87-88 (1996).

way of doing business. The taxpayer's counsel initially thought that current deductibility of such costs was self-evident and easily defensible. Only after the adverse T.A.M. did the taxpayer more carefully marshal its facts. Then it reportedly settled the case quite favorably.¹⁶⁶ Expressly based upon communications with taxpayer counsel and other non-governmental sources and not upon any knowledge from his stint with Chief Counsel, Ken suggested that such might be the case as well with the cyclical aircraft engine safety inspections. He pointed out that in many cases the actual replacement of parts is a minor part of the inspection costs. Most of the costs could involve taking the engine out of the aircraft, replacing it with a rotatable engine, and then taking apart and putting back together the engine first taken out. Thus on the specific facts presented by another taxpayer, the T.A.M.'s conclusion of material increase in value through replacement of parts might not be readily replicated.

Ken offered at the VTSG meeting the above analysis as a possible explanation of Chief Counsel Brown's written statement to Chairman Archer that the cyclical aircraft engine safety inspection T.A.M. was taxpayer specific and not a precedent. Whether revenue agents rely upon the safety inspection T.A.M. itself is a red herring. More importantly such inspections are included on the "significant issues list," thus advising agents to question their tax treatment.¹⁶⁷ Unlike an Industry Specialization Paper, however, the agent's resolution of the issue is not dictated by the National

¹⁶⁶ *Business Expenses, NAM Asks IRS to Reconsider Ruling on Just-In-Time Manufacturing Techniques*, Daily Tax Report (BNA), Jan. 25, 1996, at G-6; McCormally, *supra* note 72, at 798 ("following the issuance of the T.A.M. a settlement was negotiated in the case that was almost wholly satisfactory to the taxpayer: not only were the just-in-time manufacturing training expenditures involved in the case determined to be currently deductible (or amortizable over a relatively short time frame), but it was agreed that the taxpayer's ongoing expenditures for training could be currently deducted as ordinary and necessary business expenses"); Laura Saunders, *How to fight the IRS*, Forbes, Jan. 22, 1996, at 64 (compromise was to amortize \$9 million training costs over five years instead of eight); 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 ("The company sought to deduct four kinds of expenses associated with just-in-time manufacturing: reconfiguring the plant physically, buying materials and supplies used in the process, training workers and hiring consultants. Drawing on Danaher's assessment that just-in-time manufacturing is a 'radical redesign, a fundamental change in the business processes' at factories and that it provides long-term benefits to Danaher, the agency concluded that all the costs must be capitalized.").

¹⁶⁷ See *supra* note 19.

Office.¹⁶⁸ This article advises that if the Service concludes that four-year amortization as a freestanding intangible is the proper tax treatment, such conclusion be stated in an ISP or better-published ruling pending consideration in a negotiated regulation process.

B. Public Choice Theory and Interpretation: Congressionally Sanctioned Subsidy?

Chairman Archer's criticism of the cyclical aircraft maintenance costs T.A.M. based on the increase in the effective rate of taxation for airlines apparently flows from his opposition to *any* tax increase.¹⁶⁹ His opposition follows the tax policy factor of economic growth.¹⁷⁰ "The criterion of economic growth insists . . . that rates of marginal taxation not be confiscatory. Otherwise, significant numbers of taxpayers may lose their incentive to work and to take entrepreneurial risks."¹⁷¹ For airlines, the case has not been made that a decrease in their net after-tax income would decrease their growth. The growth potential depends primarily on the intended use of this income: plant and equipment investment, rank-and-file compensation, debt reduction, dividend payment or top executive incentives.¹⁷² In particular, any effective increase in taxation will not discourage compliance with FAA safety standards; similarly, tax favored treatment would not encourage compliance. For the airline industry will meet FAA requirements regardless of the tax laws. Any tax preference for airlines—providing a deduction even

¹⁶⁸ See *supra* note 117.

¹⁶⁹ See generally *supra* note 23.

¹⁷⁰ See Sneed, *supra* note 148, at 586-90; see *supra* note 12.

¹⁷¹ Yorio, *supra* note 148, at 1262.

¹⁷² It seems likely that income is more likely to be spent on executive compensation than increased safety measures. Consider the record of corporate downsizing coupled with soaring executive pay and increasing income disparity. See, e.g., Steven Pearlstein, *Reshaped Economy Exacts Tough Toll; Competition, Efficiency Grow—as Does Americans' Income Disparity*, Wash. Post, Nov. 12, 1995, at A1; Judith H. Dobrzynski, *New Road to Riches is Paved with Options*, N.Y. Times, Mar. 30, 1997, at 3-1 (noting that while average worker got a "meager 3.3 percent raise in 1996," top executives again enjoyed double-digit raises often approaching 20 percent due to stock options although corporate profits increased only 11 percent); Roger Lowenstein, *On the Difficulty of Hiring Good Help*, Wall St. J., Mar. 27, 1997, at C1; Michael J. McCarthy, *Thanks a Lot: CEO Gets \$102 Million Bonus*, Wall St. J., Mar. 27, 1997, at B-1.

when general expense/capitalization rules require capitalization—would provide a subsidy to do what they would do anyway rather than an incentive to do what they otherwise would not do. If an intended subsidy exists, it must be derived from the general tax laws because the statutes do not provide an explicit subsidy.

Classic public choice theory views some legislation as a private contract between legislators bent on reelection and private interest or pressure groups.¹⁷³ “Public choice [is] the economic study of

¹⁷³ See Frederick R. Anderson, *Revisiting the Constitutional Status of the Administrative Agencies*, 36 Am. U. L. Rev. 277, 284 (1987) (explaining that the “democratic process ideal presumes the value of interest group competition and representation in the political process”); Neil Duxbury, *Faith in Reason: The Process Tradition in American Jurisprudence*, 15 Cardozo L. Rev. 601, 645-48 (1993) (discussing the interaction of interest groups and government); Ernest Gellhorn, *Public Participation in Administrative Proceedings*, 81 Yale L.J. 359, 377 (1972) (explaining how public interest groups have “drawn agency attention to new techniques for fulfilling their mandate”); Mark R. Killenbeck, *A Matter of Mere Approval? The Role of the President in the Creation of Legislative History*, 48 Ark. L. Rev. 239, 248 (1995) (discussing the impact of a lawyer-lobbyist on legislative history); Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 Colum. L. Rev. 223, 224 (1986) (explaining the “so-called interest group . . . theory of legislation” which contends that “market forces provide strong incentives for politicians to enact laws that serve private rather than public interests, and hence statutes are supplied by lawmakers to the political groups or coalitions that outbid competing groups”); Richard A. Posner, *Legal Formalism, Legal Realism, and the Interpretation of Statutes and the Constitution*, 37 Case W. Res. L. Rev. 179, 193 (1986) (stressing the impact of special interest groups in shaping legislation); Daniel B. Rodriguez, *The Substance of the New Legal Process*, 77 Cal. L. Rev. 919, 921-22 (1989) (book review) (discussing the view of the “legislative process as a continuous series of bargains among competing interest groups”); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 Am. J. Tax Pol’y 221, 248-49 (1995) (pointing to the impact of special interest groups on the distribution of wealth); David A. Strauss, *Presidential Interpretation of the Constitution*, 15 Cardozo L. Rev. 113, 126 n.24 (1993) (describing the “pluralist model of democracy” as a system “under which optimal outcomes are thought to be produced by the competition among interest groups”); John Vitha, Comment, *Allegheny Pittsburgh Coal Co. v. County Commission of Webster County, West Virginia: The Supreme Court Gives “Welcome Stranger” Tax Assessments a Cold Reception*, 56 Brook. L. Rev. 1383, 1407 (1991) (discussing judicial review of laws enacted by constitutional referendum or supported by grassroots organizations); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 Yale L.J. 1165, 1171-84 (1993) (“Public choice analysis . . . reinforces Madison’s preference for competitive political processes that pit diverse and conflicting groups against one another.”).

Commentators have criticized interest group competition as leading to economic waste. See Lynn A. Baker, *Direct Democracy and Discrimination: A Public Choice Perspective*, 67 Chi.-Kent L. Rev. 707, 737 (1991) (criticizing the notion that “legislation enacted by a representative body is . . . more likely to realize ‘the common good’”); Douglas M. Branson, *A Corporate Paleontologist’s Look at Law and Economics in the Seventh Circuit*, 65 Chi.-Kent L. Rev. 745, 753 (1989); Dennis Honabach & Roger J. Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 Chi.-Kent L. Rev. 681, 725-28 (1989) (explaining how the

nonmarket decision making, or simply the application of economics to political science.”¹⁷⁴ Without debating the accuracy of this theory’s tenets as to the origin of legislation,¹⁷⁵ the following rules of statutory construction derived from public choice scholarship are supported by various judicial and administrative tax rulings. First, when the special interest groups and Congress act against a backdrop of reserved judicial or agency power, that power should be applied broadly.¹⁷⁶ In the tax arena, the clear reflection of income is such a power reserved to the judiciary and the Service. Second, when the fact finder can determine that a particular provision is the product of private compromise that produces asymmetrical benefits between taxpayer groups, the terms of the statutory “contract” or “devil’s bargain” should not be extended to other taxpayers or tax provisions.¹⁷⁷ Taxpayers are entitled to the preferences Congress awards by relying on form even when little or

“‘interest group’ approach . . . views legislation as the product of compromise among competing interest groups” and arguing that the court’s role should be to enforce the bargain struck between the interest groups as reflected in the legislation); Jerry L. Mashaw, *The Economics of Politics and the Understanding of Public Law*, 65 Chi.-Kent L. Rev. 123, 132 (1989) (discussing the history of interest group involvement in agency and noting that critics have seen interest groups as “pursuing their own ends”).

Other commentators criticize such competition as preserving the status quo. See Ethan Fishman, Loper, *Begging and Civic Virtue*, 46 Ala. L. Rev. 783, 794-95 (1995) (“When civic virtue is defined by competing interest groups, it becomes possible for cohesive minority interests to have a disproportionate influence on public policy.”).

¹⁷⁴ Dennis C. Mueller, *Public choice II* 1 (1989 rev.).

¹⁷⁵ In studying this issue, Professors Daniel Farber and Philip Frickey reached several conclusions about public choice theory. See Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 Tex. L. Rev. 873 (1987). First, “[a]lthough it is true that legislators are influenced by special interests, and that legislatures are faced with the possibility of incoherence, legislatures need not be mere pawns of special interest, nor are they doomed to chaos.” *Id.* at 883. Second, “the behavior of members of Congress is dictated by three basic goals: achieving reelection, gaining influence within the House, and making good public policy.” *Id.* at 889. Third, “[t]he economic theory of legislation . . . does not perform well empirically.” *Id.* at 895. Fourth, “[o]ur best view of the political process . . . is a mixed model in which constituent interest, special interest groups, and ideology all influence legislative conduct.” *Id.* at 900. “In addition, . . . political parties and chief executives, among other forces, also influence outcomes.” *Id.* at 900 n.165. These other forces influencing legislation include the popular press, in particular investigative tax reporting.

¹⁷⁶ Cf. Frank H. Easterbrook, *Foreward: The Court and the Economic System*, 98 Harv. L. Rev. 4, 50-51 (1984).

¹⁷⁷ See Easterbrook, *supra* note 176, at 46, 50. Judge Easterbrook posits that the “more detailed the law, the more evidence of interest-group compromise and therefore the less liberty judges possess.” See *supra* note 176, at 16. See also Honabach & Dennis, *supra* note 173.

no economic substance exists apart from the tax preference.¹⁷⁸ The taxpayers, however, can expect no more.¹⁷⁹ Third, when the fact finder determines that a provision does not originate from special interest but rather public interest, a classic Holmesian fill-in-the-gaps-by-analogy analysis should be used when Congress failed to address an item.¹⁸⁰ Well-known disparate tax doctrines appear implicitly bottomed on this common sense construct.¹⁸¹

The subsidy intended by Congress in the expensing/capitalization area is the cost recovery deductions through depreciation under section 168. Although theoretically enacted to represent the exhaustion or decline in value, depreciation—in particular accelerated depreciation—serves as an investment incentive in addition to its representation of wear and tear.¹⁸² Thus, taxpayers that meet the congressional objective of making an investment can receive this subsidy regardless of any actual exhaustion or decrease in value; taxpayers that meet the terms of the statutory contract are entitled to a depreciation deduction despite the lack of economic substance. For example, in *Liddle v.*

¹⁷⁸ Ironically, essentially this approach to statutory construction was followed by the Board of Tax Appeals in *Gregory v. Commissioner*, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). The trial court upheld a transaction meeting the letter of the newly revamped reorganization statute. 27 B.T.A. at 225. The appellate courts adumbrated that the transaction still failed to meet the spirit of the law. *See Rough Justice*, *supra* note 16.

¹⁷⁹ *See* Easterbrook, *supra* note 176, at 54 (“[Courts should] look for and enforce the bargain, but do not elaborate.”).

¹⁸⁰ *Cf.* Easterbrook, *supra* note 176, at 50.

¹⁸¹ These notions, albeit unarticulated, underlie the Tax Court’s “statutory tax shelter” as contrasted with “generic tax shelter” doctrine (articulated in *Rose v. Commissioner*, 88 T.C. 386 (1987), *aff’d on other grounds*, 868 F.2d 851 (6th Cir. 1989)). For an excellent discussion of the “generic tax shelter” test, see Note, *The Tax Court’s Rose Test: More Thorns in the Sides of Taxpayers*, 8 Va. Tax Rev. 905 (1989). Similarly the ability of a taxpayer to form a tax entity just to obtain the tax benefits Congress intended that such entity could provide, such as Subchapter S status or Western Hemisphere Trade Corporation status or corporate qualified retirement benefits prior to 1982 rests on these ideas. A similar policy of enforcing congressionally intended special interest subsidy underlies certain administrative practices. *E.g.*, Rev. Rul. 79-300, 1979-2 C.B. 112, *considered in* G.C.M. 38,117 (Sept. 28, 1979), discussed at *infra* notes 282-88 and accompanying text.

¹⁸² This discrepancy with the theoretical basis is apparent in the statutory recovery periods of section 168 that are often much shorter than the actual useful life. For example, as personal property, a newly acquired aircraft engine is classified as seven-year property even though with proper maintenance its useful life approximates twenty-two years. I.R.C. § 168.

Commissioner,¹⁸³ the Third Circuit permitted a musician to depreciate an antique musical instrument as theoretically subject to wear and tear even though the antique possessed an indeterminate useful life and non-diminishing value.¹⁸⁴ Under the public choice doctrine, taxpayers that make the investment are entitled to the subsidy regardless of the economic results.¹⁸⁵

Congressional modifications of this basic depreciation provision were fairly restricted and left expenditures for aircraft engine overhauls to case law doctrines. Over the past fifteen years, Congress carved out, wherever possible, self-created intangible assets from the basic depreciation provisions via sections 195, 197, and 263A. These exceptions are quite specific and cannot be judicially expanded to cover other expenditures not enumerated in the statutes. Therefore, Congress presumably left the treatment of overhaul costs to the case law doctrine of achieving a clear reflection of income. Nothing in the statutes indicates that Congress intended to provide the airline industry with preferential treatment beyond the accelerated depreciation allowed under section 168. This conclusion seems reasonable given that most likely neither Congress nor the FAA took account of any tax policies when establishing the safety rules. The result might have differed if Congress or the FAA established a policy assuming certain tax consequences. But here the tax and safety policies appear

¹⁸³ 65 F.3d 329 (3d Cir. 1995).

¹⁸⁴ See *id.* at 335; cf. *Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995); A.O.D. CC-1996-009 (July 15, 1996); Joseph M. Dodge & Deborah A. Geier, *Simon Says: A Liddle Night Music With Those Depreciation Deductions, Please*, 69 Tax Notes 617 (Oct. 30, 1995); Lee Sheppard, *Violins, Ferraris, and the Music of Class Lives*, 69 Tax Notes 669 (Nov. 6, 1995); Note, *Which Concept of Depreciation Should Guide Us? Trying to Develop a Consistent Framework for the Federal Income Tax System*, 14 Va. Tax Rev. 753 (1995).

¹⁸⁵ Several references in the T.A.M. hint that capitalization might be required under some sort of tax benefit/recapture notion to restore the depreciation deductions previously taken. See T.A.M. 96-18-004 (Jan. 23, 1996) ("[The] major engine inspections have the effect of replacing the engine that was previously wasted during [the airline's] previous operations."); cf. G.C.M. 34,959 (July 25, 1972); G.C.M. 39,162 (Mar. 2, 1984). After *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983), however, the "fundamentally inconsistent event" test is not triggered in a subsequent year when the initial deduction effectuated the purpose Congress intended. See generally John W. Lee & Mark S. Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. Corp. L. 137, 199-206 (1987); see also Rev. Rul. 85-186, 1985-2 C.B. 84; T.A.M. 92-06-004 (Oct. 16, 1991). Thus, the airline was entitled to the depreciation subsidy initially by satisfying the congressional purpose of making an investment, and the character of subsequent expenditures for overhauls should not represent a recapture of that subsidy.

independent. With the lack of a subsidy entitlement, the airlines must satisfy one of the rough justice rules to obtain an immediate deduction.

*C. Application of the Rough Justice Rules to Cyclical
Aircraft Maintenance Costs*

Assuming *arguendo* that the rough justice rules apply to large taxpayers,¹⁸⁶ the conclusion that future benefit automatically leads to capitalization must be reconsidered. One of the exceptions outlined above might provide a justification for reversing the T.A.M.'s conclusions.

1. De Minimis or Short-Lived Benefit

Although the approximately \$90,000 to \$120,000 cost of an overhaul may not seem *de minimis*, a current deduction might be justified by a minimal distortion of income standard.¹⁸⁷ Judge Sterrett suggested in *Wolfsen Land & Cattle* that the absolute amount of an expenditure may require capitalization.¹⁸⁸ As a comparative standard, Congress carefully limited the statutory equivalent of *de minimis* deductions to \$17,500 (to gradually increase to \$25,000)¹⁸⁹ in section 179.¹⁹⁰ Thus, the relatively large

¹⁸⁶ See *supra* notes 110-14 and accompanying text (discussing the appropriate scope of the rough justice rules in the context of amount of taxpayer's income).

¹⁸⁷ This article does not consider the repair doctrine that permits a current deduction for incidental repairs because repair cases should be decided on the preferred distortion of income basis—it's not a question of classifying an expenditure as a repair, the question is: Does it distort income to currently deduct the expenditure? See Gunn, *supra* note 53, at 457-61.

¹⁸⁸ See *Wolfsen Land & Cattle*, 72 T.C. at 13. The Service appears to waiver on this point. Compare T.A.M. 94-24-002 (Feb. 9, 1994) (denying a repair deduction due to the substantiality of nearly \$1 billion spent for temporary work performed to raise oil rig platforms and to construct a barrier wall around a storage tank), with Rev. Rul. 94-38, 1994-1 C.B. 35 (permitting a deduction of presumably substantial soil remediation expenditures). The aircraft maintenance costs, however, seem to greatly exceed the *de minimis* standard when compared with Chief Counsel's prior recommendation of a \$100 *de minimis* safe harbor. See G.C.M. 34,959 (July 25, 1972).

¹⁸⁹ See Pub. L. No. 104-188, § 1111(a), 110 Stat. 1755, 1758 (1996).

¹⁹⁰ See I.R.C. § 179(b)(1). In more recent years, Congress has found itself "paying" for any extensions of tax expenditures, see *supra* note 25, suggesting that any *de minimis*-flavored exception in the \$90,000 to \$120,000 range is probably not viable in today's economic and

amount of these expenditures tends not to suggest a *de minimis* characterization. Ken Kempson, at the VTSG Spring 1997 Symposium, flatly rejected any notion that the magnitude of an expenditure militated towards capitalization, although recognizing that a case could be made for a minimum expensing rule.

The inspection costs, however, might not distort income if deducted as incidental repairs under a generally applicable repair ratio. The T.A.M. reveals that these costs amount to about 1/10 the cost of a new engine and 1/100 the cost of a new airplane.¹⁹¹ Restated as ratios, these costs seem much less substantial. Although never formally adopted, the Chief Counsel's Office once proposed a safe harbor deduction for cyclical repair expenditures that fell below 50% of the original cost of an asset.¹⁹² Providing taxpayers with a generalized repair ratio would satisfy the goal of minimal distortion of income through rough justice rules—the ratio achieves simplification and horizontal equity by providing one straightforward rule for all taxpayers. Accordingly, further consideration of a safe harbor repair ratio seems warranted.¹⁹³ Nevertheless, the fairly small ratio of aircraft maintenance costs to initial investment makes the absolute cost more credible as a *de minimis* amount. Given the ambiguous conclusions from the absolute amount and the repair ratio, the proper tax treatment of the cyclical maintenance costs may be too close to call on this one factor alone.

2. Steady State Recurring Costs

The fact that these maintenance costs recur in approximately four-year cycles places them right on the line between deductible and capitalizable expenditures. As noted above, precedent indicates that three-year-or-less cycles often provide deductions whereas five-year-or-longer cycles require capitalization and

political climate.

¹⁹¹ See T.A.M. 96-18-004 (Jan. 23, 1996).

¹⁹² See G.C.M. 34,921 (June 26, 1972) (denying a deduction for railroad car rehabilitations that often exceeded 50% of the original cost).

¹⁹³ See Notice 96-7, 1996-1 C.B. 359 (requesting comments on guidance needed for capitalization issues).

depreciation.¹⁹⁴ Individually, each engine is inspected every four years. A four-year period might just push the envelope enough that it begins to tear. Although somewhat inconclusive, viewing the inspection performed on each engine on an individual basis may suggest capitalization. Aggregating the costs on a year-by-year basis, however, indicates that the costs recur annually, which supports a deduction. In particular, the airline probably overhauls 25% of its fleet on a rotating basis each year.¹⁹⁵ With these steady state recurring costs, there would appear to be little difference in the measurement of income between expensing and capitalizing/depreciating these expenditures.¹⁹⁶ Once again, under the rough justice rules, it is a close call in deciding whether to consider the individual or aggregate bases.

3. Costs With Temporally Limited Benefit When Depreciation Remains Unavailable

An extensive analysis under the third rough justice rule should be unnecessary. The need to perform the inspections every four years in accordance with the FAA's safety requirements demonstrates that these expenditures provide temporally limited benefits. In addition, the T.A.M. itself states that these costs are

¹⁹⁴ See *supra* notes 129-32 and accompanying text.

¹⁹⁵ To minimize the downtime of serviced aircraft, airlines often simply replace the inspected engine with one of their "rotable engines" kept on hand in a pool. For a discussion of the use of rotatable parts, see generally Dennis J. Gaffney, *Rotable Spare Parts: How Did a "Terrible" Accounting Method Become So Bad?*, 70 Tax Notes 1009 (Feb. 19, 1996); Calvin H. Johnson, *Federal Circuit Plays Dirty Pool with Inventory Accounting*, 70 Tax Notes 111 (Jan. 1, 1996); W. Eugene Seago, *Rotable Parts: IRS Discretion Under the Clear Reflection of Income Standard*, 67 Tax Notes 117 (Apr. 3, 1995). The removed engine is overhauled and placed into the rotatable parts pool and depreciated under Revenue Ruling 69-200, 1969-1 C.B. 60. Smaller airlines might purchase or lease reconditioned engines from a reconditioning center and send the inspected engine back to that center. The T.A.M. hints at a mixture of both patterns. It states that the airline, "[i]n performing a major inspection, . . . is required to remove a large portion of engine component parts and replace these parts with new or reconditioned parts." T.A.M. 96-18-004 (Jan. 23, 1996). In addition, "a newly inspected engine . . . is of an interchangeable nature, and is treated by [the airline] as a substitute or standby component." *Id.*

¹⁹⁶ Cf. *Encyclopaedia Britannica*, 685 F.2d at 217 (considering recurring payments by a publisher to authors developing books). With the current industry practice of immediately expensing the costs, any distortion normally created by the transition period to a steady state will be absent in this situation.

recoverable through depreciation.¹⁹⁷ Therefore, minimal distortion of income should occur because the expenditures will be allocated through depreciation to future benefited periods to achieve matching. This is not a situation where this rough justice exception is intended to apply (i.e., for expenditures capitalized, but non-recoverable through depreciation despite the temporally limited usefulness of the expenditures).

This rough justice rule may apply, however, due to the long depreciation period suggested by the T.A.M. The T.A.M. capitalized the costs of the overhauls to the engines that will generate depreciation deductions over the next eight years.¹⁹⁸ Common sense says that depreciating a cost that recurs every four years, over eight tax years, is wrong. Particularly in the capitalization area, unreasonable approaches tend to backfire by provoking courts to apply rough justice solutions.¹⁹⁹ If litigated, a court may perceive the eight-year recovery period as "overreaching" by the Service,²⁰⁰ and the court simply may allow a current deduction for the expenditure.²⁰¹ The key to avoiding this result is achieving a clear reflection of income by capitalizing the costs to the right "asset."²⁰²

¹⁹⁷ See T.A.M. 96-18-004 (Jan. 23, 1996).

¹⁹⁸ See *id.*; Wald, *supra* note 7.

¹⁹⁹ See *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 52-56 (discussing courts' willingness to adopt the separate, saleable asset doctrine to alleviate the harshness of capitalization in response to perceived overreaching by the Service).

²⁰⁰ *NCNB I*, 651 F.2d at 959 ("It was, in short, an attempted overreaching by the tax collector. If he failed, he had less basis for protest than if he had confined his demands to those which were properly Caesar's.").

²⁰¹ See *Capitalization Rules*, *supra* note 16, at 677. For instance, the Ninth Circuit in *Moss*, 831 F.2d 833, allowed a taxpayer operating a hotel a current deduction for the recurring costs of interior painting and re-papering of hotel rooms customarily redone on a three-year cycle. *Id.* at 841-42. Using the general plan of rehabilitation doctrine, see *infra* note 200, the Service sought to add the costs to the depreciable basis of the hotel building that had a remaining useful life of thirty years. *Moss*, 831 F.2d at 835. Ironically, the Service permitted the taxpayer to depreciate over seven years the costs of remodeling, beds, and drapes, see *id.*, that probably had longer useful lives than the repainting. The court permitted an immediate deduction for the repainting costs to minimize the harshness of the Service's suggested excessive capitalization period. *Id.* at 841-42. Such sweeping of a shorter-lived, recurring expenditure into the greater longer-lived structure offends a court's sense of justice.

²⁰² See *Gunn*, *supra* note 53, at 492; see also *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 4 n.3 (listing the various assets that courts use to capitalize start-up costs).

With a comparatively sparse discussion of depreciation,²⁰³ the cyclical aircraft engine maintenance T.A.M. buttressed its conclusion on Revenue Ruling 88-57, which capitalized the cyclical repair costs of freight-train cars and treated the reconditioned cars as new assets under the general plan of rehabilitation doctrine.²⁰⁴ The reconditioning of the railroad cars occurred every eight to ten years,²⁰⁵ and new cars were depreciated over eleven years under the

²⁰³ See Sheryl Stratton, *IRS Draws Flak for Aircraft Overhaul Capitalization TAM*, 73 Tax Notes 119, 122 (Oct. 14, 1996) (crediting this observation to Professor Annette Nellen).

²⁰⁴ See Rev. Rul. 88-57, 1988-2 C.B. 36. Under a judicial gloss of section 162 or perhaps 263, the otherwise deductible cost of a repair is capitalized if the repair was part of an overall pattern of rehabilitation. See *United States v. Wehrli*, 400 F.2d 686, 689-90 (10th Cir. 1968) ("[C]ourts have superimposed . . . an overriding precept that an expenditure made for an item which is part of a 'general plan' of rehabilitation, modernization, and improvement of the property, must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair."). The most sound rationale for this doctrine is that the execution of a plan of rehabilitation constitutes the acquisition of a new capital asset so that all the related expenses must be capitalized. See *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 34; see, e.g., *California Casket Co. v. Commissioner*, 19 T.C. 32, 37-38 (1952) (requiring the capitalization of all renovation costs when the building was acquired with the express intention of completely renovating it to conform with specific business requirements). So viewed, the plan of rehabilitation rule is analogous to the rule that an expenditure which is part of the acquisition cost of a capital asset must be capitalized even though standing alone, or incurred after the completion of the process of acquisition, would be deductible. See *Estate of Wilbur*, 43 T.C. at 327 n.6 (1964) (capitalizing the last coat of paint applied during construction), *acq.* 1965-2 C.B. 7; *Mt. Morris Drive-In Theater Co. v. Commissioner*, 25 T.C. 272, 274-75 (1955) (capitalizing the cost of a drainage system installed after the completion of the theater because it would have been capitalized as part of the original construction and it was obvious that the drainage system was needed), *aff'd*, 238 F.2d 85 (6th Cir. 1956); *Start-up Costs and Clear Reflection of Income*, *supra* note 53, at 32-38. The Ninth Circuit correctly limited the "rehabilitation doctrine" to substantial capital improvements and repairs to the same specific asset, usually a structure in a state of disrepair. See *Moss*, 831 F.2d at 841.

²⁰⁵ See Rev. Rul. 88-57, 1988-2 C.B. 36. TEI has recently pointed out in a supplement to its Submission of comments pursuant to Notice 96-7 that the railroad car reconditioning occurred near the end of the useful life of the car and following a long period of continuous use without repairs. Letter from James R. Murray of Tax Executive Institute, Inc., dated March 25, 1997, to Commissioner Margaret M. Richardson re: Capitalization Issues Under Notice 96-7 and Follow-up on IRS-TEI Liaison Meeting, *reprinted in Additional Guidance Needed Regarding Capitalization Issues*, 97 Tax Notes Today 64-46 (Apr. 3, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit. 97 TNT 64-46) ("The economic life of any asset, and the corresponding asset guideline class and applicable MACRS class life in which the asset falls [twelve years under Rev. Proc. 87-56, 1987-2 C.B. 674], is premised on the taxpayer undertaking periodic repairs in order to keep the asset in an ordinarily efficient operating condition. Indeed, following the T.A.M.'s reasoning to its logical extreme, periodic oil changes for automobiles or delivery trucks would be subject to capitalization. Establishing a prudent policy of periodic repairs and incurring expenses under that policy do not, in our view, transmogrify periodic repairs into a capital asset with a useful life beyond the year incurred.").

then-applicable depreciation system.²⁰⁶ By fortuity, the new asset depreciation period was close to the right period for cyclical railroad car repairs. This similarity may have misled the drafters of the aircraft maintenance T.A.M. into believing that treating the capitalized costs as new assets depreciable over eight years would produce the proper result. In fact, the eight-year recovery period is too long; it should approximate four years.

In support of its new asset treatment, the T.A.M. was on far sounder ground in concluding that “major engine inspection costs had the effect of replacing the engine with a newly inspected and reconditioned engine.”²⁰⁷ The airline normally would recover the cost of a new engine over an eight-year period; therefore, the Service could justify its eight-year recovery period for the maintenance costs by characterizing the reconditioned engine as new. In this regard, section 168’s prohibition of component depreciation and requirement of composite depreciation²⁰⁸ probably motivated the Service’s characterization.²⁰⁹ Following Revenue Procedure 87-57, any additions or improvements to property are treated as separate properties with the same recovery period, convention, and depreciation method as applicable to the underlying property.²¹⁰ Instead of depreciating the maintenance costs over their own period, the Service considered them to constitute part of the engine and used the engine’s recovery period.

Rough justice suggests, as an alternative to current deduction, sidestepping these section 168 rules by treating the recurring maintenance costs as creating a freestanding intangible asset or deferred charge, apart from the engine, depreciable under section 167.²¹¹ Treating the cost as a freestanding asset depreciable over

²⁰⁶ See G.C.M. 39,743 (July 14, 1988); see also G.C.M. 34,921 (June 26, 1972).

²⁰⁷ T.A.M. 96-18-004 (Jan. 23, 1996).

²⁰⁸ See I.R.C. § 168(i)(6). The component method depreciates a structure component-by-component according to the useful life of each component whereas composite depreciation treats the structure as a whole and depreciates the entire structure as one unit.

²⁰⁹ The T.A.M. referred to the use of composite depreciation twice. See T.A.M. 96-18-004 (Jan. 23, 1996) (“[The airline] depreciates the aircraft and engines as one unit under the composite method of depreciation.”).

²¹⁰ See Rev. Proc. 87-57, 1987-2 C.B. 687, 689.

²¹¹ See I.R.C. § 167(a) (permitting depreciation deductions for assets not covered by MACRS in section 168).

four years on a straight-line basis²¹² under section 167 minimizes the income distortion that occurs by depreciating the maintenance as a reconditioned engine purchase under section 168 over eight years. Once again, this is an attempt to settle on the middle ground.²¹³ Moreover, to the extent that the cyclical safety inspection costs largely consist of removing the engines, taking them apart, and inspecting and reassembling rather than replacing parts, those costs do not resemble permanent improvements.

The proposed freestanding depreciable intangible approach mirrors that taken by the Tax Court in *Wolfsen Land & Cattle*. The taxpayer in *Wolfsen Land & Cattle* incurred substantial costs in dredging irrigation ditches every ten years in lieu of performing annual maintenance.²¹⁴ The parties presented the court with two income distorting options: either allow a current deduction of the *substantial* costs or capitalize the costs to the *non-depreciable* basis of the land with an indefinitely useful life.²¹⁵ Judge Sterrett unraveled this Gordian knot²¹⁶ by treating the maintenance cost itself as a deferred charge depreciable over ten years.²¹⁷

²¹² The ideal rule for capital recovery would include indexing the asset's basis for inflation and using the economic life with straight-line depreciation. See 2 U.S. Dep't Treasury, *supra* note 48, at 151-211 (1984). Failure of such rules to account for greater use in particular years may prevent those rules from being perfect. See Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 Mich. L. Rev. 1, 42 (1979). Certainly straight-line depreciation over the period benefited without other adjustments is not the ideal rule, but it is probably close enough for tax expenditure analysis. *Contra id.* Other academics have suggested a wide variety of ideal rules to account for multi-period costs. See, e.g., Thomas L. Evans, *The Taxation of Multi-Period Projects: An Analysis of Competing Models*, 69 Tex. L. Rev. 1109 (1991); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 722 (1990); Larry D. Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*, 53 Tex. L. Rev. 1119 (1975).

²¹³ See *NCNB Corp. v. Commissioner*, 684 F.2d at 295 (Murnaghan, J., dissenting) (finding "an opportunity to resort to the golden mean"); cf. *supra* notes 141-45 and accompanying text.

²¹⁴ *Wolfsen Land & Cattle*, 72 T.C. at 8.

²¹⁵ *Id.* at 13. In an uncharacteristic reversal of roles, the Service argued for an immediate deduction and the taxpayer sought capitalization. *Id.* at 10. Perhaps the Service's position was principled; an immediate deduction produces less distortion than capitalization without amortization. See *supra* notes 138-40 and accompanying text. A more likely explanation, however, is that the Service attempted to put the dredging costs into an earlier tax year so that the benefit of the deduction would be barred by the statute of limitations.

²¹⁶ Alexander the Great, of course, cut through the Gordian knot with his sword. Courts may believe that such option is open only to Congress; they must unravel the problem. See *Board of Trade of Chicago v. SEC*, 677 F.2d 1137, 1168 (7th Cir. 1982) (Campbell, J., concurring).

²¹⁷ *Wolfsen Land & Cattle*, 72 T.C. at 13; accord Rev. Rul. 68-483, 1968-2 C.B. 91

Thus, we are faced with something of a conundrum, how do we treat a maintenance-type expense substantial in amount, which only restores its subject to its original operating condition, yet need be repeated only on the average of every 10 years and is performed on a subject of indefinite life.

To permit a current deduction of such a large expenditure with a beneficial effect lasting on the average of 10 years would surely distort that [year's] income. Yet to deny even an amortization deduction for an expenditure with a specific demonstrable beneficial life on the grounds that its deductibility is contaminated by its relationship to an asset of indefinite life, i.e., the land, would similarly require an uneven reporting of income.

Since a basic premise of the income tax laws is to relate expenses to the income which they helped earn, a reasonable solution to our conundrum is to hold that the expenses in issue should be written off over their useful life. In short we would subscribe independent status to those expenditures on the basis that they create a free-standing intangible asset with an amortizable 10-year life.²¹⁸

(depreciating recurring redredging costs as a freestanding asset over the period until the next required redredging); cf. *Gunn*, *supra* note 53, at 446 ("The distinction between asset as cost and asset as property may be helpful in determining the proper period for recovery of capitalized costs through depreciation or amortization.").

²¹⁸ *Wolfsen Land & Cattle*, 72 T.C. at 13 (footnote omitted).

This common sense solution²¹⁹ is equally applicable to cyclical aircraft maintenance costs. Given the ambiguous results under the de minimis and recurring prongs, the airline probably should depreciate the costs separately as freestanding intangible assets over each four-year period of benefit to assure that no distortion of income occurs.

Ironically, the factors weighing against the use of a four-year recovery period are the horizontal equity and economic efficiency goals of taxation. Horizontal equity seeks to treat similarly situated taxpayers similarly.²²⁰ Economic efficiency attempts to avert any influence that a tax might have on taxpayers' decisions about the use of economic resources.²²¹ These two goals appear

²¹⁹ Unfortunately, the Service has refused to adopt generally the depreciation of a freestanding intangible asset approach to recurring costs. *But see* T.A.M. 94-24-002 (Feb. 9, 1994) (using the period of recurrence as the useful life to depreciate the costs incurred to raise a sinking seawall). Consequently, it often strains to find an appropriate depreciable asset that could have the recurring costs tied to it. For example, in the case of employee training costs, the Service initially permitted depreciation of capitalized new nuclear power plant employee training costs over the life of the building in which the workforce was employed. *See* T.A.M. 75-09-099-440A (Sept. 9, 1975). Contemporaneously, the Service capitalized training costs as start-up costs of a new plant in an existing lumber business as a depreciable intangible asset—"an operational fiberboard plant." *See* T.A.M. 75-04-281-070A (Apr. 28, 1975); *cf.* G.C.M. 37,500 (Apr. 5, 1978) (suggesting, but not ruling, that pre-opening costs like training should be capitalized and amortized over the life of the facility). Subsequently, during the period the Service followed the separate asset doctrine, it allowed a current deduction for the costs of training a work force in connection with the establishment of a new manufacturing facility by a taxpayer with similar existing operational plants in other locations. *See* T.A.M. 83-03-012 (Oct. 7, 1982), *modifying* T.A.M. 82-04-061 (Oct. 28, 1981). Later, the Service amortized employee training costs over the life of a plant's forty-year Nuclear Regulatory Commission license. *See* T.A.M. 94-30-003 (Apr. 22, 1994). This awkward progression strongly suggests that the Service should recognize generally the approach of capitalizing costs as freestanding assets depreciated over their own useful lives.

²²⁰ *See Sneed, supra* note 148, at 579; 2 U.S. Dep't Treasury, *supra* note 48, at 151-211; *see, e.g., Idaho Power Co.*, 418 U.S. at 14 (requiring the capitalization of depreciation from vehicles used during self-construction projects to maintain tax parity with taxpayers that hire independent contractors because the contractors would include the depreciation in their charge that the taxpayer would capitalize as paid); *cf. Iowa-Des Moines*, 592 F.2d at 436 (permitting a taxpayer to deduct credit screening costs paid to outsiders in part because the costs of performing the screening in-house would have been currently deductible).

²²¹ *See Sneed, supra* note 148, at 586-90. Judge Posner provides a good explanation of this policy:

Because of the time value of money—real riskless interest rates are positive—a deduction taken today is worth more than one taken a year from now. Hence if an expense incurred to produce future income can be deducted from current income rather than postponed until it has borne its fruits, taxpayers will have an incentive to incur such expenses earlier than they would if there were no income tax; and tax law seeks, to the extent compatible with revenue and distributive objectives, to interfere as little as

violated by the contrary treatment of airlines that maintain engines in a rotatable parts pool and airlines that purchase replacement engines.²²² Self-repairing airlines that draw upon a rotatable part pool, to replace the engines in aircraft while performing the inspection on the removed engines, could justify using a four-year recovery period. They would treat the overhaul costs as a freestanding asset. Conversely, airlines that purchase replacement engines and perform inspections on the removed engines before returning them to the seller would capitalize the inspection costs *as part of the acquisition price*. As demonstrated above, a newly reconditioned and inspected engine is depreciable over an eight-year period.²²³ Thus, different treatment is afforded two similarly situated taxpayers, with self-repairing airlines receiving a preference of a shorter recovery period.²²⁴

Conceptually, the true parity problem may be that an eight-year recovery period fails to account for extraordinary obsolescence. The need for major inspections and overhauls of engines every four years suggests that aircraft engines simply fall within the wrong recovery property class. In that case, the answer to the lack of parity between airlines that self-repair and those that purchase reconditioned engines is not to lengthen the period, from four to eight years, for recovering costs capitalized as freestanding intangible assets. Instead, the better answer provides for this extraordinary obsolescence legislatively through MACRS or perhaps administratively or judicially under the clear reflection of income standard.

possible with the pattern of expenditures that would exist in the absence of taxation. *Fishman v. Commissioner*, 837 F.2d 309, 312 (7th Cir. 1988) (Posner, J.); accord *Cabintaxi Corp.*, 63 F.3d at 619 (7th Cir. 1995) (Posner, J.) ("The purpose of these [start-up cost] rules (the second, the requirement of capitalization, more clearly than the first [of not yet carrying on a trade or business]) is to require the matching of expenses to income temporally, a major objective of efficient tax policy.") (citation omitted).

²²² See *supra* note 194 (discussing the industry practice of using either a parts pool or acquiring replacement engines to minimize the downtime while servicing aircraft).

²²³ See *supra* notes 207-10 and accompanying text.

²²⁴ Airlines that lease engines presumably pay fairly level annual rental payments. Thus, the airlines obtain much the same annual dollar deduction result by annually deducting the rent for four years as by depreciating the capitalized costs of repairs as a freestanding asset over four years.

4. *More-Trouble-Than-It's-Worth*

Based on tax considerations alone, the T.A.M.'s facts do not indicate that the burdens of capitalization/depreciation outweigh the benefit of a more clear reflection of income. For a large taxpayer, the administrative costs of compliance are minor. In particular, the clearly identifiable period of recurrence—four years—provides the ideal depreciation period. This period assures against income distortion and avoids the burden of attempting to estimate a proper recovery period. This method also avoids any perceived horizontal inequity in the transportation industry by treating the airline as all other taxpayers that must capitalize their repair costs. These tax considerations alone make capitalization/depreciation over four years worthwhile.

Political factors, however, raise the Service's administrative costs and make it more-trouble-than-it's-worth. The threat of congressional intervention into the administration of the tax laws might derail the Service's post-*INDOPCO* strategy of incrementalism and regulation by litigation rather than by regulations. These political factors will concentrate on non-tax policies without regard to the tax standard of achieving a clear reflection of income. Deviations from the ideal tax policy will establish contrary precedent that make the already difficult area of capitalization more confusing.

The non-tax policy arguments raised against the airline maintenance T.A.M. may call to mind the fate of the soil remediation T.A.M. previously issued by the Service.²²⁵ The soil remediation T.A.M. capitalized substantial and fairly non-recurring costs to treat soil "contaminated" by PCPs, which were dumped after they had lubricated machines that pumped natural gas.²²⁶ As it turns out, that T.A.M. allowed depreciation of such capitalized costs over the life of the pipeline used by the natural gas pumping company.²²⁷ This laudable result²²⁸ was reversed by a published

²²⁵ T.A.M. 93-15-004 (Dec. 17, 1992); *see also* Stratton, *supra* note 203, at 122 (indicating that Professor Annette Nellen noted this similarity).

²²⁶ T.A.M. 93-15-004 (Dec. 17, 1992).

²²⁷ These facts were gleaned from tax journals and a subsequent article by Glenn Carrington. *See* Glenn R. Carrington, *Capitalization After Indopco*, 53 *Inst. on Fed. Tax'n* § 25.01, § 25.03[5][c], at 25-29 to 25-30 (1995); *see also* Avakian-Martin & Carson, *supra* note

ruling that allowed a current deduction of the remediation costs.²²⁹ A current deduction was not allowed on the basis of sound tax policy, instead it resulted from intense political opposition.

Sacrificing tax policy for the sake of largely political arguments of critics cannot provide the right answer to this problem. A hasty exception granted to one interest group only encourages others to badger the Service for similar exceptions. Conversely, ignoring non-tax policies invites congressional intervention to correct the frustration of certain social goals. These alternatives threaten the consistency of the tax laws. This threat certainly suggests that requiring the capitalization of the airline maintenance costs is simply more-trouble-than-it's-worth.

The apparent disapproval of the Service's position with respect to the cost of cyclical aircraft engine overhauls portends that Congress will step in and attempt to protect what it sees as a threat to a governmental airline safety policy. The apparent orchestration of events culminating in the House Conference Committee Report verbally chastising the Service's position on these costs²³⁰ seems an omen of Chairman Archer's plan to bypass the pay-go rules²³¹ should the Service continue ignoring his requests to consider FAA safety policies in determining how to treat these costs. Congress has assumed the role of guardian in the past. In several instances during the second half of the 1970's, Congress prohibited the Service from executing particular aspects of the tax law.²³² Congress has instituted similar prohibitions on other government agencies in a host of other areas as well.²³³

145, at 925-26.

²²⁸ See Juliann Avakian-Martin, *Does the IRS Need to Clean Up its Ruling on Cleanup Costs?*, 59 Tax Notes 728, 729 (May 10, 1993) (quoting Professor John Lee's approval of the soil remediation T.A.M.).

²²⁹ See Rev. Rul. 94-38, 1994-1 C.B. 35 (permitting a current deduction for soil remediation costs but requiring the capitalization of the cost of a permanent ground water cleaning facility).

²³⁰ See *supra* notes 9, 13, 24, 28 and accompanying text. It is probably no coincidence that the date of Chairman Archer's news release of his letter to Commissioner Richardson corresponds with when the Budget Committee was deciding on the IRS budget for the next fiscal year.

²³¹ See *supra* note (discussing the "pay-go" procedures).

²³² See Parnell, *supra* note 26, at 1370-75.

²³³ See Neal E. Devins, *Regulation of Government Agencies Through Limitation Riders*, 1987 Duke L. J. 456, 461-63 (1987).

One technique, seen in the Tax Reform Act of 1976,²³⁴ suspended the application of a revenue ruling mandating the capitalization of prepublication costs²³⁵ by "substitut[ing] earlier IRS rules for IRS execution in place of subsequent Service rules."²³⁶ This suspension was to last until prospective regulations dealing with prepublication expenditures were issued.²³⁷ The generic term in the literature for such legislative strategies is "limitation riders." The classic limitation rider is a floor amendment or "rider" to an appropriations bill that prohibits the agency from using any funds generally appropriated to the agency for a specific purpose identified by Congress during the next fiscal year. In the tax arena, limitation riders commonly are enacted by revenue, rather than appropriation, acts without amending the Internal Revenue Code.²³⁸

The use of limitation riders, to suspend application of the reasoning in the aircraft maintenance T.A.M. until promulgating regulations, would be the *least* intrusive potential Congressional interference with IRS and Treasury administration of the

²³⁴ Tax Reform Act of 1976, Pub. L. No. 94-455, § 2119, 90 Stat. 1520, 1912 (1976).

²³⁵ See Rev. Rul. 73-395, 1973 C.B. 87 (requiring capitalization but "allowing" depreciation under the income forecast method).

²³⁶ See Parnell, *supra* note 26, at 1370. See *id.* 1370-71, 1371 n. 77. Section 2119 of the Tax Reform Act of 1976 stated that the

application of sections 61 (as it relates to cost of goods sold), 162, 174, 263, and 471 of the Internal Revenue Code of 1954 to any prepublication expenditure shall be administered—(1) without regard to Revenue Ruling 73-395, and (2) in the manner in which such sections were applied consistently by the taxpayer to such expenditures before the date of the issuance of such revenue ruling.

Pub. L. No. 94-455, § 2119, 90 Stat. 1520, 1912 (1976). Chairman Archer's complaint that Chief Counsel Brown failed to even acknowledge that the Service's treatment of the cyclical aircraft engine safety inspections was a new interpretation takes on a new light against this backdrop. See Archer Reply, *supra* note 19.

²³⁷ See Tax Reform Act of 1976 § 2119. Such regulations were never issued. Instead, Treasury believes that the Tax Reform Act of 1986 superseded this provision. See Temp. Reg. § 263A, 52 Fed. Reg. 10,052, 10,054 (1987) ("If, and to the extent, that section 2119 of the 1976 Act would otherwise contravene the clear Congressional intent underlying section 263A of the Tax Reform Act of 1986 regarding the production of books, then section 263A, the more recent expression of Congressional intent, is properly viewed as the legally determinative provision and section 2119 is viewed as modified, accordingly."). As long as noted author Senator Patrick Daniel Moynihan, D-N.Y., serves on the Senate Finance Committee, the Treasury's belief might not be very sound.

²³⁸ See Parnell, *supra* note 26, at 1370-71; discussion *infra* part IV.

capitalization standards.²³⁹ Ideally these regulations would be issued after a public hearing in which FAA representatives participated.²⁴⁰ Congress could also express its concern with the Service's disregard for airline safety policy by prohibiting consideration of the cyclical aircraft engine inspection T.A.M. or, even more broadly, by cutting off funding for selected activities,²⁴¹ including audits or development of industry guidelines dealing with capitalization. If Chairman Archer's long-term goal is "to tear out the income tax by its roots,"²⁴² he would certainly be willing to prune a capitalization limb or two now. However, such congressional guidance is not without its risks, in that it could very

²³⁹ If the Service continues to ignore FAA airline safety policy, the House acting in this manner is a virtual certainty.

²⁴⁰ A thesis of this article is that the new formulations of capitalization rules should be through public rule making and ideally through negotiated rulemaking resulting in structured discretionary justice regulations.

²⁴¹ In the 1970's Congress repeatedly substituted prior IRS rules for proposed regulations or revenue rulings. Examples were rules as to salary reduction plans, employer reporting of tips paid to employees by charge cards, deductibility of travel expenses, and nonqualified deferred compensation plans. Parnell, *supra* note 26, at 1370-72. Commentators were even more critical of congressional prohibitions at this time of IRS providing nationwide guidance without any substitution of a prior IRS rule thereby creating a total administrative ruling void as was the case with fringe benefits. Parnell, *supra* note 26, at 1372-74. On occasion without amending the taxing statute, Congress prohibited IRS guidance but provided guidelines for rulings as in the case of classification of taxpayers as employees or independent contractors. Parnell, *supra* note 26, at 1373-74. Still another tack during this era was to limit IRS use of appropriated funds to implement nationwide guidance as in the case of denial of tax-exempt status to schools on account of racial discrimination. Devins, *supra* note 233, at 1374. See Devins, *supra* note 233, for additional non-tax examples. Professor Devins points out that House rules now restrict the last approach of appropriation limitations. Parnell, *supra* note 26, at 462.

²⁴² 142 Cong. Rec. H3408 (daily ed. Apr. 16, 1996) (Remarks of House Ways and Means Chairman Bill Archer, R-Tex.); *Transcript of W&M Hearing on Impact of Tax Reform on Manufacturing, Energy, Natural Resources* (July 31, 1996), 96 Tax Notes Today 154-27 (Aug. 7, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 154-27) (Remarks of Chairman Bill Archer, R-Tex.) ("[I]t is my goal in the years that I will continue to serve in the Congress to tear the income tax out by its roots and to get the IRS completely and totally out of the lives of every individual American."); *Archer Announces Hearing on Replacing the Federal Income Tax and Its Impact on Small Business* (Apr. 1, 1996), reprinted in *W&M Schedules Hearing on Effect of Tax Reform on Small Business*, 96 Tax Notes Today 65-19 (Apr. 2, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 95-19) ("In announcing the hearings, Chairman Archer stated, 'This hearing is a continuation of our effort to replace the Federal income tax. My goal is to tear out the income tax by its roots so that it can never grow back. I believe that small businesses will be significant beneficiaries of a new, simpler tax system.'"); Rosenbaum, *supra* note 12; Editorial, *Income Tax or Sales Tax*, Wash. Post, June 6, 1995, at A18; Peter Passel, *The Tax Code Heads into the Operating Room*, N.Y. Times, Sept. 3, 1995, at 3-1, col. 2.

well subject the Service's interpretation of applicable tax law to congressional micromanagement.²⁴³ Regardless, these early indications suggest that the Service should consider the role of non-tax policies when interpreting the tax laws.

IV. CONSIDERATION OF FAA SAFETY POLICY IN FASHIONING TAX POLICY: THE PUBLIC POLICY DOCTRINE

The obvious public safety issues that pervade the subject of aircraft maintenance costs raise the question of whether the Service should consider non-tax public policy in fashioning tax policy with regard to the treatment of these costs. This article sets forth the thesis that a two-step analysis should apply in determining whether public policy expressed in a non-tax statute or rule should be taken into account in the formulation of a given tax policy. According to this analysis, in order for non-tax policy to be considered in the modeling of tax policy, Congress or the courts must first have clearly identified an overlap of this recognized non-tax policy with the tax policy in question. The second step of the analysis would then require that the application of this general tax policy *severely* frustrate the non-tax policy with which it overlaps.

The classic public policy tax doctrine required legislative identification of the non-tax public policy. Historically, the Service *has* taken the public policy underlying judicial decisions and federal, state, and local legislation into account in the formulation of tax policy in certain areas. The following discussion examines how the Service has historically applied non-tax policy in some of these areas.

²⁴³ *Tax Executives Institute-Department of the Treasury Liaison Meeting* (Nov. 19, 1996), reprinted in *Agenda for TEI-Treasury Liaison Meeting*, 96 Tax Notes Today 228-32 (Nov. 22, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit. 96 TNT 228-32) (warning Treasury that "the dearth of generally applicable guidance places taxpayers in the position of having to seek clarification of any challenged expense deduction, and may well open the door to Congress's micromanaging the IRS's interpretation of the tax law").

A. *Previous Applications of Non-Tax Public Policy*

1. *Public Policy Doctrine: Ab Initio*

As early as 1919, Treasury took broad non-tax policy into account in fashioning remedial rules as to involuntary conversions due to World War I. Without a statutory basis, the Revenue Act of 1918 Regulations provided that the amount received by a taxpayer (a) for property lost or destroyed in whole or in part through fire, storm, shipwreck, or other casualty, or (b) in requisition or eminent domain proceedings resulting in a loss of title to property (or voluntary conveyance induced by reason of an imminent proceeding for such a purpose) was taxable only to the extent gain exceeded the amount actually and reasonably expended to "replace or restore the property substantially in kind, exclusive of any expenditures for additions or betterments."²⁴⁴

Treasury's *Notes on the Revenue Act of 1918* recommended a statutory amendment providing for a "replacement fund for the replacement in kind of lost or damaged property."²⁴⁵ These *Notes* clearly rested their involuntary conversion proposal on a general hardship policy.²⁴⁶ This public policy consideration, spawned by the flurry of involuntary conversions from the war, can be seen in the Revenue Act of 1921, retroactively applicable in this instance to

²⁴⁴ Treasury Department, *Regulations 45 Relating to the Income Tax and War Profits and Excess Profits Tax Under the Revenue Act of 1918*, H.R. Doc. No. 1826, 65th Cong., 3d Sess., Art. 47, 26-27 (1919).

²⁴⁵ Secretary of Treasury, *Notes on the Revenue Act of 1918*, § 213(e) (1919).

²⁴⁶ See *id.* Section 213(e) provides:

During the war, in the case of property requisitioned for war purposes by the Government and property lost or destroyed in whole or in part through war hazards, especially in the case of ships, it happened that at the time of requisition or loss the market value of such ships was considerably increased over the cost or market value as of March 1, 1913, in cases in which the property was acquired prior to that date, and that in practically no case would the taxpayer have been willing to sell the property for its appraised value at the time of requisition or loss.

To require the taxpayer to pay income and war profits and excess profits taxes upon the difference between the cost or market price on March 1, 1913, and the compensation received at the time of requisition or loss would have been to take such a large proportion of the amount received for the vessel that, although the owner desired to replace the same, the taking of the tax by the Government would have made it impossible in practically every instance.

Id.

1918.²⁴⁷ This Act provided relief to taxpayers whose property was converted for government use, by allowing a deduction for amounts the taxpayer expended from the proceeds of “compulsorily or involuntarily” converted property or its equivalent “in the acquisition of other property of a character similar or related in service or use to the property so converted.”²⁴⁸ Thus the Act clearly showed an early congressional recognition of the utility of using non-tax public policy to help shape tax policies that would best serve the public interests.

2. Public Policy Doctrine: Deduction Disallowance of Penalty Payments

The most widely known tax rule that takes non-tax policies into account is the common law frustration of public policy doctrine that limits the allowance of certain deductions otherwise allowable based upon the literal language of the Code. In one instance, the public policy at stake was the deductibility of illegal payments and penalties. This doctrine’s limitation was initially a judicial gloss on the section 162²⁴⁹ term “necessary,”²⁵⁰ which the Service later adopted,²⁵¹ based upon the Chief Counsel’s Office acknowledgment that the ensuing flood of lower court decisions were difficult to

²⁴⁷ See *Pelican Bay Lumber Co. v. Blair*, 31 F.2d 15, 16 (9th Cir. 1929), *cert. denied*, 279 U.S. 870 (1929).

²⁴⁸ Revenue Act of 1921, ch. 136, § 214(a)(12), 42 Stat. 227, 241 (1921). Alternatively, a deduction was provided for the acquisition of 80% or more of the stock or shares of a corporation owning such other property or in the establishment of Commissioner approved replacement fund. See *id.*

²⁴⁹ I.R.C. § 162(a) (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .”).

²⁵⁰ See *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 33-34 (1958) (holding that an expenditure otherwise qualifying as a business expense under section 162 could not qualify as necessary “if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof”).

²⁵¹ See Rev. Rul. 54-27, 1954-1 C.B. 44; see also G.C.M. 38,611 (Jan. 16, 1981), *considering* Rev. Rul. 82-127, 1982-1 C.B. 215, *declaring obsolete* Rev. Rul. 54-27, 1954-1 C.B. 44.

reconcile²⁵² and that subsequent Supreme Court cases only confused matters further.²⁵³

In the Tax Reform Act of 1969,²⁵⁴ Congress's intent to codify a *limitation* of the public policy doctrine as to ordinary and necessary business expenses came to fruition in the amendment of section 162(c)²⁵⁵ and the addition of sections 162(f) and (g).²⁵⁶ These sections operated to deny deductions for certain illegal bribes, kickbacks, and other payments;²⁵⁷ deductions for "any fine or similar penalty paid to a government for the violation of any law;"²⁵⁸ and deductions of certain treble damage payments under the antitrust laws.²⁵⁹ The 1969 Senate Finance Committee Report explained the Committee's rationale for the changes and additions under sections 162(c), (f), and (g) as provisions, designed "for the denial of the deduction for payments in these [section 162(c), (f), and (g)] situations . . . deemed to violate public policy [which are] intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."²⁶⁰

²⁵² See G.C.M. 36,671 (Mar. 30, 1976) (citing "Dwight, *The Doctrine of Public Policy*, 46 *Taxes* 377 (1968); Gordon, *The Public Policy Limitation on Deductions from Gross Income: A Conceptual Analysis*, 43 *Indiana L.J.* 406 (1968); Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 *Tax L. Rev.* 665 (1965); Lamont, *Controversial Aspects of Ordinary and Necessary Business Expenses*, 42 *Taxes* 808 (1964); Lindsay, *Tax Deductions and Public Policy*, 41 *Taxes* 711 (1963); and Note, *Business Expenses, Disallowance and Public Policy: Some Problems of Sanctioning With the Internal Revenue Code*, 72 *Yale L.J.* 108 (1962)"); see also O.M. 18,744 (Dec. 22, 1976), *Illegal Bribes, Kickbacks and Other Payments*; John Y. Taggart, *Fines, Penalties, Bribes and Damage Payments and Recoveries*, 25 *Tax L. Rev.* 611 (1970).

²⁵³ See James J. Freeland et al., *Fundamentals of Federal Income Taxation*, 539-44 (9th ed. 1996), and Paul R. McDaniel et al., *Federal Income Taxation*, 374-89, 484-85 (Foundation Press 3d ed. 1994), for an excellent summary of the modern rules.

²⁵⁴ Pub. L. No. 91-172, 83 Stat. 487 (1969).

²⁵⁵ I.R.C. § 162(c). The Revenue Act of 1971 further amended section 162(c). See Pub. L. No. 92-178, 85 Stat. 497 (1971).

²⁵⁶ I.R.C. §§ 162(f), (g). Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13222, 107 Stat. 312, 477 (1993); in a similar vein disallows any deduction for lobbying expenses in amended section 162(e).

²⁵⁷ I.R.C. § 162(c).

²⁵⁸ I.R.C. § 162(f).

²⁵⁹ I.R.C. § 162(g).

²⁶⁰ S. Rep. No. 91-552, at 274 (1969).

One of the problems inherent in Congress's implementation of public policy in the formulation of tax policy, however, is the Service's propensity not to follow these limitations when applying that public policy. For example, despite the Committee's limitation on public policy as a reason to disallow deductions in situations beyond those addressed in sections 162(c), (f), and (g), the Service readily ruled that its disallowance of a section 165 loss, based on a violation of public policy, remained unchanged by the Tax Reform Act amendments and stated congressional policy.²⁶¹ Moreover, the Service extended the same arguments it traditionally used to support its public policy gloss on "necessary" even further by finding that expenses resulting from behavior which violated public policy were not "ordinary" business expenses in that they were not normal, common, usual, or customary.²⁶² Ultimately this tack resulted in holdings such as that in *Raymond Bertolini Trucking Co. v. Commissioner*,²⁶³ where the Tax Court disallowed a deduction for regular kickback payments which violated a (decidedly unenforced) Chicago anti-kickback statute because these costs were not "ordinary" in the public policy sense.²⁶⁴ This holding produced precisely the same result as application of a common law public policy doctrine that Congress had sought to bar in 1969, which probably underlies the Sixth Circuit's reversal of the Tax Court.²⁶⁵

²⁶¹ See G.C.M. 36,965 (Dec. 22, 1976), considering Rev. Rul. 77-442, 1977-2 C.B. 264 ("Our position is that the amendments to Code § 162 do not limit public policy considerations applicable to other sections of the Code. . . ."); see also Rev. Rul. 77-126, 1977-1 C.B. 48, considered in G.C.M. 36,665 (Mar. 26, 1976); accord, Rev. Rul. 81-151, 1981-1 C.B. 74, considered in G.C.M. 38,547 (Oct. 24, 1980); Rev. Rul. 81-24, 1981-1 C.B. 175 and Rev. Rul. 82-74, 1982-1 C.B. 110, considered in G.C.M. 37,985 (June 19, 1979); G.C.M. 36,962 (Dec. 22, 1976) and attached O.M. 18,744 (Dec. 22, 1976), *Illegal Bribes, Kickbacks and Other Payments*.

²⁶² See O.M. 18,744 (Dec. 22, 1976), *Illegal Bribes, Kickbacks and Other Payments*, *supra* note 255. Perhaps the better position is set forth in Judge Sterrett's dissent in *Mazzei v. Commissioner*, 61 T.C. 497, 506 (1974) (Sterrett, J., dissenting) ("[W]hen a deduction should be denied should remain under the control of Congress.") (emphasis omitted). Judge Tannenwald's concurring opinion illustrates the attraction of the public policy doctrine to the fact finder. See *id.* at 504 (Tannenwald, J., concurring) ("The obvious reply to the contention that my approach may involve 'the task of grading criminal activity' is that, . . . the courts will simply be dealing with another instance of line-drawing which is part of the daily grist of judicial life."); see also McDaniel et al., *supra* note 253, at 484-85.

²⁶³ 45 T.C.M. (CCH) 44 (1982), *rev'd*, 736 F.2d 1120 (6th Cir. 1984).

²⁶⁴ 45 T.C.M. (CCH) at 50.

²⁶⁵ See *Raymond Bertolini Trucking Co. v. Commissioner*, 736 F.2d 1120 (6th Cir. 1984).

3. Public Policy Doctrine: Charitable Exemptions and Illegal Purpose

A second area of taxation in which public policy has played a major role is qualification as a charitable organization under section 501(c)(3).²⁶⁶ This area actually provided the most natural niche of all for public policy, given the fact that the Code does not define "charitable . . . purposes."²⁶⁷ Instead, the regulations use the "broad outlines of 'charity' as developed by judicial decisions" as the benchmark for the tax-exempt purposes set forth in section 501(c)(3).²⁶⁸ The Service interpreted these common-law decisions as establishing the notion that neither the purposes nor operations²⁶⁹ of an exempt charity could be illegal or contrary to public policy.

The Service also has relied upon the general trust law prohibition of purposes and activities that are illegal or contrary to public policy as an interpretive tool in justifying the denial of tax-exempt status to organizations.²⁷⁰ In Revenue Ruling 71-447, the Service utilized the general common law of charitable trusts to determine that racially discriminatory private schools were not described in section 501(c)(3) because they violated a clear federal public policy against racial discrimination in education.²⁷¹ The Supreme Court in effect confirmed this determination in *Bob Jones*

²⁶⁶ I.R.C. § 501(c)(3).

²⁶⁷ *Id.*

²⁶⁸ Reg. § 1.501(c)(3)-1(d)(2) (1996).

²⁶⁹ General Counsel Memorandum 37,858 describes the operational test for determining tax-exempt status:

[I]f the overall consequences of carrying on such activities would be contrary to public policy, the organization carrying on the activities will not qualify for exemption under section 501(c)(3) regardless of the legality of the activities. For instance, although the granting of scholarships is, in and of itself, legal and not contrary to public policy, such activity will be considered contrary to public policy if the scholarships are limited in such a way that the overall effect of the activity is to promote racial discrimination in education.

G.C.M. 37,858 (Feb. 16, 1979).

²⁷⁰ See Restatement (Second) of Trusts § 377 cmt. c (1959) (noting that a charitable trust cannot be created for a purpose which is illegal or contrary to public policy); Iva A. Scott, *The Law of Trusts* § 377 (4th ed. 1989) (stating that where a policy is articulated in a statute making certain conduct a criminal offense, a trust is illegal if its performance involves such criminal conduct or tends to encourage such conduct).

²⁷¹ Rev. Rul. 71-447, 1971-2 C.B. 230.

University v. United States,²⁷² which revoked the tax-exempt status of the university due to the school's prohibition of interracial relationships.²⁷³

The Service has also indicated that it will focus upon whether the activities of purportedly exempt organizations are contrary to a *fundamental* public policy. In outlining its analysis of the public policy doctrine, the Service relied upon the Supreme Court's opinion in *Bob Jones University* for guidance, stating:

We believe that in *Bob Jones* the Court set a standard that the public policy involved must be fundamental and there must be no doubt that the activity involved is contrary to that fundamental public policy.

In beginning our analysis of whether the activities of the Association violate a fundamental public policy we must first determine whether the public policy involved is clear and fundamental. Then consideration must be given to whether the specific activities of the Association violate that fundamental public policy.²⁷⁴

The Service, however, has yet to clearly set forth a consistent definition and scope of what constitutes a fundamental public policy. The Service has stated that it only rarely denies section 501(c)(3) status "based on illegal acts or violations of clear federal public policy outside the area of racial discrimination in education."²⁷⁵ While the frequency of such an application of public policy may not be great, the scope of public policies considered in General Counsel Memoranda (and more rarely published rulings

²⁷² 461 U.S. 574 (1983).

²⁷³ See *id.* at 605; see also Miriam Galston, *Public Policy Constraints on Charitable Organizations*, 3 Va. Tax Rev. 291 (1983) (criticizing the Court's reading of the trust law doctrine in *Bob Jones* while supporting the Court's conclusion to deny the school's section 501(c)(3) exemption under a broader theory of public policy).

²⁷⁴ G.C.M. 39,800 (Oct. 25, 1989); see also G.C.M. 36,797 (July 23, 1976) ("Formal legislative action on the national level is commonly regarded as a controlling determinant of Federal public policy with regard to the subject of such legislation."); see, e.g., *Building Serv. Employees Int'l Union v. Gazzam*, 339 U.S. 532, 537-38 (1950) (affirming its earlier pronouncement in *Twin City Pipe Line Co. v. Harding Glass Co.*, 283 U.S. 353, 357 (1931) (stating that it is primarily "for the lawmakers to determine the public policy of the State.")).

²⁷⁵ G.C.M. 39,800 (Oct. 25, 1989).

and cases) in fact is broad.²⁷⁶ Even though a strict definition of “fundamental” is lacking, an argument can be made that the legislative and judicial recognition prong of the suggested analysis is tantamount to the requirement that only fundamental public policy should be considered.

4. Public Policy Doctrine: Preserving Statutory Subsidies

The public policy doctrinal area that is conceptually closest to the cyclical aircraft overhaul tax issue arose from tax shelter preferences used by individuals to offset income from other activities and investments. Repeatedly during the 1970's, the Service modified certain doctrines that were a part of its tax policy in order to avoid thwarting Congress's clear intent of providing a particular subsidy or tax preference. From the perspective of this article, the determinative factor was Congress's awareness of the overlap of public policy and tax policy as evidenced by these subsidies.

One example of the Service's reversal of tax policy in recognition of congressional public policy occurred in the waning days of the Ford Administration. In 1977, Commissioner Don Alexander proposed anti-tax-shelter revisions to the “association” (an entity tax classification) regulations which would have taxed many pass-through²⁷⁷ limited partnerships as corporations.²⁷⁸ These revisions

²⁷⁶ See, e.g., Rev. Rul. 75-384, 1975-2 C.B. 204 (holding that an anti-war protest organization could not be exempt because its primary activity was sponsoring protest demonstrations in which participants were urged to commit violations of local ordinances and breaches of public order); G.C.M. 39,862 (Nov. 22, 1991) (“[E]ngaging in conduct or arrangements that violate the anti-kickback statute is inconsistent with continued exemption as a charitable hospital.”); G.C.M. 39,800 (Oct. 25, 1989) (determining that insufficient evidence existed to find a violation of fundamental public policy of the First Amendment of the United States Constitution from a tax-exempt organization paying the salary of a public high school teacher who taught three courses on the Bible as literature and history); G.C.M. 37, 858 (Feb. 16, 1979) (holding that rent strikes, economic boycotts, picketing, and mass demonstrations, although legal, must be closely analyzed to determine whether they are contrary to public policy); G.C.M. 36,797 (July 23, 1976) (finding that an apprentice training school that gave a preference to Native Americans was exempt since it carried out national public policy as provided for by federal legislation).

²⁷⁷ In this context the essence of a pass-through entity is the ability of the owner to deduct currently the owner's “share” of the entity's tax losses, which are “passed through” to the owner. I.R.C. §§ 702(a), 704(a), and 704(d).

²⁷⁸ See Prop. Reg. § 301.7701-1(b), (c), 42 Fed. Reg. 1038-44 (1977); see generally Lee, *supra*

would have ended the use of tax losses from limited partnerships' real estate activities as passive offsets to partners' income from services and investments.²⁷⁹ However, the regulations were "hastily withdrawn" upon the Department of Housing and Urban Development's (HUD) protest that such a revision would hinder its attempts to encourage investments in low-income housing.²⁸⁰ In essence, Treasury subordinated its application of the tax policy of "corporate resemblance"²⁸¹ to HUD's policy of encouraging private investment in low-income housing.

The Service revealed its rationale behind this subordination of tax policy to HUD's non-tax policy in Revenue Ruling 79-300.²⁸² In this ruling, the Service explained that the application of the section 183²⁸³ profit motive requirement to low-income housing projects, qualifying under section 236 of the National Housing Act [hereinafter NHA section 236], would frustrate the congressional intent of encouraging the construction of low-income housing.²⁸⁴ Most significantly, the ruling noted that Congress had been aware

note 114, at 61 n.9.

²⁷⁹ See Prop. Reg. § 301.7701-1(b), (c). This revision would have had the same immediate practical effect as the Passive Activities Loss [hereinafter PAL] rules eventually enacted in 1986 (and much more adverse long-term effect since PAL only suspends the passed-through losses, whereas association treatment traps the losses inside the entity which is taxed as a C corporation). See I.R.C. § 469.

²⁸⁰ See *Withdrawal of Notice of Proposed Rule Making*, 42 Fed. Reg. 1489 (1977); Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U. L. Rev. 408, 410 (1977); Alan S. Oser, *Battle is Joined on I.R.S. Partnership-Corporation Ruling*, N.Y. Times, Jan. 7, 1977, at A11.

²⁸¹ See *Larson v. Commissioner*, 66 T.C. 159, 185 (1976) (holding that a tax shelter limited partnership "failed" the mechanical test of corporate resemblance under the regulations because it lacked continuity of life and limited liability and hence was not an association taxable as a corporation as the IRS asserted).

²⁸² 1979-2 C.B. 112, *considered in* G.C.M. 38,117 (Sept. 28, 1979).

²⁸³ I.R.C. § 183 (setting forth the "hobby loss" rules requiring that an activity be engaged in for profit for the deductibility of losses under sections 162, 167, and 212); see generally *Start-up Costs and Clear Reflection of Income*, *supra* note 53.

²⁸⁴ Rev. Rul. 79-300, 1979-2 C.B. 112, 113. In this ruling, the Service stated:
The above legislative history indicates that in limiting rental charges, Congress assumed deductions of tax losses would be allowed to encourage investment in projects providing decent housing for low or moderate income families under the Act. Consequently, application of section 183 of the Code to the present case would frustrate congressional intent in enacting the housing legislation. Therefore, section 183 will not be applied to disallow losses incurred in activities to provide low and moderate income housing under section 236 of the National Housing Act.

Rev. Rul. 79-300, 1979-2 C.B. 112, 113.

when enacting the enabling legislation for the NHA section 236 program that: (a) section 236 project partnerships likely would not realize any economic profit due to limitations on the amounts chargeable as rent and distributable in cash to partners and (b) a partner's investment return in such partnerships would compare adequately with returns on other investments only if tax losses could be taken into account.²⁸⁵ The General Counsel Memorandum accompanying the ruling explained that "[c]onsequently, the Commissioner has made a policy decision that Section 183 will not be applied to disallow losses incurred by partners engaged in the construction and operation of low and moderate income housing under Section 236 of the National Housing Act."²⁸⁶ This explanation sounds more like "administrative convenience,"²⁸⁷ but the ruling clearly adopted a public policy rationale that the Service later extended to other low and moderate income housing partnerships where the expectations of economic profits were doubtful.²⁸⁸

²⁸⁵ *Id.*

²⁸⁶ G.C.M. 38,117 (Sept. 28, 1979). In the litigation context of *Blitzer v. United States*, 684 F.2d 874 (Ct. Cl. 1982), the offices of the Commissioner and the Chief Counsel as well as the representatives of Treasury decided that the Service would not rely on an "economic reality" to disallow losses from such activities. G.C.M. 38,117 (Sept. 28, 1979). The Department of Justice agreed. *Id.*

The section 236 program is designed to provide decent housing for many low and moderate income families who otherwise could not afford it. As the above legislative history indicates, the program relies on certain tax benefits to encourage private investors to construct and manage low and moderate income housing projects. If section 183 were applied to deny these tax benefits to the section 236 projects, few, if any, would invest in these projects. As a result, the goal of building more low and moderate income housing would not be fulfilled.

When Congress enacted section 183, it recognized that this section was a broad provision that might technically encompass certain situations to which it was not intended to apply. The Committee on Finance expressed its desire that section 183 be reasonably administered and stated that the Service should limit the disallowance of the deduction of losses under this provision to cases in which "it is generally recognized that this is appropriate." S. Rep. No. 91-552, 91st Cong., 1st Sess., 103-104 (1969), 1969-3 C.B. 423, 490.

G.C.M. 38,117 (Sept. 28, 1979).

²⁸⁷ See *supra* notes 81-96 and accompanying text.

²⁸⁸ See, e.g., P.L.R. 85-31-065 (May 9, 1985). The letter ruling sets forth the Service's conclusion that:

[T]he fact that individual dwelling units may be sold under options to low-income tenants at a price which limits the Partnership's profit will not cause the Project to be treated as "an activity not engaged in for profit" under section 183(a) of the Code, and

*B. Application of the Public Policy Doctrine to Cyclical
Aircraft Maintenance Costs*

In order for the FAA safety policy to be considered in the tax treatment of cyclical aircraft maintenance costs, the model analysis set forth earlier in this article requires that two tests be met. First, Congress or the courts must have clearly identified an overlap of the FAA safety policy with the tax policy applicable to the treatment of these costs. Next, the application of the Service's tax policy, with respect to the capitalization of these maintenance costs, must severely frustrate the FAA's safety policy underlying the required cyclical overhauls of aircraft engines. As the subsequent discussion indicates, the airline industry's case is much stronger as to the former requirement than the latter.

*1. Clear Identification of Overlap of IRS and FAA Policies as to
Maintenance Costs*

History suggests that expressions not subject to a formal vote of Congress or Committee are not sufficient to trigger the public policy doctrine.²⁸⁹ Based on this, Chairman Archer's letter to

the Service will not use the "not for profit" argument to deny related deductions under sections 162, 165, 167 and 212.

Id.

²⁸⁹ For instance, the Service apparently ignored an October 7, 1987 letter to House Ways and Means Chairman Rostenkowski, D-Ill., signed by *all* of the other members of the Committee. See Letter from Thomas Downey et al., Representative, U.S. House of Representatives, to Dan Rostenkowski, Chairman, House Ways and Means Committee (Oct. 7, 1987), reprinted in *Ways and Means Members as for Technical Correction to Relieve Free-Lance Writers from the New Uniform Capitalization Rules*, 87 Tax Notes Today 197-10 (Oct. 9, 1987) (LEXIS, FEDTAX lib., TNT file, elec. cit. 87 TNT 197-10). The letter requested the Chairman's "assistance in reconsidering the application of the uniform capitalization rules of section 263A, added by the Tax Reform Act of 1986, to the expenses of professional free-lance creators, such as writers and photographers." *Id.* The letter described the administrative issues arising from the application of income forecasting in depreciation to writer prepublication expenses:

As noted in our report accompanying H.R. 3838, it was not intended that the uniform capitalization rules would apply "where application of the rules might be unduly burdensome". (H.R. Rep. No. 99-426, p. 625). In fact very substantial administrative and accounting burdens, including allocation and income forecasting requirements that are unlikely to be manageable by either taxpayers or the Internal Revenue Service would be imposed on professional creators such as writers and photographers by the uniform capitalization requirements. In the case of free-lance writers, for instance, each of a writer's legitimate professional expenses must be "allocated" among all pending

Commissioner Richardson²⁹⁰ and the bipartisan Ways and Means Committee Members' letter to Treasury Secretary Robert Rubin,²⁹¹ both of which criticized the Service's failure to consider FAA safety policy in its treatment of aircraft maintenance costs, would *not* satisfy the suggested prerequisite of clear congressional identification of the overlapping policies.

The discussion in the 1996 Conference Committee Report, however, probably would meet the clear identification requirement of the analysis.²⁹² The major question with respect to the committee discussion is whether congressional recognition of the overlap of tax and non-tax policy was established too late. Under classic rules of statutory construction, the views of a later Congress cannot affect the meaning of a term enacted by an earlier Congress unless the act of the earlier Congress is being statutorily amended

works and then recovered based on the projected profitability of the novel, article or poem. The task of allocating the expense of each telephone call and expenditure for supplies among each pending project is nearly impossible. In addition, the requirement of estimating the likely profitability of a project that has only begun is equally difficult. In each case little more than guesswork is involved. . . . In sum, we think there is little question that any theoretical benefit of applying capitalization requirements to the expense of professional free-lance creators such as authors or photographers is far-outweighed by the countervailing considerations of the significant burden imposed on these taxpayers, the introduction of material uncertainty in the computation of tax liability by these individuals, and the unfairness of singling out this group of individuals who earn income from their personal efforts.

Id. Action by the Service came only after Congress began to act in 1988. *See infra* notes 292-93 and accompanying text.

²⁹⁰ *See* Archer Letter, *supra* note 9.

²⁹¹ *See* Letter from Mac Collins et al., *supra* note 13. The Committee members urged reversal of the T.A.M. stating:

This Congress and the Administration, through the Federal Aviation Administration, is working hard to enhance the safety of the traveling public. The United States airline industry has the best safety record in the world. We do not believe the Administration intends to increase the cost of ensuring the public safety by making it more expensive to perform routine maintenance and repair of aircraft. Clearly the IRS is overstepping its authority in attempting to impose this tax penalty on air safety.

We are troubled by the IRS's change of policy without the benefit of legislation or rulemaking. If the IRS intends to implement a change in policy of this magnitude, we believe the change should be the subject of hearings before the Committees of appropriate jurisdiction in the Congress.

Letter from Mac Collins et al., *supra* note 13.

²⁹² *See* H.R. Conf. Rep. No. 104-863, at 1149 (1996), 142 Cong. Rec. H11644, H12009 (daily ed. Sept. 28, 1996). *See supra* notes 24 and 28.

by the later Congress.²⁹³ This rule of statutory construction should probably not apply here because the issue is not the intended meaning of a tax term, but rather identification of an overlap of tax and non-tax policies. The Service's actions in 1988 as to writers' prepublication costs indicate that this form of congressional identification of non-tax and tax policy overlap may be sufficient.²⁹⁴

Notice 88-62 authorized writers to elect to capitalize prepublication costs and then depreciate 50% of these costs in the tax year in which they were paid and 25% in each tax year thereafter.²⁹⁵ The Notice was based on a standard expressed in the 1986 legislative history to section 263A that sought to reduce the administrative complexities of complying with the Uniform Capitalization Rules.²⁹⁶ The Service reasoned that the three-year depreciation safe harbor substantially reduced the administrative difficulties associated with compliance by eliminating the necessity to amortize the capitalized costs under the income forecast method.²⁹⁷ The Service's application of this standard in Notice 88-62 is germane to the Service's treatment of cyclical aircraft maintenance costs in two ways. First, the Service's recognition of the policy enunciated in the 1986 legislative history shows its reliance on congressional identification of the overlap of policies. Second, it is also indirect support for the exercise of a broad mandate in allowing a current deduction, under section 446(b)'s clear reflection of income standard, at a point sooner than such deduction would otherwise be allowed—essentially the standard this article advocates for capitalization under section 263.

²⁹³ See *Rough Justice*, *supra* note 16.

²⁹⁴ See Notice 88-62, 1988-1 C.B. 548.

²⁹⁵ *Id.*

²⁹⁶ See S. Rep. No. 99-313, at 142 (1986).

²⁹⁷ Notice 88-62, 1988-1 C.B. 548. The Service noted:

The legislative history of section 263A indicates that Congress was aware of the possible administrative complexities resulting from the application of the uniform capitalization rules to businesses. In response to this concern, Congress granted the Treasury Department authority under section 263A to "adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits." S. Rep. 99-313, 99th Cong. 2d Sess. 141-42 (1986).

Id.

2. Severe Frustration of the FAA Safety Policy

The argument that the current tax policy with respect to the treatment of cyclical aircraft maintenance costs would severely frustrate the FAA's airline safety policy is weaker than the argument supporting the congressional identification of policy overlaps. Allowing a current deduction for these cyclical maintenance costs will not free up revenues to spend on airline safety as Chairman Archer has implied because the airline industry is currently deducting these costs anyway.²⁹⁸ The airlines economically must perform the required FAA safety inspections and overhauls regardless of the tax consequences. Therefore, revoking the Service's capitalization rule as set forth in the T.A.M. still would not allow the airlines to reduce safety costs below FAA standards, nor would it increase revenues likely allocable to increased airline safety since the airlines are unlikely to take safety measures above those required by the FAA.

The argument that allowing a current deduction for cyclical maintenance costs would be a revenue loser for the federal government is also an anomaly. Assume (as the Ways and Means Committee does) that all airline industry taxpayers have been expensing the cost of FAA-mandated aircraft engine overhauls in the year these costs were incurred. Thus the costs relating to the overhaul of any one engine are incurred and deducted once every four years. Under the pay-go rules,²⁹⁹ the ideal rule of capitalizing and depreciating the overhaul costs would be included in the base line so that a statute allowing a current deduction would be counted as a revenue loser. Assuming that the correct depreciation period is four years and that one quarter of the engines are overhauled each year, the deduction in the fourth year would be the same under both approaches. Thus, in three to four years the current airlines would have the same amount of deductions for depreciation as they would if they had currently expensed the costs of the overhauls. Such a result seems to only bolster the idea that the Service's approach is indeed more-trouble-than-it's-worth, even without considering the possible frustration of non-tax policy.

²⁹⁸ See *supra* text accompanying note 12; *supra* notes 169-71 and accompanying text.

²⁹⁹ See *supra* note 25.

Despite the weakened severe-frustration prong of the public policy doctrine analysis in this case, reading the public policy doctrine together with a handful of rulings, in which the Service did not apply a general tax rule because it would frustrate a non-tax congressional policy,³⁰⁰ could support the Service's adoption of a position that would take FAA safety policies into account and reverse the T.A.M. Further consideration of non-tax public policy in light of rough justice current deduction rules would tend to allow factors, such as the fact that the interval of recurrence is only one year longer than a three-year cycle which often has been found to support current deduction³⁰¹ and the fact that the amount of the costs involved is relatively de minimis,³⁰² to tip the scales in favor of a current deduction. Whether the Service's tax policy severely frustrates FAA airline safety policy is an area that requires more attention; however, any consideration of non-tax policy in this area should be explicit.

Based upon comments at the VTSG Spring 1997 Symposium, it is unlikely that any frustration of public policy argument here would carry the day in litigation in the Tax Court. Nor is it likely to be very appealing to Chief Counsel.

C. *Negotiated Rulemaking: Evolution from Notice 96-7*

Negotiated rulemaking constitutes an open process in which representatives of the administrative agency and various pressure groups work together to find a compromise solution to the problem facing the administrative agency.³⁰³ Congress has on occasion

³⁰⁰ See *supra* discussion, part IV.A.

³⁰¹ See *supra* discussion, part II.B.2.

³⁰² See *supra* discussion, part II.B.1.

³⁰³ See Philip J. Harter, *Negotiating Regulations: A Cure for Malaise*, 71 Geo. L.J. 1 (1982); Henry H. Perritt, Jr., *Administrative Alternative Dispute Resolution: The Development of Negotiated Rulemaking and Other D14* Pepp. L. Rev. 863 (1987); Lawrence Susskind & Gerard McMahon, *The Theory and Practice of Negotiated Rulemaking*, 3 Yale J. on Reg. 133 (1985); Susan Rose-Ackerman, *Consensus Versus Incentives: A Skeptical Look at Regulatory Negotiation*, 43 Duke L.J. 1206 (1994); Daniel J. Fiorino, *Dimensions of Negotiated Rulemaking: Practical Constraints and Theoretical Implications*, in *Conflict Resolution and Public Policy* 141 (Miriam K. Mills ed., 1990); Administrative Conference of the United States, *Negotiated Rulemaking Source Book* 1 (1990).

mandated such endeavors.³⁰⁴ In the tax arena negotiated rulemaking has been much more informal. Probably the most significant examples of informal negotiated regulation or its functional equivalent are the "collegial" tax reforms of the late 1970's and early 1980's. Staff from Treasury and the tax writing committees at times met with representatives from the tax professional groups (e.g., ABA and AICPA) to agree upon tax reform rules to be presented to the committees against a backdrop of public hearings in which the more traditional, or at least overt, pressure groups could voice their view on the reforms.³⁰⁵

In mid-1979 the Chairs of the House Ways and Means and Senate Finance Committees introduced a bill to clarify and simplify section 453, intended as the first of a number of discrete simplification bills to be introduced over the next several years.³⁰⁶ Treasury's Deputy Tax Legislative Counsel, Hank Gutman, saw this bill as an "important barometer of the fortunes of the simplification effort."³⁰⁷ The 1979 installment reporting bill, largely drafted by Treasury,³⁰⁸ ran into much opposition from pressure groups in the 1979 Hearings.³⁰⁹ House Ways and Means Chairman

³⁰⁴ The Environmental Protection Agency was one of the first agencies to institutionalize this process and provide problem selection criteria. 48 Fed. Reg. 7494 (1983); see also 5 U.S.C. §§ 561-570 (Supp. V 1994).

³⁰⁵ See Howard J. Hoffman, *The Role of the Bar in the Tax Legislative Process*, 37 Tax L. Rev. 411 (1982) (Examples: Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980); Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (1980); Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982); and Limitation on Net Operating Loss Carry Forwards enacted in Tax Reform Act of 1986, Pub. L. No. 99-514, § 621, 100 Stat. 2085, 2254 (1986), where no consensus was reached, but the tax writing committees struck their own balance). The more recent section 197, Treatment of Intangibles, enacted in Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312, 532 (1993), had more extensive public hearings and more hard data on actual practice than prior reform efforts, but again apparently less negotiated-regulation, with the tax writing committees simply dictating the result.

³⁰⁶ H.R. 3899, 96th Cong. (1979); see Hoffman, *supra* note 305, at 495-96.

³⁰⁷ *Installment Sales, Subtitle F Simplification, and Miscellaneous Tax Measures: Hearings on H.R. 2536, H.R. 2770, H.R. 3660, H.R. 3899, H.R. 3900, H.R. 42001, and H.R. 4726 Before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm.*, 96th Cong. 33 (1979) (prepared statement of Deputy Tax Legislative Counsel Harry L. Gutman) [hereinafter 1979 House Hearings].

³⁰⁸ Hoffman, *supra* note 305, at 507.

³⁰⁹ *Tax Simplifications: Hearings on S. 1062 and S. 1063 before the Subcomm. on Taxation and Debt Management Generally of the Sen. Finance Comm.*, 96th Cong. 50 (1979) (statement of Senator Harry Byrd, D-Va.); 1979 House Hearings, *supra* note 307, at 81 (statement of

Dan Rostenkowski, D-Ill., then directed Treasury to work with representatives from the Bar Associations and the AICPA to come up with a mutually acceptable reform provision. They did, in a consensual process³¹⁰ ably spearheaded by Professor Martin Ginsburg.³¹¹

More recently, the development of market segment understandings³¹² and some Industry Specialization Program ("ISP") coordinated issue papers constitute further examples of informal negotiated regulation.³¹³ Lee understands, from an Eastern Virginia CPA/attorney involved on a national level with tax administration in a professional society, that at least one Market Segment Specialization Program ("MSSP") guide was also developed in this manner.

Professor Martin Ginsburg) ("only truly controversial provision" is the barring of installment reporting to sales to a related party); 1979 House Hearings, *supra* note 307, at 71, 74-75, 78-79 (statement and prepared statement of Herbert J. Lerner, Chairman Tax Accounting Subcommittee, Federal Tax Division, American Institute of Certified Public Accountants). Professor Ginsburg had advocated that ratable basis recovery and not cost recovery should obtain wherever the total purchase price is fixed. Martin D. Ginsburg, *Taxing the Sale for Future Payment*, 30 Tax L. Rev. 469, 493-94 (1975).

³¹⁰ Staff of the Joint Comm. on Taxation, 96th Cong., 2d Sess., *Description of H.R. 6883 Relating to Revision of Installment Sale Reporting Rules* 1 (Comm. Print 1980) [hereinafter 1980 Staff Description]; *Miscellaneous Tax Bills IX: Hearings before the Subcomm. on Taxation and Debt Management Generally of the Senate Fin. Comm.*, 96th Cong. 97 (1980) (Prepared Statement of Deputy Assistant Secretary (Tax Legislation) Daniel Halperin) ("The objective was to produce a revised bill incorporating the proposals made and resolving adequately the issues raised in the testimony and comments received by the Subcommittee. Treasury, along with those groups whose representatives were willing to donate the requisite time and effort to engage in constructive dialogue were, thereafter, intimately involved with the staff in the development of the revised installment sale bill.").

³¹¹ Hoffman, *supra* note 305, at 499-500 ("Professor Martin D. Ginsburg, who represented the two New York tax groups and was vice chairman of the Special Committee on Simplification was the most active participant, initiating the informal contacts and subsequently serving as the focal point for the discussion, as well as liaison among the tax groups and the government."); *Installment Sales Revision Act of 1980 and Minor Tax Bills: Hearings on H.R. 6883, H.R. 5616, H.R. 5729, H.R. 6039, H.R. 6140, H.R. 6247, H.R. 6824, and H.R. 7009 before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm.*, 96th Cong., 3, 23, 26, 29 (statements of Chairman Dan Rostenkowski, D-Ill.; Harry Gutman); *id.* at 36-37 (statement of Charles Walker, Chairman Section of Taxation of American Bar Association); *id.* at 46 (statement of Chairman Dan Rostenkowski, D-Ill.) ("We are aware of the amount of time and effort you [Professor Ginsburg] have devoted to this legislation. We know that you were truly one of the principal architects of this legislation . . .").

³¹² See, e.g., Ann. 96-105, 1996-42 I.R.B. 19; IR-95-49, 1995 IRB Lexis 261 (Aug. 3, 1995).

³¹³ See Phil Brand, *IRS Alternative Dispute Resolution Techniques*, 71 Tax Notes 529, 531 (Apr. 22, 1996).

We do not view, as some academics do, garden-variety hearings on proposed regulations and ensuing modifications in response to pressure group complaints as rising to the level of negotiated rulemaking or "neg-reg," but do agree with Professor Carole C. Berry³¹⁴ that Treasury regulations would often benefit from this process. Indeed, we see Treasury regulation of capitalization tax issues as crying out for this approach.³¹⁵ We believe that the ideal solution for cyclical airplane engine overhauls is the promulgation of legislative regulations pursuant to a statutory authorization, enumerating factors that in rough form had been the subject of public hearings and then were refined by a negotiating group of Treasury and IRS officials (and former officials concerned with capitalization issues), FAA and Department of Transportation folks, the accounting and legal professions, pressure groups, and academic representatives directed by the Chairman/Commissioner to come up with a solution. This article offers such negotiated rulemaking as a defusing technique that would address all of the problems raised herein, including above all, the political one. Were Technical Advice Memorandum 96-18-004 simply reversed with a tersely worded published ruling, as was the case with the soil remediation T.A.M., every other industry faced with a new post-*INDOPCO* ruling or ISP, MSU or significant issue will seek to challenge it politically.³¹⁶ Conversely if the Service does not consider FAA policy and/or hold a public hearing or equivalent, considering at least in part the tax treatment of cyclical safety aircraft engine overhauls, Congress in the near future might suspend, through limitation riders or the like, application of the reasoning of Technical Advice Memorandum 96-18-004 until the Service acts. Either way the Service may well find its whole post-*INDOPCO* strategy much more trouble than it ever could have been worth. We recommend that the apparent IRS strategy be shifted from establishing rules through audit, litigation and occasional

³¹⁴ Carole C. Berry, *Sub S One Class of Stock Requirement: Rulemaking Gone Wrong*, 44 Cath. U. L. Rev. 11, 20-24, 54-58 (1994).

³¹⁵ We are very grateful to Ms. Berry's work for acquainting us with this useful concept. Professor Lee's colleague Charles Koch, a recognized administrative law expert, helped as well.

³¹⁶ Cf. Art Pine, *Congress Stirs Up IRS Enforcement*, Wash. Post, Dec. 22, 1978, at E1. That is just what happened the first time.

rulings to utilizing the medium of “structured discretionary justice” regulations. Such regulations, ideally modeled after the revised section 355 corporate separations regulations or perhaps the partnership anti-abuse regulations, should cover capitalization and depreciation in general. Ideally these structured discretionary justice regulations, containing detailed balancing tests, should themselves be formulated through negotiated rulemaking in which FAA representatives, etc., are invited to participate on appropriate topics. A marriage of the Installment Sales Revision Act of 1980 and the “collegial tax reform” experiences of the amortization of purchased intangibles provision offers a handy analogue for negotiated rulemaking for capitalization/depreciation versus expensing regulations. Major steps towards simplification and towards the Service being less intrusive in business decisions could result from implementation of all (or perhaps even any) of these proposals.

V. CONCLUSIONS: A STREAM CAN RISE NO HIGHER THAN ITS SOURCE

IRS-bashing by Congress here seems hypocritical. In the area of capitalization versus expensing, the tax writing committees repeatedly have chosen to leave the question of deductibility, particularly as to self-created intangibles like long-term recurring repairs, to the case law. Time after time in the aftermath of such deliberate congressional inaction, however, the mercies of the case law proved to be not as tender as the pressure groups had anticipated.³¹⁷ Moreover in light of this inaction, transaction costs have mounted as capitalization doctrines have ebbed and flowed between the Supreme Court’s puzzling pronouncements in *Commissioner v. Lincoln Savings & Loan Ass’n*³¹⁸ and *INDOPCO, Inc. v. Commissioner*.³¹⁹

³¹⁷ See, e.g., *supra* notes 225-29 and accompanying text (discussing the fate of the soil remediation T.A.M.).

³¹⁸ 403 U.S. 345 (generating the supposedly determinative separate and distinct asset analysis).

³¹⁹ 503 U.S. 79 (resurrecting the future benefit analysis).

Yet the Service does not come forward with clean hands either. Officials from Treasury and the Service have repeatedly claimed that *INDOPCO* did not change the law as to capitalization. Nevertheless, the Field is currently interpreting the future benefit presumption of capitalization much more broadly than in the past³²⁰ and in litigation the Service has argued that *INDOPCO* created a “new look.”³²¹ An examination of rulings over the past two decades shows that the Chief Counsel’s Office in fact followed the judicial trend of the moment as the separate asset doctrine rose and then fell, but it never stopped auditing and litigating for a future benefit capitalization rule. In the meantime, Chief Counsel’s Office, recognizing the hazards of litigation and administrative concerns, from time to time recommended rough justice current deduction rules that the Commissioner almost never followed. Thus, Chief Counsel Stuart Brown’s claim that the cyclical aircraft engine overhaul T.A.M. does not reflect a change in the Service’s position is ingenuous.

The advancement of general capitalization regulations is overdue. For almost twenty years, the Field has been desperate for guidance by the National Office as to the standards—actually it prefers rules—for capitalization. Despite protestations of denial, the Chief Counsel’s Office position as to the capitalization rules did change as the tide of cases shifted from the taxpayer “separate asset doctrine” victories to the government victories under other tests culminating finally in *INDOPCO*. Regulations should be introduced that follow the discretionary justice approach outlined earlier, including the various safe harbor deductions that avoid income distortion. Furthermore, an open dialogue must take place to determine whether and, if so, under what conditions other agency policies should be taken into account in fashioning tax rules. Ideally, this dialogue would culminate in the suggested negotiated rulemaking strategy. Given the numerous inconsistencies and frustration of public policy, a limitation rider mandating such a process and regulations might not be such a bad thing.

³²⁰ See *Rough Justice*, *supra* note 16.

³²¹ See *Sun Microsystems*, 66 T.C.M. (CCH) at 1002.