1997

Restating Capitalization Standards and Rules: The Case for "Rough Justice" Regulations (Part Two)

John W. Lee  
*William & Mary Law School, jwleex@wm.edu*

Eldridge Blanton

Veena Luthra

Glenn Walberg

Darryl Whitesell

Repository Citation

http://scholarship.law.wm.edu/facpubs/215

Copyright © 1997 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.  
http://scholarship.law.wm.edu/facpubs
Restating Capitalization Standards and Rules
The Case for “Rough Justice” Regulations (Part Two)

JOHN LEE,*
ELDRIDGE BLANTON,**
VEENA LUTHRA,***
GLENN WALBERG,****
DARRYL WHITESELL*****

I. Introduction ............................................. 1484
II. General versus Detailed Guidance ......................... 1486
   A. The Literature on General and Detailed ................. 1487
   B. Service’s Regulatory Philosophy ....................... 1489
   C. The Rest of the Gregory v. Helvering Story:
       The Stage for Discussion .......................... 1492
   D. Lessons from the Partnership Anti-Abuse Regulations 1500
   E. Lessons from Debt-Equity Regulation .................. 1511
   F. Structured Discretionary Justice and Horizontal
       Equity or Rough Justice Politically ................. 1513
   G. Conclusion ........................................... 1516
III. Rough Justice Exceptions to Future Benefit Capitalization 1522
   A. De Minimis or Short Lived Benefit Expenditures ....... 1523
      1. De minimis ....................................... 1523
      2. Short-lived Benefits ............................. 1527
   B. Steady State Recurring Costs .......................... 1529
      1. Recurring How Often? ............................. 1541
      2. Recurring Less Frequently and Freestanding
         Depreciable Intangible ............................ 1543
      3. Recurring How Often? Aggregate Basis ............. 1546
   C. Current Deduction if Amortization Unavailable ......... 1549
   D. Other Administrative Difficulties ...................... 1553
IV. Safe Harbor Amortization .................................. 1553
V. Conclusion .............................................. 1558

* John W. Lee, III, 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.
** M. Eldridge Blanton, III, B.S. Virginia Military Institute, 1962; M.H. University of Richmond,
  1972; J.D. University of Richmond, 1994; LL.M (Taxation) William and Mary, 1996.
*** Veena Kumari Luthra, A.B., Brown University (1990), J.D., College of William and Mary
  (1993); LL.M. (Taxation), College of William and Mary (1996). Ms. Luthra is an attorney in the District
  Counsel’s Office, Internal Revenue Service Richmond Virginia.
**** Glenn Charles Walberg, B.B.A. University of Notre Dame, 1991; M.B.A. and M.Acc.,
  University of Wisconsin, 1993; J.D., College of William and Mary.
***** Darryl Duane Whitesell, B.A., Lynchburg College, 1991; C.P.A.; J.D., College of William
  and Mary.
I. INTRODUCTION

In Part One we concluded that administrative guidance as to capitalization versus expensing in the form of "rough justice" regulations was in order. Part Two primarily addresses the best form such regulations should take. First order options are (a) general standards or (b) detailed rules, or both; or (c), numerous factual examples with bottom line conclusions, or a combination of all. Section II considers these options. A "standard" consists of a general principle or policy of the particular body of substantive law. In the instant context of capitalization versus current deduction, this article argues that the standard is minimum distortion of income from the timing or character of deductions. Under jurisprudential theory, a standard's inherent functional approach requires the decision maker to determine whether the facts of the particular transaction merit the desired treatment. A "rule" in contrast is definitional and ideally capable of generating precise and predictable answers. The justly-discredited no "separate saleable asset" doctrine and the arguably more correct not more than 1-year benefit constitute capitalization rules of thumb. Tax lawyers should recognize the standard-rule dichotomy as the familiar substance and form debate in another guise; common lawyers, as the equity versus law tension. Professor Daniel Shaviro uses the compelling illustration of a stated speed limit as a rule and an admonition to drive not unreasonably fast in light of all the circumstances as a standard.


4. Kennedy, supra note 1, at 1687-88.

The second order options are as to the form of rough justice rules for current deduction or capitalization and depreciation over safe harbor standard periods discussed in Sections III and IV. This article maintains that in some capitalization areas the doctrine and policy have evolved far beyond simple case-by-case rules and any regulation should reflect that. Thus, as elaborated in Section III below, proposed regulations should not only state the general principle of minimum distortion of income from timing but also should contain rules such as (1) a presumption of capitalization where an expenditure provides future benefits, with (2) exceptions for average lives of not more than 12 months, de minimis and regularly recurring expenditures and where depreciation is impractical. Similarly Section IV calls for capitalization and amortization over uniform periods of substantial, irregularly recurring expenditures. The regulations should state in the context of timing distortions the clear reflection (minimum distortion) of income standard, these rules and specific problem areas such as (1) business expansion costs, (2) advertising, (3) employee training costs (including just-in-time retraining), (4) repairs including cyclical overhauls, (5) pollution clean up expenses, and (6) writers prepublication costs should be addressed through examples based upon judicial precedents and the Service’s ruling experience.

Another fundamental capitalization principle mandates capitalization where necessary to avoid a character mismatch between a current ordinary

---

During the Clinton administration, Treasury has continued the previous administration's practice of writing broad general rules that are adaptable to the circumstances. Kohl compared those rules to the Montana practice of telling people to drive at a speed that is reasonable for the circumstances, rather than setting a specific and inflexible speed limit that may not be appropriate for all circumstances. Anti-abuse rules, he argued, are intended to address the tax law equivalent of reckless driving.

Id.

6. Structured discretionary justice regulations should set forth the factors that are to be applied, for example, in determining (1) de minimis and (2) how infrequently recurring and how much variation from average annual costs is permitted under a recurring exception.

7. At the time of Professor Lee's 1993 testimony recommending that Congress authorize legislative regulations as to capitalization with the Service first developing a body of ruling experience which it would then distill into legislative regulations, he had not yet investigated the body of Service non-published rulings which provide both the necessary factual experience and legal reasoning supporting many of the rules proposed in our Submission and this article. At the time of the Submission Professor Lee anticipated that the final version of this article would apply the model to the areas mentioned in text as well as other areas. That turned out to be too many stories for one article to carry. Professor Lee will participate in a discussion on capitalization at the Virginia Tax Study Group Seminar in March 1997 and to give a speech in June at the 49th Annual Virginia Federal Tax Conference at Charlottesville, Virginia that will attempt that project. In the meantime good discussions of the areas are presented by Glenn Carrington, Capitalization after INDOPCO, 2 N.Y.U. 53RD INST. ON FED. TAX. CH. 25 (1995); Peter Faber, INDOPCO: The Still Unsolved Riddle, 47 TAX LAW. 607 (1994).
deduction and related tax preferred income. The precedents and rulings there are less developed than the timing authorities.8 This article proposes that minimum distortion of income as to character at this time be addressed primarily through examples in the regulations applying the "origin of the claim" doctrine, particularly as to merger issues. The Solicitor General's Office attempted in argument and on Brief to make that argument to the Court in INDOPCO,9 but the Court, perhaps understandably,10 appears to have been fixated on the future benefit rationale. This article argues that this does not mean that INDOPCO precludes adoption of a character distortion rationale for denying a current deduction to a (hostile) takeover or any other merger. Rather, it means that the argument once received favorable policy review at a high level of tax administration and thus any future administrative development should very seriously consider it.11

II. GENERAL VERSUS DETAILED GUIDANCE

The core issue of general standard (or principle) and detailed rule of application have been much written about issues in recent years in general, and increasingly in Federal taxation, although often not couched in those terms. The exception is academic scholarship where "there is a substantial body of scholarship that deals with the rules of standards and rules in the law."12 One strand of the debate centers on the choice of general versus specific tax statutes or regulations. Tax theorists, perhaps most notably Harvard Professors Stanley Surrey and Ernest Brown three and four decades

---

8. See generally Lee & Murphy, Capital Expenditures, supra note 2, at 509-27.
10. Kent Jones at times seemed to merge and thus obscure the doctrines. Additionally Justice Blackmun was the author of the leading cases adopting the future benefit rationale and capital transaction for capital expenditures, Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1973) (Blackmun, J.); Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971) (Blackmun, J.) respectively, which naturally Kent Jones played to.
11. Professor Lee must once again acknowledge a "vested interest" here. The Solicitor General's Brief and Assistant Jones' argument were solidly grounded on Professor Bittker & Lokken's income tax treatise as well as Professor Bittker & Eustice's corporate tax treatise. Professor Lee is most proud of his collaboration with Professor Bittker on the former and of some of his capitalization work having made Professor Jim Eustice's long and short lists. (Perusal of Lee's work here will show how much he followed in their footsteps.)
12. See Colliton, supra note 1, at n.1, and the "substantial body of scholarship" the author lists. In addition to his list see Lee, Structured Discretionary Justice, supra note 1, at 1030-32 (sketches rules and standard scholarship of Professor Duncan Kennedy and structured discretionary justice thinking of Professor Davis and applies to the noteworthy evolution of the Section 355 regulations in a "collaborative model"). My colleagues Professors Charles Koch and Alan Gunn had read them the first time. Thanks again for turning me on to them, guys.
ago, have long debated the advantages of generalized tax statutes, that is, standards, versus detailed, rule-oriented tax statutes. Currently the Janus-like faces of "check-the-box" (formalism is almost dead) and anti-abuse authority of the Commissioner to disregard the form say of partnership tax shenanigans if they are abusive best brings out the general standard versus detailed rules issues as seen by the Treasury/IRS and practitioners. As discussed in Part One, the notion of "rough justice" versus detailed, unadministrable exact justice also is related to this debate. In the real world a question going to the heart of tax administration is the role of the revenue agent's discretion. The theme of Professor Lee's 1993 testimony before House Ways and Means Subcommittee Chair Charles Rangel, D-N.Y., and in our Submission in 1996 pursuant to the Internal Revenue Service's request for comments on INDOPCO has been that only structured administrative justice can cure the malaise at that level. Strong evidence that the Chief Counsel's Office is pursuing a deliberate policy here of obfuscating its true policy, to "advise" by litigation not regulation arose far too late to put in Part One or even this Part, if truth be told. Our editors and in particular Brett Woodburn have been far more than understanding and helpful. The emerging contours of that story are sketched in the Conclusion to this Article.

A. The Literature on General and Detailed Regulation

Tax theoreticians, including Harvard's Professors Ernest Brown and Stanley Surrey, have long debated the advantages of generalized tax standards versus detailed rules. Writing under Professor Brown's tutelage, Charles Whitman, in a seminal article on corporate divisions, called for a focus on the underlying policy (device) and a lessening of the role of

13. ERNEST J. BROWN, 86TH CONG., 1ST SESS., AN APPROACH TO SUBCHAPTER C, 3 TAX REVISION COMPRENDIUM, HOUSE COMM. ON WAYS AND MEANS, 1619, 1619-20 (Comm. Print 1959) (detailed tax statutes lead to deficiencies and anomalies appearing which requires even more intricate elaborations of pattern; fundamental source is an attempt to eliminate the necessity for responsible administration); accord Colliton, supra note 1. Contrast Stanley S. Surrey, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, 34 LAW & CONTEMP. PROBS. 673, 695-702-10 (1969) (debate between generalized and particularized tax statutes; concludes ideal is generalized statute with detailed regulations). Interestingly, the Tax Reform Act of 1969, which was Surrey's brainchild, rarely took this tack (Section 385, which came from the forehead of Assistant Secretary Ed Cohen, constitutes a conspicuous exception). See John W. Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process, 8 VA. TAX REV. 57, 132 n.346 (1988) [hereinafter Lee, Entity Classification].

14. This section of the Article is largely derived from Lee, Structured Discretionary Justice, supra note 1.

15. See supra note 13.
the additional mechanical statutory detail arising from the active business test.\(^{16}\) How pleased he must have been to see the Service follow his advice.\(^{17}\) Many tax commentators in the past followed the Surrey school of a general tax statute implemented and amplified through indisputably detailed Treasury regulations. The greater flexibility of administratively amending regulations in light of developing administrative and judicial experience under the statute carried the day. This is a part of the incremental “Muddling Through” notion discussed in Part One.

Under the Surrey approach, the role of courts in resolving the substance and form dichotomy in tax law is thought lessened. Conventional jurisprudential wisdom holds that the advantages of rules are (1) the restraint of arbitrariness by the decision maker and (2) the attainment of certainty or predictability.\(^{18}\) A cost generally is the lack of precision in rules alone in carrying out the underlying policy objectives, which standards more readily effect.\(^{19}\) Standards often further differ from rules in the former’s greater generality in an attempt to deal with as many different potential fact patterns as practicable. According to jurisprudential thinking such generality

\(\text{16. Whitman, supra note 3, at 1252-57.}\)

\(\text{17. Professor Lee showed how the First Circuit in Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), cert. denied, 408 U.S. 922 (1972), in addition to explicitly adopting (a) this reversal of device (more standard oriented) and active business rules as the first tier defense of the policy of Section 355, and (b) reorientation of device as well to focus on the standard of worthy of deferral, went out of its way (i.e., extreme dictum hypotheticals in footnotes) to salute the host of active business issues raised by Whitman. See John W. Lee, Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty, 27 TAX L. REV. 453 (1972) [hereinafter Lee, Functional Divisions]. The Service agreed with his reading of Rafferty and the soundness of Whitman’s advice. Gen. Couns. Mem. 36,069 p. 14 (Nov. 5, 1974). The 1989 revised regulations made that shift abundantly clear. That was the easy part. (Professor Peter Weidenbruch, shortly thereafter to serve as Assistant Commissioner Technical [in charge of rulings], had walked all of us Georgetown night LLM students through the old Section 355 regulations on active business in class, in problems, and on the exam as best Lee now recalls, and had given us a syllabus with the leading cases and commentators. The latter can be found in Lee, Functional Divisions). Lee was worried in initially planning the article about the device portion because Whitman, and hence the First Circuit, had not provided the same guidelines. Researching and writing the active business portion laid his fears to rest. Boris Bittker and Jim Eustice had already thought deeply about the questions raised by a device potential approach. Lee applied their analysis of bailout potential. The pro and con device factor approach of the revised regulations in general and the related function test in particular can be traced back to earlier editions of their corporate tax treatise. Both Jim and Boris must be proud of this too. For just a taste of the awe all feel for them, search “Bittker w/5 Eustice” in the LEXIS, Fedtax, memos file. Then search the casrel file to pick up the cases and other private rulings. Do the same with Bittker’s Treatise. Awesome.}\)

\(\text{18. Kennedy, supra note 1, at 1688-89; but cf. Frank V. Battle, Jr., The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax System, 48 TAX LAW. 801, 803, 805 (1995) (arguing that where rules are minutely detailed, anti-abuse rules become meaningless) (The Gregory story suggests this is overstated.)}\)

\(\text{19. Kennedy, supra note 1, at 1689.}\)
increases the number of occasions of lawmaking by the decision maker, as contrasted with the legislative occasions.20 "The difference between the two approaches . . . [is] the difference between ex ante and ex post decision making: When a law is drafted as a rule, it is known in advance whether particular transactions or acts fall within or without the law. Laws setting out only broad standards create less certainty. It is up to some decision maker — usually, a court or administrative body — to determine whether a transaction or act satisfies the standard."21 The debate over standards or general principles versus rules lies at the heart of the recently re-emerging anti-abuse rule school of bold Treasury regulation drafting versus the earlier drafting approaches of detailed statutes implemented by even more detailed legislative regulations.22 Conversely, jurisprudence scholarship views detailed legislation as generally decreasing the decision maker's discretion.23 This notion may be accurate as to judges laboring in the tax field who follow the rules, but not so much as to courts that fashion new standards to overcome the inequitable rules as witnessed, for instance, by the cases forging ways around the no deduction of start-up costs rule.24

Professor Duncan Kennedy holds that rules and standards tend to shade into each other. For instance, a standard may be implemented by a number of per se rules, either in the statute or accompanying regulations or case-law adjudication. Conversely, such wisdom holds that decisionmakers may create so many exceptions to a rule (or often legal fictions in the case of courts), in order to avoid injustice in penumbral cases, that the rule becomes like a standard in effect.25

B. Service's Regulatory Philosophy

Starting with the Bush Administration's rough justice campaign discussed in Part One of this Article and continuing under the Clinton Administration, the government's approach to regulation of tax laws has been (1) to promulgate simpler regulations with fewer bright-line rules and

20. Id.
22. See infra Part II.C.
23. Kennedy, supra note 1, at 1690. See Gregory v. Commissioner, 27 B.T.A. 223, 225 (1932), rev'd, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935) ("A statute so meticulously drafted must be interpreted as a literal expression of taxing policy, and leaves only the small interstices for judicial consideration"). The Second Circuit formulated the opposing force to literalism of a broad, free-standing judicial standard — business purpose. See infra Part II.C.
25. Kennedy, supra note 1, at 1700-01.
often backed up by broad anti-abuse standards, and (2) to prefer less authoritative published revenue rulings, revenue procedures, private letter rulings including technical advice memoranda.26

How detailed the rules should be, how many transactions they should aim to encompass, "is a resource allocation issue," said [Deputy Tax Legislative Counsel Michael] Thomson. He applies a mental equation to arrive at a "global picture of the tax system" by gauging how much a benefit a project will produce using a limited amount of resources.

Treasury's view is to get guidance out as quickly as possible, Thomson said. "To wait until we've gotten every answer to every situation would take too long," he said. "We have to stop short, but the question is how short?"

Reg writing begins with articulating the principles in the statute, and then fleshing those principles out as they apply to factual situations, Thomson explained. In recent years, Treasury and the IRS have favored the use of "purpose-based backstop" rules, known as anti-abuse rules. All statutes should be read in light of the general principles, Dunn and Thomson stressed.

No matter how a rule is written, no one should be able to apply the rule literally in all cases; Dunn and Thomson agreed. Each application has to be informed by congressional intent and context, Thomson said. "We ultimately rely on the good judgment of taxpayers and practitioners."

The leading industry voice on the current capitalization versus expensing issues, Tax Executives Institute, scored the Treasury for issuing "only limited published guidance on the proper treatment of certain expenditures as ordinary or capital in nature (thereby affecting their current deductibility) and hence spawned considerable audit activity as field agents have sought to capitalize expenses that have long been treated as currently deductible."28 It also objected to "the IRS's aggressive expansion of the amorphous concept of 'clear reflection of income' to override longstanding taxpayer positions" and to "adoption of vague and sometimes torturous

27. Reg Writing Process, supra note 26, at 549.
'anti-abuse' rules that are engrafted on various sets of substantive regulations . . . .''29

Insight into recent IRS and Treasury thinking as to options regarding regulation of capitalization versus expensing may be gleaned from officials publicly discussing environmental clean up costs guidance. "At issue, according to [Treasury accounting specialist] Kilinskis, is the form the guidance should take — whether rulings, regulations, or legislation — and what position the government ought to adopt with respect to cleanup costs — whether deductible in all cases, capitalizable with no recovery, or capitalize it with some sort of recovery."30 Then Assistant Chief Counsel Income and Accounting Issues Glenn Carrington discussed similar regulatory options apparently as to self-created intangibles in general:

First, IRS is considering whether to tailor revenue rulings to particular taxpayer fact patterns, according to Carrington.

"Some would argue that maybe we should take the typical examples and publish revenue rulings addressing them, saying, 'If you fall within the four corners of these particular facts, the answer is x, y, z or whatever," he said.

A second option would be to publish an analysis similar to that for package design, under which taxpayers would capitalize the costs and write them off over a period of five years or 10 years, Carrington said.

However, IRS is concerned that many taxpayers would not buy into that system, he said. "It may help people in the very gray area and other people would continue to do what they're doing and it won't be useful," he said.

Asked whether IRS believes it has regulatory authority to "arbitrarily" require capitalization over a fixed period, such as five years or 10 years, Carrington responded, "It would be arbitrary, but we've done arbitrary — reasonably arbitrary — things in the past."

Third, IRS is exploring the adoption of the presumption that taxpayers would capitalize the expenditures if they already would capitalize them under the rules under generally accepted accounting principles, according to Carrington.

29. Id.

[Responsibility for the heavy burden that the tax system imposes lies in part] with efforts to apply the current tax law — which was developed to deal with a manufacturing-based ("bricks and mortar") economy -- to one that turns on services, information, and other intangibles. In many respects, the "round peg" of the Internal Revenue Code is being forced into the "square hole" of an ever-changing international marketplace, and the result has been uncertainty -- and mind-numbing complexity.

"We hear that agents are raising Indopco and long term benefit and really causing problems out there and maybe we should look and see what you're doing and if you're saying it's capitalized and you're following the GAAP rules maybe that's what we should use. Maybe that's good bright line test," he said.

Carrington acknowledged that normally the GAAP rules do not control for purposes of the tax code, but that IRS would be looking at those rules to see whether they "are somewhat in line with what we think the law is." 31

C. The Rest of the Gregory v. Helvering Story: The Stage for Discussion

There are an amazing number of tax stories as to general standard versus detailed rule, far too many to tell in this Article. Nearly all are illustrated in the rest of the story of Gregory v. Helvering. 32 The story starts over a decade before the actual litigation with Dr. T.S. Adams and Mr. A.W. Gregg, special Treasury tax advisers. Dr. Adams was the famous Treasury expert who to this day is known as the father 33 of the much studied Revenue Act of 1921, which began the alphabet soup of

31. IRS Environmental Cleanup Guidance May Be Out by July, Official Says, 1993 DAILY TAX REP. 89 d15 (May 11, 1993). Robert Kilinskis, a tax specialist in Treasury's Office of Tax Legislative Counsel, suggested that many taxpayers would not like the results of applying GAAP to determine capitalization. Juliann Avakian-Martin, Environmental Cleanup Costs Addressed at Two ABA Tax Section Meetings, available in LEXIS, Fedtax Library, TNT File, 93 TAX NOTES TODAY 165-67 (Aug. 9, 1993). Carrington apparently was thinking of the package design safeharbor discussed in Part One. The three-year front loaded depreciation of writer's prepublication costs serves as an even better example of a "reasonably arbitrary" rule.

32. 293 U.S. 465 (1935).

33. United States v. Rogers, 122 F.2d 485, 490-91 (9th Cir. 1941) (Haney, J., dissenting) ("appellant concedes was 'the Treasury expert' and the 'father' of the 1921 act"); E.I. Du Pont de Nemours & Co. v. United States, 471 F.2d 1211, 1214 (Ct. Cl. 1973); Ohio Nat'l Life Ins. Co. v. United States, 11 Cl. Ct. 477, 479 (1986), aff'd, 807 F.2d 1577 (Fed. Cir. 1986); Phillips Petroleum Co. v. Commissioner, 97 T.C. 30, 33 (1991) (Parker, J., dissenting) ("considered to have been the 'father' of the Senate bill"). But cf. 61 CONG. REC. H8073 (Nov. 21, 1921) (Remarks of Rep. Garner) ("We had a Treasury expert there who came in in the morning and made a very interesting and, I thought, conclusive argument; then the Secretary of the Treasury would give him different instructions, and in the afternoon he would make the most conclusive argument on the other side of the same proposition that I ever heard in my life. This expert helped to make up this bill in the House, and when he was asked why amendment 41 was put in here, he said, that 'it was thought wise at the time, but is not thought wise now.' ") (referring to flip-flops on applying the predecessor of Section 1031 to exchanges of investment properties).

34. William J. Turnier, Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation, 64 CAL. L. REV. 902, 912-13 (1976); Marjorie E. Kornhauser, Section 1031: We Don't
reorganizations and in general was the first modern Federal income tax statute. Adams, an economist on leave from Yale, articulated as his drafting goal "a rather simple tax law that the average man can understand." He walked the members of the Senate Finance Committee through the Act, literally line-by-line. In the reorganization area the Act in fact or at least in effect functionally codified the existing regulations under the Revenue


37. The earliest corporate income tax acts in this century were silent as to the tax effects of reorganizations or combinations of corporations. Treasury promulgated in this vacuum Regulations 33, revised in 1918 under the Revenue Act of 1916, providing in Article 124 non-recognition treatment at the corporate level only as to stock-for-stock acquisitions (as well as subsequent transfers of assets from the now subsidiary corporation to its corporate parent). Regs. 33, Article 124, reprinted in 132 1909-1950 LEGISLATIVE HISTORIES, provided that in an acquisition by purchasing corporation (P) of all of target (T) corporation's stock in exchange for P stock, T recognized no income on such acquisition nor upon its transfer of its assets up to the new sole corporate shareholder, but in a P stock-for-T assets acquisition, T was taxable and had to include in its amount realized its liabilities assumed, or taken subject to, by P. See also Regs. 33, Articles 101 and 118. In short "reorganizations" were taxable at the corporate level in the case of asset acquisitions but not stock acquisitions. Conversely apparently stock acquisitions, but not asset acquisitions, were usually taxable at the shareholder level even if P stock or securities were received. The Revenue Act of 1918 first statutorily considered the tax treatment of reorganizations, granting non-recognition at the shareholder level as to the receipt of "new stock or securities of no greater aggregate par or face value [in exchange for] stock or securities owned by him in connection with the reorganization, merger, or consolidation of a corporation." The new stock or securities were "treated as taking the place of the stock, securities, or property exchanged." See Heverly v. Commissioner, 621 F.2d 1227, 1237 (3rd Cir. 1980). The "par value" limitation "was framed upon the idea that there was merely a swapping of shares of stock of a definite par value, and that it would really amount only to an exchange of shares of stock of a definite par value, each being equal to the other in par value." 61 CONG. REC. S6562 (October 21, 1921) (Remarks of Sen. Jones). Note that Senator Jones, a Democrat with populist leanings judging from the legislative history, focused on the mere change in form policy for non-recognition. Regulations 45 promulgated in 1919 under the 1918 Act adopted a transactional approach continued in successive versions of the regulations for the next decade: (1) dissolution of corporation B (in modern terminology "T"arget corporation) and sale of its assets to corporation A (in modern terminology the acquiring or "P"urchasing corporation), (2) sale of assets by T to P and then dissolution of T; (3) sale of T stock to P and then dissolution of T; (4) merger of T into P; and (5) consolidation of T and P. Article 1569 following the statute converted the excess par value limitation into a "boot" rule rather than a disqualification rule. In transactions (1) through (4), i.e. mergers and "practical" or "de facto" mergers, Article 1567 provided for non-recognition so long as no income was received, i.e., "recognized" in modern terminology, from the transaction by T or P or their shareholders provided that (a) no greater aggregate par value stock was received than the par value
Act of 1918’s very bare bones reorganization provision. 38 A case can be made that the non-recognition reorganization and like-kind exchanges rules together with the low flat rate capital gains preference 12 1/2 percent (1/4 of the maximum ordinary rate) were intended to render the apparent progressivity a facade, 39 which was in fact the case. 40 Moreover, it is possible that Adams and Secretary of Treasury Mellon intentionally left some very big loopholes. 41 In any event, at the beginning of the Roaring 20’s, when in a good year the top 10,000 taxpayers reported around half of the income of the class income tax, 42 loopholes did immediately develop

---

of the old stock or securities surrendered and (b) the only consideration received by T and its shareholders was P stock or securities. T shareholders’ cost in their T stock became their basis in the new stock received in the reorganization; similarly P, or the new corporation in a consolidation, took over T’s assets at their cost in T’s hands and T’s other attributes. Article 1568. The inheritance of T’s “new invested capital” was particularly important for the excess profits tax, the big corporate sector revenue raiser. Dr. Adams explicitly codified the consolidated return regulations, the involuntary conversion provisions, and the incorporation provisions from earlier regulations into the Revenue Act of 1921. Union Pac. R.R. v. Commissioner, 17 B.T.A. 793, 798 (1929)(consolidated returns)("Senator Smoot. You are putting the regulations into law, that is what this is? Dr. Adams. Yes.").

38. See supra note 37. Dr. Adams also “was a member of the first Advisory Tax Board appointed under the Revenue Act of 1918.” Dr. Adams had stated that the Revenue Act of 1918 was “filled with difficult, ambiguous points, and all the regulations are filled with doubtful rulings.” Lawrence v. Commissioner, 44 B.T.A. 128, 130 n.2 (1941). In many cases the 1919 regulations had indeed strong-armed the statute. Hearings on Revenue Revision before the House Ways and Means Comm., 66th Cong. 40 (1920) (colloquy Rep. Cordell Hull, D-Tenn., and Dr. Adams), reprinted in 1 1909-1950 LEGISLATIVE HISTORIES.


41. Unlike the prior regulations, the 1921 Act afforded no carryover basis to P as to assets received in the organization or reorganization. Turnier, supra note 34, at 911; Randolph Paul, The Background of the Revenue Act of 1937, 5 U. CHI. L. REV. 41, 44 n.28 (1937) (“like taking candy from children”). The “boot” rules and like-kind exchanges of stock were also defective prompting a special legislative session just for “exchanges of property” in 1923. 64 CONG. REC. H2855, 2851 (Feb. 1, 1923); 64 CONG. REC. 2854 (Feb. 1, 1923) (Remarks of Rep. Fordney); see Secretary of Treasury Mellon’s Jan. 13, 1923 letter to Rep. Green, R-Iowa, Acting Chair of House Ways & Means, reprinted in H.R. Rep. No. 1432, Exchange of Property, 67 Cong. 1-2 (1923), reprinted in 95A 1909-1950 LEGISLATIVE HISTORIES and in 64 CONG. REC. H2852 (Feb. 1, 1923) (Remarks of Ways & Means Chair Green); 64 CONG. REC. H2851-54 (Feb. 1, 1923); 64 CONG. REC. H2852 (Feb. 1, 1923) (Remarks of Rep. Gamer).

42. See Lee, Death and Taxes, supra note 40.
necessitating an emergency Congressional session to close. After that Dr. Adams left the Treasury and returned to Yale. Secretary of the Treasury Andrew Mellon, of course, stayed. Adam's successor A.W. Gregg followed the diametrically opposite school of drafting in the Revenue Act of 1924:

complications come primarily from a complicated policy, [including reorganizations. The bill will cover a given case definitely and certainly. Under the existing law there are hundreds of cases where nobody knows the effect of the transaction upon the tax. This law is definite enough so that the taxpayers will be able to tell the effect of a given transaction ... .]

The complications were evident in the “Gregg Statement” published by the *New York Times*, which ultimately became the Committee Report. In any event, the case may also be made that the 1924 Act reorganization amendments were intended to sanction the various forms of reorganization that taxpayer representatives dreamed up, and hence a preferential provision.

---

43. After the 1923 emergency session (January-February), Secretary of Treasury Andrew W. Mellon, at the request of the Ways and Means Chairman established a committee, chaired by A.W. Gregg, Special Assistant to the Secretary of the Treasury, (Dr. Adams having returned to Yale,) to prepare amendments for simplification and clarification of the 1921 Act. *See Explanatory Note* p. 5, 66 1909-50 LEGISLATIVE HISTORIES. The Committee worked closely with Treasury and Internal Revenue Bureau personnel (predecessor to the IRS), but the tax writing Committees grilled Gregg unmercifully in 1924 Hearings on his background, *Hearings before the Sen. Fin. Comm. on H.R. 6715 (Revenue Act of 1924)*, 68th Cong. 2, 57 (1924) —probably 1924 Act flip-flops from Dr. Adams' positions were raising questions in Members of Congress' minds. Or, why are we doing this again? In January 1924 Treasury prepared a draft of a proposed bill and accompanied it with a “Statement of the Changes made in the Revenue Act of 1921 by the Treasury Draft and the Reasons Therefor.”


46. “The theory of these provisions in the 1924 law ... was that reorganization might be accomplished in great variety of ways and that the desirable policy was to permit the reorganization to be accomplished in any one of the ways which it might normally take.” *Confidential Hearings on H.R. 7835 (Revenue Act of 1934) before Sen Fin. Comm. (Part 4), 73rd Cong. 115 (1934)* [hereinafter 1934 Confidential Senate Hearings] (statement of Dr. Roswell Magill, Under Secretary of the Treasury). Magill defended the status quo on the grounds that over the rest of the decade “a large number of reorganizations ... [were] carried through.” *Id* at 115 (statement of Magill.) H.R. REP No. 179 and S. REP. No. 398 indeed state that the purpose of the amendments to the reorganization provisions was to exempt “from tax the gain from exchanges made in connection with a reorganization in order that ordinary business transactions will not be prevented.” H.R. REP. No. 68-179 (1924); S. REP. No. 68-398 (1924).
Congress predictably failed to anticipate the avoidance techniques or "mere devices" such as those employed by Mrs. Gregory to avoid dividend treatment on a distribution by her wholly owned corporation. Relying upon Gregg's corporate spin-off provisions, she caused her wholly owned holding company to transfer shares in a publicly traded "target" subsidiary to a newly-formed wholly owned subsidiary which the holding company "spun off." Three days later, she liquidated the new subsidiary, obtaining a stepped-up basis at a capital gain rate in the public shares, which she then sold to the buyer at no further gain.

The first aspect is the effect of this special interest origin of this reorganization provision manifested in a detailed statute as Seventh Circuit Judge Frank Easterbrook holds special interest provisions are wont. In 1932, the Board of Tax Appeals upheld Mrs. Gregory's scheme as a transaction clearly within the confines of the statutory language. "A statute so meticulously drafted must be interpreted as a literal expression of taxing policy, and leaves only the small interstices for judicial consideration." Judge Easterbrook views such detail as limiting judicial discretion. Notwithstanding such statutory detail, Judge Learned Hand, writing for the Second Circuit in Helvering v. Gregory, formulated the opposing force to detailed literalism of a broad, free-standing judicial standard — business purpose.

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . Therefore, if what was done here, was what was intended by . . . [the definition], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute

47. Brown, supra note 13, at 1619-20; Whitman, supra note 3, at 1199.
48. Frank H. Easterbrook, Foreword: The Court and the Economic System, 98 HARV. L. REV. 4, 16 (1984) (arguing that the "more detailed the law, the more evidence of interest-group compromise and therefore the less liberty judges possess").
50. Id.
51. See supra note 48, and accompanying text.
52. 69 F.2d at 809, 811 (2d Cir. 1934).
increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the section is plain enough; men engaged in enterprises — industrial, commercial, financial, or any other — might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as “realizing” any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders’ taxes is not one of the transactions contemplated as corporate “reorganizations.”

The Supreme Court in *Gregory v. Helvering* affirmed the Second Circuit. It created the famous “device” image and following Hand imposed a business purpose requirement or standard.

When . . . [the definitional paragraph] speaks of a transfer of assets by one corporation to another, it means a transfer made “in pursuance of a plan of reorganization” . . . of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the

53. *Id.* at 810-11 (Emphasis supplied).
statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. 54

The Gregory/spin off/standard vs. rule story has yet more chapters. The Democrat-controlled Congress of 1933, generally unsympathetic to business problems, was "acutely hostile to tax avoidance schemes." 55 Resisting its first inclination to repeal the reorganization provisions in toto, 56 which President Franklin Roosevelt's Treasury strongly opposed, 57 Congress in 1934 repealed only the spin-off provision and tightened up the

55. Whitman, supra note 3, at 1200. In 1933 and 1934 tax avoidance was very much in Congress' eyes [they could taste the paybacks after a dozen years of a Republican Treasury headed by Andrew Mellon]. Compiler's Note Regarding the Legislative History of the Revenue Act of 1934, — 1909-1950 Legislative Histories; Heverly v. Commissioner, 621 F.2d 1227, 1238 (3rd Cir. 1980). Particularly subject to abuse were the 1921 Act defective "boot" rule which allowed basis recovery and the much more egregious allowance of $P$ [and/or $T$ shareholders] to obtain a fair market value basis in [stock or assets?] acquired in the reorganization. H.R. Rep. No. 68-179, at 13 (1924); see generally Daniel Q. Posin, Taxing Corporate Reorganizations: Purging Penelope's Web, 133 U. Pa. L. Rev. 1335, 1349 (1985). The latter omission is puzzling, even suspicious, given the earlier substituted basis in the Revenue Act of 1918 as to stock acquired and carryover basis as to assets received under Regulations 45, Article 1568. Both loopholes were more or less corrected by the Revenue Act of 1924 (the Revenue Act of 1928 finished patching up the basis provisions which had only been supplied for incorporations in 1924). But the Revenue Act of 1924 authorized "spin off" divisive reorganizations without out any "safeguards" against bailouts (tax-free split-ups were already permitted). Additionally from the beginning populists were aware that preferences such as the reorganization provisions (and especially the capital gains preference) allowed high income individuals to evade progressivity. See 57 Cong. Rec. S828-29 (daily ed. December 23, 1918) (statements of Sen. LaFollette).

56. Prevention of Tax Avoidance, Preliminary Report of a Subcommittee of the Committee on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws, together with Suggestions for the Simplification and Improvement thereof, 73d Cong. 8 (Comm. Print 1933). See Chapman v. Commissioner, 618 F.2d 856, 865 (1st Cir. 1980). To the traditional "mere paper profit" (equity) and "interference with business" (economic efficiency) arguments the Subcommittee replied that by being able to defer the gain realized on such exchanges and to elect the year of recognition/reporting, "the taxpayer is able to escape tax on these gains entirely." In the light of the capital losses just generated by the 1929 Crash and the fact that 1/3 to 1/2 of individual capital gains were and are never taxed by the Federal income tax system due to step up in basis at death, the statement was largely true.

57. "In the cases of complicated subjects of this kind, it is almost impossible to foresee all the ingenious devices which lawyers will invent, and to provide against them expressly in the statute. The more effective plan is to place the responsibility squarely upon the Department administering the law from day to day. It can readily amend its regulations to cover new situations as they arise." Statement of the Acting Secretary of Treasury Regarding the Preliminary Report of a Subcommittee 9-10 (1934). Roswell Magill of the Treasury Department weakened Morgenthau's proposal by expressing satisfaction with the 1924 Act definitions, but suggesting legislative regulations if the Committee wanted to make changes. It disagreed with both points. Hearings on Revenue Revision 1934 before the House Ways and Means Comm., 73d Cong. 74-75 (1934).
definition of reorganizations in general.\textsuperscript{58} (Split-ups continued to be permitted under that general reorganization definition.\textsuperscript{59}) About 15 years later as control of Congress bounced back and forth between almost evenly matched Republicans and Democrats from 1947 to 1951, Congress manifested antipathy to judicial innovations in the reorganization area through adoption of detailed active business and device rules in reintroducing non-recognition divisive reorganizations in the 1939 Code predecessor to present Section 355. Congress anticipated that courts would not add new conditions to the statute, on the theory that detailed rules lessen the decision maker's discretion.\textsuperscript{60} Of course, in fact, this set the stage for the ultimate "collaborative model" of scholarship influencing courts, thus influencing more scholarship which in turn influences the agency in its rule making culminating in the 1989 revised Section 355 regulations.\textsuperscript{61} When Lee separately described to Professors Gunn and Koch such neat evolution of the Section 355 regulations,\textsuperscript{62} Alan told him about Professor Kennedy's

\begin{itemize}
  \item \textsuperscript{58} Lee, \textit{Structured Discretionary Justice}, supra note 1, at 1033. The full House Ways and Means Committee compromised in its Revenue Bill of 1934 by proposing the repeal of "B", "C" and divisive "D" reorganizations, while retaining "A" type statutory merger or consolidation. Confidential Comm. Print No. 1, 73d Cong. § 112(g)(1), pp. 85-6 (Feb. 2, 1934); H.R. REP. No. 73-704, at 12-14 (1934); 78 CONG. REC. H2663 (daily ed. February 14, 1934) (remarks of Rep. Hill, D-Wash.); Heverly, 621 F.2d at 1237; Chapman, 618 F.2d at 865. Treasury acquiesced at the time. Letter of February 12, 1934 from Sec'ty of the Treasury Morgenthau to House Ways & Means Chairman Bob Doughton, D-N.C., read into the record 78 CONG. REC. H2512 (daily ed. Feb. 14, 1934). The 1934 Executive Session or Confidential Senate Finance Committee Hearings reveal that the origin of the "voting stock" requirement in Type \textit{B} and Type \textit{C} reorganizations in the Revenue Act of 1934 lay in the Senate Finance Committee's competing desires to permit non-statutory mergers, while preventing the abuse of sale-like transactions obtaining reorganization status. The Committee's compromise was to codify the "idea of continuity of interest" contained in the then recent \textit{Pinellas} case (Pinellas Cold Storage Ice Co. v. Commissioner, 287 U.S. 462, 468-69 (1933) ("the seller must acquire an interest in the affairs of the purchasing corporation more definite than that incident to ownership of its short-term purchase-money notes" which were not securities since payable within four months)) in order to ensure that shareholders of \textit{T} did not sell their stock pursuant to a stock-for-stock or stock-for-assets reorganization. \textit{1934 Confidential Senate Hearings, supra} note 46, at 117.
  \item \textsuperscript{59} BORIS I. BITTKER & JAMES S. EUSTICE, \textit{FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS} ¶11.01[2][b] (6th ed. 1994).
  \item \textsuperscript{60} Whitman, \textit{supra} note 3, at 1202.
  \item \textsuperscript{61} See generally Lee, \textit{Structured Discretionary Justice}, supra note 1.
  \item \textsuperscript{62} The legislative treatment of corporate divisions has varied. Initially, they were included with the organization provisions, and the predecessor to present section 355 spawned \textit{Gregory v. Helvering}. Although the government triumphed in the \textit{Gregory} case, Congress thought \textit{Gregory} was insufficient to protect the Federal fisc. Corporate divisions offered too great an opportunity for bailing out corporate earnings, and the tax-free blessing was withdrawn from them. This blanket consignment to tax purgatory, however, was argued to be too broad. By 1951, Congress was receptive to the notice that the good and the bad could be effectively distinguished, and corporate divisions were revived, but tax deferral was denied to
standards and rules scholarship; Charles, about Professor Davis' idea of structured discretionary justice.

D. Lessons from the Partnership Section 701 Anti-Abuse Regulations

Subchapter K sets forth the taxation of partners and partnerships, following a pass-through regime under which the partnership as such is not subject to the income tax; persons carrying on a trade or business as partners are liable for income tax in their separate or individual capacities. Each partner in determining her Federal income tax must take into account separately her distributive share of gain or loss reported by the partnership. A partner's distributive share in turn is determined according to the partnership agreement so long as its allocation of such transactions used principally as devices for the distribution of earnings and profits to shareholders. In regulations issued in 1955, the Internal Revenue Service (IRS) drew the line mandated by Congress primarily by restricting corporate divisions to distributions of an entire business. Under these regulations, a corporate division also could effect a business division only by surrendering its tax-free status. In practice, the IRS relied on this active business requirement, but supplemented it with the argument that some distributions essentially were equivalent to a dividend and were, therefore, devices for a distribution of earnings and profits.

The first prong of this two-part test did not fare well in the courts, and in 1964, after the courts had determined that a single business could be divided, the IRS announced that it would revise the regulations to permit the division of a single business. The promise of revision was hailed by the tax bar, and advice that it be a complete overhaul of the existing regulations soon was abundant. Recognizing that any distribution necessarily produced a distribution of earnings, many commentators argued that the presence of a good business purpose should be sufficient to pass the tax deferral test. They also thought that less reliance should be placed on the definitional aspects of an active business. In short, they wanted less formalism and more inquiry into the question of whether a given distribution could be supported by reasons other than the desire to reduce the barriers between the shareholder and realization of the corporate earnings.

Revision finally arrived a quarter of a century later, and the final regulations recently promulgated under section 355 largely accomplish these goals. These regulations give substantial guidance to the practitioner about whether a transaction complies with them. More importantly, they deal with the underlying policy and provide their guidance at a level of sophistication that is unparalleled in Treasury regulations.

Lee, Structured Discretionary Justice, supra note 1, at 1029-30.


64. I.R.C. § 702 (1997). Section 702(b) provides that the character of any item included in a partner's distributive share under paragraphs (1) through (7) of section 702(a) is determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Treas. Reg. § 1.702-1(b) provides "character" determination rules. Treas. Reg. § 1.702-1(b) (1996).
share has "substantial economic effect." Professor Lee suspects that in many cases allocations produce results at odds with the taxpayer's treatment had she acted as a sole proprietor, thus violating the fundamental policy of Subchapter K—seeking "to tax a partner in the same manner as a hypothetical individual entrepreneur or proprietor in similar circumstances would be taxed."

In May, 1994, the IRS and Treasury proposed regulations under Section 701 adding an anti-abuse standard under Subchapter K. The regulation was finalized at the end of the year. The drafters expected that it would

66. The Treasury regulations implementing section 704(b), according to some observers, were written for the benefit of the tax shelter promoters. Section 704(b) was amended in 1976 to require that partnership allocations of tax items must have "substantial economic effect." The present section 704(b) regulations give lip service to substantial economic effect by requiring that capital accounts be adjusted for these allocations. But this ignores the time value of money, according to Professor John Lee of William & Mary's Marshall-Wythe College of Law. After all, what limited partner in a tax shelter cares what his capital account says? Assistant Treasury Secretary J. Roger Mentz has pointed out at congressional hearings on pass-through entities that these mere chargebacks do not reflect economic reality. The regulations permit flip-flops of income and losses — arrangements which, if the time value of money is taken into account, achieve the same result that the Tax Court condemned in Orrisch, 55 T.C. 395 (1970).

Lee A. Sheppard, The Gauntlet: Joint Committee's Corporate Base Broadeners, 36 Tax Notes 9, 10 (1987). Professor Lee's point is consistent with legislative history cited by the Preamble to the Section 701 Regulations:

Subchapter K was enacted to permit businesses organized for joint profit to be conducted with "simplicity, flexibility, and equity as between the partners." S. REP. NO. 83-1622, at 89 (1954); H.R. REP. NO. 83-1337, at 65 (1954). It was not intended, however, that the provisions of subchapter K be used for tax avoidance purposes. For example, in enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if such concepts are more appropriate in applying other provisions of the Code. H.R. CONF. REP. NO. 83-2543, at 59 (1954). Similarly, in later amending the rules relating to special allocation, Congress sought to "prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes." S. REP. NO. 94-938, at 100 (1976).


69. The regulations were filed on December 29, 1994 and published in January 1995. 60 Fed. Reg. 23, 33 (1995). This speed in finalization parallels the speed in its inception. "Former Deputy Assistant Secretary of the Treasury Leslie Samuels is credited with fathering the partnership anti-abuse
only affect a relatively small number of partnership transactions that make inappropriate use of the rules of Subchapter K and would not interfere with bona fide joint business arrangements.70 The Eighth Circuit in Brown Group, Inc. v. Commissioner put it well:

[F]or transactions occurring on and after December 30, 1994, Congress for the first time has apparently permitted, in special circumstances not relevant here, the recasting of partnership income under Subpart F. Treasury Regulation [section] 1.701-2 was thereafter announced. That Regulation, characterized as the “anti-abuse rule,” permitted the IRS to recast partnership transactions that make inappropriate use of Subchapter K rules. In particular, [section] 1.701-2(e) provided that the IRS can treat a partnership as an aggregation of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.71

The drafters spelled out that “[i]mplicit in the intent of subchapter K are . . . [three] requirements.”72 These broad standards are (1) substantial business purpose, (2) substance over form, and (3) clear reflection of income, subject to an exception for “administrative convenience.”73 Where a principal purpose of formation or use of a partnership is “to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction . . . .”74 The regulations further provide seven non-exclusive factors that may indicate the tainted principal purpose. These factors cluster around (1) present value of tax liabilities are substantially less than if the partners had owned the assets directly and conducted the activity directly; (2) one or more partners is protected against risk of loss or has little or no participation in profits other than a preferred return; (3) substantially all the partners are related; (4) allocations to

regulation, which is said to have gone from his brain to the Federal Register in six weeks.” Reg Writing Process, supra note 26.

70. Partnership Industry Coordinated Issue Subchapter K Anti-Abuse Rule Regulation Section 1.701-2 (June 19, 1995), available in LEXIS, Fedtax Library, TAX NOTES TODAY File 95, TNT 124-10 (June 27, 1995).

71. Brown Group, Inc. v. Commissioner, 77 F.3d 217, 222 (8th Cir. 1996). The court also noted that the regulation also permitted recasting partnership transactions “as appropriate to achieve tax results that are consistent with the intent of subchapter K”. Id. For types of recasting see Samuel C. Thompson Jr., Ex-Government Officials Challenge Partnership Anti-Abuse Reg: An Analysis, 69 TAX NOTES 1395, 1396 (1995).


73. Id.

74. Treas. Reg. § 1.701-2(b) (1996). Such recasting may include disregarding the partnership or a partner, changing the partnership’s method of accounting or method of allocation of items between partners; or otherwise adjusting or modifying the claimed tax treatment. Id.
functionally tax-exempt partners; and (5) the burden and benefits of ownership of property contributed to a partnership are in substantial part retained by the contributing partner or shifted to a distributee partner before actual distribution.75 These factors are very consistent with, even mandated by, Lee's "hypothetical proprietress" aggregate approach to subchapter K.76 In an outstanding illustration of structured discretionary justice accompanying examples include "the weight to be given to relevant factors" so listed and provide transactions that are consistent and inconsistent with the intent of Subchapter K.77

Outside the regulation, the Service administers the anti-abuse standard through the Industry Specialization Program78 with direction of revenue agents to contact the partnership industry or issue specialist when considering a Section 1.701-2 issue.79 The problem is less "rogue" agents80 and more less specialized agents.81

78. See supra Part I for a discussion of ISP's.
80. Before leaving the discussion of the partnership anti-abuse regulation, I would like to say a few words about the so-called "rogue agent" argument being proffered by critics of the regulation. Many have suggested that the proposed regulation could be used as a powerful tool by IRS agents to recharacterize partnership transactions inappropriately. First of all, we do not have a "rogue agent" problem in the Service. Our revenue agents are generally well-trained, professional individuals with high ethical standards, who do their best to ensure that the proper amount of tax is collected in all circumstances. These agents are capable of handling cases in a fair and judicious manner, even those cases presenting the most difficult conceptual issues.

We recently announced a national coordination of partnership issues, including the anti-abuse regulations, through our Industry Specialization Program. I want to note that this announcement was not made because we feel our agents cannot properly apply broad regulations. Remember, these are the same agents who are out there every day applying the "clear reflection of income" doctrine and the transfer pricing rules. We made the announcement because the anti-abuse regulation is intended to be part of an integrated compliance strategy which will include increased audit coverage of partnerships, particularly those with large foreign or corporate partners. The new audit plan is a significant undertaking and, therefore, like our other important compliance initiatives, it will be coordinated nationally.

Commissioner's Remarks, supra note 79.
81. I think the thing that scares us most is that very few agents, in all honesty as well trained as they are, understand partnership taxation. They get a transaction they don't
Commentators believe that the "partnership antiabuse regulation changed the landscape, and certainly has brought into discussion — both on a specific (i.e., Subchapter K) and a broader conceptual basis — the

understand, they don't like, they use this as a hammer. It's got to be coordinated through national office, but it's a very, very big job to try to do that.

I think this is a step in the right direction, but it's something that you're really going to have to wrestle with if you're going to put in a broad anti-abuse rule such as this and use it effectively.

Unofficial Transcript of IRS Hearing on Partnerships, available in, LEXIS, Fedtax Library, TNT File 94 TNT 147-18 (July 29, 1994) (Statement of Charles H. Egerton, representing the Section of Taxation, American Bar Association) [hereinafter Partnership Hearing Transcript]. News journalists found it noteworthy that Egerton did not challenge the authority of the Service to issue the regulations. Id. ("Particularly surprising was the failure of ABA Tax Section Partnership Committee Chairman Charles H. Egerton to call the validity of the regulation into question, as the members of the section did in many pages of the written comments they submitted."). Professor Lee was not surprised; he knew Charlie was too good a partnership theorist and a leading proponent of the aggregate approach (which Lee believes supports the regulation) to so challenge. See also Stratton, supra note 79. Samuels Addresses New Tax Committee Chairs' Concerns About Anti-Abuse Reg., available in, LEXIS, Fedtax Library, TNT File 94, TNT 255-18 (Dec. 30, 1994).

With the clearance procedure, the Service appears to have made good on Treasury Assistant Secretary for Tax Policy Leslie B. Samuels' promise to establish a procedure that would "alleviate any fears taxpayers may have had regarding inappropriate application of the regulation." ...

Examiners Told to Get Clearance Before Raising Anti-Abuse Reg., available in, LEXIS, Fedtax Library, TNT File 95, TNT 220-03 (Nov. 9, 1995).

Treasury and the IRS were "serious about it and acting in good faith," said Michael L. Schler, Cravath, Swaine & Moore, New York. The procedure represents "one more step to centralize the process," he said.

The procedure "fills in the void" left by Announcement 94-87, commented Charles H. Egerton, who chairs the partnership committee of the American Bar Association's Tax Section. "It is basically what the committee was going to suggest in terms of implementation," Egerton noted. "I'm very pleased with it." Particularly important to Egerton is the procedure's two levels of review. "If the issue passes muster with the specialist and he wants to proceed, he must run it by the National Office," noted Egerton. "That's the way it should be."

Indeed, a major criticism of the anti-abuse rule has been that because it lacks objective standards, it could be applied inconsistently and arbitrarily by "rogue agents" in the field. Although she has generally supported the reg from the outset, Pamela F. Olson of Skadden, Arps, Slate, Meagher & Flom, Washington, says she became concerned when agents began "raising the issue in contexts where it was clearly inappropriate to raise it."

Olson, though, said she's "very happy" with the new procedure and thinks it is a "terrific idea." She said she is particularly glad to see that there will be National Office attorneys "riding herd" on the field. They are needed because of their "technical expertise" in the partnership area, Olson maintains.

Id.
propriety (and validity) of antiabuse rules in general.\textsuperscript{82} A number of former high Treasury and IRS officials as well as bar association and other pressure groups strongly opposed the proposed form of this anti-abuse provision, while a much smaller number of former high officials and tax leaders supported it. Dean Samuel Thompson, Professor Lee's long-time friend from Sam's University of Virginia Law School teaching days, succinctly described the major players and the issues.

Recently, the Assistant Secretary of the Treasury for Tax Policy, Leslie B. Samuels, received several letters from former tax officials concerning the partnership anti-abuse regulations, which are set forth in Treas. Reg. section 1.701-2. Two of these letters essentially recommended that the regulations be withdrawn. One withdrawal letter was written jointly by former Commissioner of the IRS Donald C. Alexander; former Chief Counsel of the IRS Abraham M. N. Shashy; former Chiefs of the Joint Committee Staff Mark L. McConaghy, Bernard M. Shapiro, and Harry L. Gutman; and former Tax Court Judges William A. Goffe, Samuel B. Sterrett, and John B. Williams. The other withdrawal letter was written by former Commissioner of the IRS Lawrence B. Gibbs and former Deputy Assistant Secretary for Tax Policy John S. Nolan.

Another letter, written by former Chief Counsel of the IRS and former Assistant Secretary for Tax Policy Kenneth W. Gideon, was critical of the anti-abuse regulations but stopped short of urging their withdrawal. Finally, former Chief of the Joint Committee Staff David Brockway wrote in basic support of the anti-abuse regulations.\textsuperscript{83}

The major issues raised in this debate were: (1) certainty; (2) horizontal equity; (3) clear reflection of income; (4) the ISP procedure; and (5) statutory interpretation raising intent of Congress over the plain meaning of Code provisions.\textsuperscript{84} The first and last issues go to the heart of the standards versus rules debate. This was the issue in \textit{Gregory v. Helvering}— the certainty of a meticulously worded statute versus the policy or purpose of the reorganization provisions.\textsuperscript{85} Sam points out that business purpose, one of the anti-abuse regulations “intent” factors, is incorporated in the

\begin{itemize}
\item \textsuperscript{82} \textit{Anatomy, supra} note 26. For an excellent discussion of the broader question of rules and standards and particularly standards without rules see Hale Gann & Roy Strowd, \textit{The Recent Evolution of Antiabuse Rules}, \textit{66 TAX NOTES} 1189 (1995), and \textit{Compendium on Anti-Abuse Rules}, \textit{48 TAX LAW.} 799-844 (1995).
\item \textsuperscript{83} Samuel C. Thompson Jr., \textit{Ex-Government Officials Challenge Partnership Anti-Abuse Reg: An Analysis}, \textit{69 TAX NOTES} 1395 (1995) (footnotes omitted) (note 6 lists the literature on the anti-abuse proposal at that time.).
\item \textsuperscript{84} Thompson, \textit{supra} note 83, at 1397. We derived these categories from Sam's slightly different list.
\item \textsuperscript{85} \textit{See supra} notes 44, 49-50 and accompanying text; Thompson, \textit{supra} note 83, at 1399.
\end{itemize}
amalgamating and divisive reorganization regulations, although not contained in the underlying statute. 86 Moreover it has explicit support in the legislative history of Subchapter K. 87 Likewise the substance over form intent factor applies elsewhere even though not mentioned in the particular Code provision. 88 Assistant Secretary of Treasury Leslie Samuels noted that this “regulation generated an intense debate. One interesting part of the debate was whether in fact any abuses needed to be curbed. Some suggested that the world was virus free, or at least no vaccination was needed. Others thanked us for the regulation." 89 Protection of practitioners from aggressive clients was repeated by Government officials. 90 In the public hearings on the proposed version of the regulations government participants scoured representatives of organizations who had in the context of other partnership provisions argued for a non-literal approach. 91 The argument that uncertainty emanating

86. Thompson, supra note 83, at 1399. In the hearing on the proposed regulations academic witnesses such as Professor Rebecca Rudnick and Professor Joseph Bankman took similar positions on intent versus literal language. Partnership Hearing Transcript, supra note 81. See also Joseph Bankman, The Proposed Antiabuse Rule: Appropriate Response to Serious Problem, 64 TAX NOTES 270 (1994).

87. Thompson, supra note 83, at 1400.

88. Sam points to the step transaction doctrine, also well-known in the corporate tax arena. Thompson, supra note 83, at 1400.

89. Remarks of the Hon. Leslie B. Samuels, Assistant Secretary (Tax Policy) U.S. Department of the Treasury, ABA TAX Section’s May Meeting (May 11, 1996); available in, LEXIS, Fedtax Library, TNT File 96 TNT 97-57 (May 16, 1996).

90. Forthcoming Guidance, supra note 5 (“Kohl argued that the government’s job in writing regulations is to give comfort to the conservative tax practitioner who needs some backup when he has to say ‘no’ to a client or, more likely, a client’s investment banker.”).

91. For instance, the Chicago Bar Association had vociferously argued that the proposed regulation should be withdrawn. E.g., Letter dated February 20, 1995 from Karen V. Kole and Douglas J. Antonio of the Chicago Bar Association to Rep. McIntosh and Sen. Nickles (seeking exclusion of anti-abuse regulation from exception for Treasury regulations from proposed moratorium on regulations), reprinted in 66 TAX NOTES 1203 (1995). The New York State Bar Association Tax Section (NYSBA) to the contrary objected to any “targeted application of a legislation moratorium to one specific, existing regulation.” Partnership Anti-Abuse Regs. Via Moratorium, available in, LEXIS, Fedtax Library, TNT File 95 TAX NOTES TODAY 62-44 (March 30, 1995).

At the hearing Antonio argued that the regulation was legislative because not supported by any statutory language. Further he argued: “It is not possible to determine the purposes of the provision of the Code as opposed to the literal language of the Code. If a transaction complies with the literal language of the Code, it complies with the intent of the Code." Partnership Hearing Transcript, supra note 81. Paul Kugler, Assistant Chief Counsel, Passthroughs and Special Industries took CBA to task for inconsistency.

I am frankly a little confused as to what this CBA’s views are as to the proper role of the IRS in administering the tax laws. We’ve seen in your papers and your speech today your being critical that we’re not sufficiently differential to the tax court’s views in the Brown Group case, yet in 1981 when the tax court decided the Campbell case, the CBA was at the front of the line requesting us to grant prompt administrative relief effectively overturning the tax court
from a broad anti-abuse standard would retard commerce— the nuclear winter claim—justly received short shrift. Indeed, many supported

... If that's your position today, that's fine, but it hasn't always been. *Campbell* is not a literal interpretation. You know, the result that results in no taxable income even when there's a value.

Also, you know, prior CBA comments have asked us to override the literal words of statutes on more than one occasion, because the literal language, for instance, of Section 168(j)(9) would imply a transaction Congress didn't intend. In a CBA comment on the Q-tip regulations, you stated that "In view of the oppressive result produced by such an overly, literal construction of 2519, we suggest that the Q-tip regulations could and legitimately should construe the statute as requiring. . . ." then you went on to describe a non-literal interpretation.


92. *E.g., Anatomy, supra* note 26, at 1862; Cunningham, *supra* note 21, at 124; Gann & Strowd, *supra* note 82; Gideon, *supra* note 21, at 639.

93. *Current tax law and regulations are flexible enough to respect the bargain for economic needs for the money partner, the idea partner and the property partner, as long as the economics follow the taxes. Take this flexibility and relative certainty away and nuclear winter will descend upon the joint venture profit-oriented partnership.*


94. While government representatives gave good answers, the best was by Professor Bankman.

I want to shift focus a little to address a concern voiced by some commentators here today that this approach of the Treasury, placing greater emphasis on purpose, will have a chilling effect on investment. In the words of — to paraphrase one commentator that "It will be the nuclear winter of productive joint ventures."

You know, one way to approach this issue, I think, is to look at the experience the tax system has had with judicially developed doctrines, such as substance over form, business purpose, step transaction and the like. These doctrines have been uniformly, I think, accepted by courts, at least in principle, and are at least as vague in scope as the proposed regulations and applied to transactions in and out of Subchapter K.

Have these transactions discouraged productive investment? Is it possible to identify a class of transactions that would have added to the social product, but were abandoned because of the doctrines? Would we be a wealthier society without them?

I suspect that most tax lawyers will find these questions rhetorical. In general, I believe the investment community has more to fear than the tendency to over legislate against loopholes, than it does from adding to the Treasury's authority to interpret the law in a manner that takes into account legislative purpose.

One thing's missing, I think conspicuously, from the discussion of the proposed regulation is any acknowledge of its benefits. The most logical alternative to the approach that Treasury has now embarked is increasing reliance on detailed rulemaking. One disadvantage, quite obviously to this approach, is that it gives taxpayers a multi-year window in which to cash in on even the most egregious tax-driven transactions so long as those transactions are supported by the literal language of one or more statutes.

The delay inherent in this approach may produce an ongoing revenue shortfall of substantial magnitude. Social wealth, of course, is reduced by the fact that transactions are
a standard as retarding abusive transactions due to its uncertainty.\textsuperscript{95} Horizontal equity is surely promoted by a standard that rests in large part on whether a different tax result would result if the transaction were carried on by individuals outside a partnership. Otherwise more sophisticated (read higher income with expensive tax advisers) taxpayers can obtain more favorable tax results that smaller income taxpayers directly carrying out similar transactions. Sam points out the ISP and review approach “should ensure uniform treatment of similarly situated taxpayers.”\textsuperscript{96} Virtually everyone applauded the ISP/review approach, but some critics of the regulations viewed the procedure as an attempt by the Service to head off a weak test case\textsuperscript{97} — the Service does believe that litigation is on the horizon.\textsuperscript{98} We believe that if a fair test case arises that the regulation will be upheld for the reasons discussed.

Sam notes that the clear reflection of income standard applies in the corporate context and should apply generally in the partnership context as well.\textsuperscript{99} Commissioner Richardson points out that the clear reflection of income standard is applied by revenue agents “every day.”\textsuperscript{100} Then Acting Deputy Tax Legislative Counsel Michael Thomson raised the same parallel at the hearing on the proposed regulations.

MR. THOMSON: I’d be very interested in your thoughts about what I view as another very, very broad rule and that is the clear reflection of income standard [of] 446(b), very open-ended, very broad, very vague. But my sense is it’s not perceived to be grossly misused by agents and I wonder if you have any thoughts on what that tells us about this regulation, or if there are things involved there that we might learn from to make sure this regulation is not misused.\textsuperscript{101}

created that fill no plausible legislative purpose and would be uneconomic but for the tax savings.

\textit{Id.}

\textsuperscript{95} See Thompson, supra note 83, at 1398; Cunningham, supra note 21, at 125.

\textsuperscript{96} Thompson, supra note 83, at 1401.

\textsuperscript{97} Stratton, supra note 79.

\textsuperscript{98} Herman Ayayo, \textit{Partnership Anti-Abuse Litigation on Horizon, IRS Official Predicts}, \textit{available in}, LEXIS, Fedtax Library, TNT File, 95 \textit{TAX NOTES TODAY} 212-23 (Oct. 30, 1995) (“We fully expect that the first [partnership anti-abuse] case that we go unagreed with, you folks are going to want to litigate it,’ Steiner told the practitioners. ‘It will be a very carefully chosen case, it’s going to be a ‘big dog case,’ and it’s probably a case like \textit{Brown Group}. It is going to be a very straightforward, in our opinion, abuse of subchapter K.’”)

\textsuperscript{99} Thompson, supra note 83, at 1400.

\textsuperscript{100} Commissioner’s Remarks, \textit{available in}, LEXIS, Fedtax Library, TNT File, 94 TNT 157-67 (Aug. 11, 1994).

\textsuperscript{101} Partnership Hearing Transcript, supra note 81.
The witness sidestepped the question. 102

Contemporaneously with development of the Subchapter K anti-abuse standard Treasury also took a giant step towards simplification with its “check-the-box” regulations permitting elective classification of business tax entities (significantly other than formally organized corporations). 103 Historically, both the courts and Treasury regulations classified entities as separate, i.e., as “associations” taxable as corporations, on the basis of the Morrissey104 “corporate resemblance” factors: (1) continuity of the entity’s life, (2) centralized management, (3) limited liability of the owners, and (4) free transferability of ownership interests. 105 At the same time entities formally organized as corporations were (and are) per se classified as corporations despite their usual inability to meet any of the four resemblance factors, 106 so long as they were organized for or carried out a business purpose. Treasury claimed in 1986 that acquiescing in state law corporate form promoted certainty and ease of administration, 107 but the political

102. Brumbaugh: I have not seen clear reflection of income used as a hammer that much.
There again, in my role — I’m a national tax partner and I’m not in the trenches as much as many of the other practitioners are on the AICPA committee.


104. Morrissey v. Commissioner, 296 U.S. 344, 359 (1935). The predecessor to the Tax Court mechanically applied the Morrissey factors in determining status of a family limited partnership, when the Service sought corporate reclassification instead of generic reallocation arguments. See Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942). Apparently for certainty as much as anything else, the early 1960 revisions of the entity classification regulations then mechanically applied Glensder Textile’s form controls approach. Prior to the 1960 revisions of the classification regulations, the Service for ruling purposes held that an organization would not be treated as an “association” if any one of the four essential characteristics — (1) associates, (2), objective to carry on a business and divide its profits, (3) centralized management, and (4) continuity of life) — were not present. See I.T. 3930, 1948-2 C.B. 126; Rev. Rul. 57-341, 1957-2 C.B. 884; Rev. Rul. 57-607, 1957-2 C.B. 887; I.T. 3948, 1949-1 C.B. 161; Rev. Rul. 54-484, 1954-2 C.B. 242. In order to provide certainty the regulations thus made classification of entities not formally organized as corporations turn on the presence of three or more of the four corporate resemblance factors. Larson v. Commissioner, 66 T.C. 159, 185 (1976) (suggesting that these regulations be revised further to reflect more faithfully the Morrissey resemblance approach, disapproving of the “thumb on the scales” in favor of partnership treatment requiring that the entity possess three of the four corporate characteristics and that these characteristics were to be equally weighted).

105. Lee, Entity Classification, supra note 13, at 85.

106. Lee, Entity Classification, supra note 13, at 87 n.112.

107. Assistant Secretary Mentz admitted that few close C corporations possessed any of the traditional corporate resemblance factors. Hearings on H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448 (Issues Relating to Passthrough Entities) before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm., 99th Cong. 19 (1986) [hereinafter 1986 Passthrough Entity Hearings]; however, he asserted that state law form, i.e., “objective” rules, was preferable to functional subjective classification, with the limited exception of publicly traded partnerships. See id. at 27-28.
reality was and is that small business pressure groups fight hard for the $3 to $4 billion a year subsidy\(^{108}\) of the graduated inside corporate rates on the first $75,000 of corporate earnings, which are much lower than the rates the business owners would be subject to were they taxed directly on the income reported by the entity. Under the aggregate policy discussed above, close corporations would be treated as passthrough entities where ownership and control are not separate,\(^{109}\) as is usually the case in close C corporations. Politics rather than sober-minded policy considerations govern as to close C corporations as has always been the case. In any event Treasury believed that it was

Often difficult and cumbersome to apply the existing regulations and rulings in determining whether an unincorporated entity is taxable as a partnership or corporation. In addition, many states revised their statutes to allow partnerships to possess characteristics traditionally associated with corporations.

Instead of devoting considerable resources to complex classification issues, such as centralized management and free transferability, taxpayers will now be able to achieve certainty in classification by doing no more

---


109. The Joint Committee staff believes, correctly, that the presence of the Morrissey factors only overlaps the passive/active participation-by-owners dichotomy which supports separate entity treatment. "In particular, to the extent that an entity is viewed as acting separately from its owners, rather than merely as their agent or alter ego, an argument can be made that it should be treated as a separate taxable unit." *Federal Income Tax Treatment of Pass-Through Entities (Including a Description of H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448)*, Staff of Joint Comm. on Taxation, 99th Cong. 13 (Comm. Print 1986) (hereinafter "Passthrough Entity Hearing Pamphlet"). See Lee, *Entity Classification*, supra note 13, at 86-87 n.118 and authorities cited therein. The underlying policy question is whether the owners are the parties that actually earn the income of the entity in a realistic and substantial economic sense. This determination should turn in large part on whether the owner is active in management. See *Passthrough Entity Hearing Pamphlet*, supra at 14-15. The still-born 1977 proposed amendments to the classification regulations identified the core of the partnership as this aggregate characteristic.

"A partnership is usually characterized by the partners' personal identification with the partnership, their personal participation in its decision-making, and their personal responsibility for its obligations." Prop. Treas. Reg. § 301.7701-2(a)(2), 42 FED. REG. at 1040 (1977), withdrawn, 42 FED. REG. 1489 (1977). For this story see Lee, *Entity Classification*, supra note 13, at 61 n.9. In summary, the only policy-based, *functional* entity classification distinction is between an aggregate approach, which treats an entity as a "collection of its owners banded together for profit" and treats the owners as if they owned proportionate shares of the entity's assets, and a separate entity approach under which owners have an interest only in the entity and not in its assets. Id. at 88, n.126 and authorities cited therein.
than filing a simple election. This simplification stands as an example of
the great strides that can be made in this area and should serve as a model
for future reform.\textsuperscript{110}

The combination of (a) substituting for easily gamed rules
(transactionally elective as to passthrough treatment) an expressly elective
classification test other than as to an entity formally organized as a
corporation or its equivalent and (b) a general anti-abuse standard for
Subchapter K embody the Treasury preference for a broad standard over
detailed rules. Entities other than per se corporations can elect passthrough
treatment, but abuse of that regime are then policed by the anti-abuse
standard, which then is applied in a structured discretionary justice manner.

\section*{E. Lesson from Debt-Equity Regulation}

Commissioner Goldberg's view in the 1992 Business Plan\textsuperscript{111} that the
average taxpayer is burdened by detailed rules while the larcenous taxpayer
finds a pathway to avoidance was probably based upon the uncomfortable
IRS/Treasury experience with Section 385 legislative regulations for
categorizing corporate debt and (disguised) equity. All versions suffered
from hyperlexis and detailed, annoyingly slightly varying rules, which
Professor James Eustice pointed out small business (from whose world the
debt-equity criteria had been developed by the courts) heartily condemned,
wanting no regulations, while the sophisticated Wall Street financiers gamed
the contingent interest rules.\textsuperscript{112}

\begin{thebibliography}{99}
\footnotesize
\item 110. \textit{Remarks of the Hon. Leslie B. Samuels, Assistant Secretary (Tax Policy) U.S. Department of the Treasury, ABA Tax Section's May Meeting} (May 11, 1996), available in, LEXIS Fedtax Library, TNT File, 96 TAX NOTES TODAY 97-57 (May 16, 1997).
\item 111. \textit{Treasury--IRS 1992 Business Plan}, available in, LEXIS, Fedtax Library, TNT File, 92 TAX NOTES TODAY 104-50 (May 18, 1992); \textit{Merits of Broad Regulations Debated by Former and Current IRS Officials}, DAILY TAX REP. (BNA) March 2, 1993, at d13 ("Monte Jackel, deputy associate chief counsel (domestic), said that even under the approach in which more detailed, more mechanical regulations were written, 'in my opinion, the line was never clear.' When IRS relied on more detailed rules, some practitioners often would apply them mechanically so that they violated the spirit of the rules, Jackel explained.").
\item 112. \textit{Hearings on Tax Aspects of Mergers and Acquisitions before the House Ways & Means Subcommittees on Oversight and Select Revenue Measures}, 99th Cong. 763 (1985) (statement of N.Y.U Professor Jim Eustice); \textit{id.} at 184 (Statement of Joint Committee Chief of Staff David Brockway) (Section 385 very controversial); \textit{Hearing on Leveraged Buyouts and Corporate Debt before the Senate Finance Comm. (Part 2)}, 101st Cong. 24 (1989) (colloquy between Senator Daniel Patrick Moynihan, D-N.Y., and Sec'ty James Brady):
\begin{quote}
\textbf{Senator Moynihan.} ...In 1969, Congress gave Treasury the ability to distinguish between corporate debt and corporate equity. It took you a long while to be able to issue regulations—it was not until 1980. And then, it turned out they could be gamed, and you withdrew them.
\end{quote}
\end{thebibliography}
In 1969 Congress dropped the debt definitional ball into the Treasury's lap. They writhed with it for 10 or 11 years; they tried with three versions of regulations to come up with the perfect world. It is unlikely that we are ever going to see the perfect world here. Due to numerous protests from different portions of the tax community— I think the small business taxpayers thought it was too complicated, but the investment bankers loved it because it had bright lines which inevitably make for bright ideas— the whole thing was withdrawn several years ago for further study, and then as far as I can tell, total interment. 113

Treasury washed its hands of the whole matter114 leaving it to Congress to nickel-and-dime legislate the current fad debt-equity abuse from time to time when it needs a nice revenue raiser115 under its pay-as-you-go

You have mentioned the problem of equal treatment of debt and equity in the Tax Code. Could I then ask if you have any plans to revisit the relevant portion of the Code—Section 385? Please answer briefly, if you can.

SECRETARY BRADY. You bet. We have looked at it for the very same reason that you have asked the question because it is very important right now. Our initial thinking is that the definees are quicker and swifter than the definors; we have found that out in the past, and we haven't come up with a definition right now that changes our view on that.

Id.

113. (Statement of Professor Eustice).
114. MR. PEARLMAN [Assistant Secretary of Treasury for Tax Policy]. As part of the section 385 regulations project, which has surfaced several versions of section 385 regulations, one of the things that the Treasury Department did seek to do was to look at some of the more esoteric kinds of securities that were being used in acquisition transactions or that might be anticipated to be used in acquisition transactions. And what we found was that it was (a) very difficult to articulate what was debt and what was equity under particular circumstances, and (b) once a determination was made, then it became a highly controversial item as to putting those rules into particular play. They produced what people viewed as inappropriate results depending on the circumstances.

My own judgment is, although I think it is important to seek to try to articulate general debt-equity rules that are available to people to be guided by, that it is essentially a case-by-case process, it has always been in this country. I think Congress, with good intent, tried to articulate some general rules in 1969, but we found that they were very difficult to generalize.

Hearing on Tax Treatment of Hostile Takeovers (S. 420, S. 476, and S. 632) before the Senate Finance Subcommittee on Taxation and Debt Management, 99th Cong. 144 (1985) (statement of Assistant Secretary Ron Pearlman). See also id. at 143.

MR. PEARLMAN. Treasury has been working on those regulations [§385] since 1969. I guess it would be accurate to say we are not actively doing anything with those regulations now, having been wounded on a number of occasions.

Id. at 143 (statement of Pearlman).

or “pay go” rules for enacting revenue losing tax legislation and to the Service to audit and litigate. This article maintains that it is time for detailed capitalization versus expensing rules. This story should not preclude detailed rules as to capitalization versus expensing so long as they are compatible with the rough justice and structured discretionary justice arguments espoused in this article.

F. Structured Discretionary Justice and Horizontal Equity or Rough Justice politically

In choosing among the many options submitted pursuant to Notice 96-7, the Service should be guided by the idea of evolutionary rule making propounded by the leading administrative law scholar, Emeritus Professor Kenneth Davis in his landmark book Discretionary Justice — A Preliminary Inquiry. His thinking here is best appreciated against the perspective of the more general jurisprudential thinking about general principles and rules discussed above. Professor Duncan Kennedy in his landmark article Form and Substance in Private Law Adjudication posits two opposed methods in American Law for implementing substantive law: standards and rules—the familiar substance and form (and equity versus law) debate in yet another guise. This was the path the debate took as to the partnership

116. See John W. Lee, Critique of Current Congressional Capital Gains Contentions, 15 VA. TAX REV. 1, 57 (1995) [hereinafter Lee, Capital Gains Contentions], for a discussion of “pay-as-you-go” or paygo procedures of OBRA 1993 which, “require revenue decreases to be offset by (a) increases in revenues . . .” or “(b) decreases in spending, so there is no net increase in the deficit.”

117. Many of the earliest ISP’s involved leveraged buyout issues such as interest incurred as to financing of stock repurchases and amortization of purchased intangibles. IRS Publishes List of ISP Guidelines, (September 30, 1996), available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 209-11 (Oct. 25, 1996).

118. Long after our Submission and after this article was substantially completed evidence was released which suggests that Chief Counsel Stuart Brown at least for now intends to keep muddling through. “What became clear through the process, however, was that there was no “magic formula” for resolving the conundrum; in other words, the IRS has not developed an approach to avoid a case-by-case analysis.” TEI Releases Minutes of IRS, Treasury Liaison Meetings (Jan. 27, 1997) [hereinafter TEI Liaison Minutes], available in LEXIS, Fedtax Library, TNT File, 97 Tax Notes Today 20-46 (Jan. 27, 1997)

119. KENNETH CULP DAVIS, DISCRETIONARY JUSTICE, A PRELIMINARY INQUIRY 103 (1969) [hereinafter DISCRETIONARY JUSTICE].

120. Kennedy, supra note 1. Neither this article, nor our Submission, nor Professor Lee’s earlier treatment of Professor Kennedy’s thought in Structured Discretionary Justice, supra note 1, attempt to either explore or describe Professor Kennedy’s central inquiry into the relationship between the “two opposed rhetorical modes for dealing with substantive issues,... individualism and altruism,” 89 HARV. L. REV. at 1685, and rules and standards: “altruist views... lead to willingness to resort to standards... while individualism seems to harmonize with an insistence on rigid rules rigidly applied.” Id. Also, this
anti-abuse standard. Yet the policy choice does not have to be *between* rules and standards; rules may be combined with standards, as where tax “safe harbors” are combined with a facts-and-circumstances test subject to the underlying standard. In fact, that is the path followed in the final partnership anti-abuse regulations. Some tax commentators long-ago advocated this format as providing certainty in the safe harbor for anyone who could 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.” Parenthetically nowadays the preserve of large, sophisticated tax departments is more likely to be the labyrinth of detailed, mechanical rules spun out in endless regulations at times implementing exceeding complex statutory regimes, such as the Section 469 passive loss rules and standards, and at times more simple statutory provisions, as in the Sections 704(b) and 752 regulations.

In contrast, detailed regulations promulgated by an administrative agency, here Treasury and the Service, increase the principled discretion of the agency as a decision maker, according to *Discretionary Justice* and subsequent administrative law scholarship. Administrative law scholars believe that agencies through structured discretion, e.g., issuing regulations (rule making) setting forth specific factors to be used in balancing tests implementing the desired standards and policies, can implement standards effectively while maintaining the bureaucrat’s discretionary judgement in application. They believe that such detailed rules channeling agency exercise of discretion can develop from first considering one concrete problem at a time, announcing the hypothetical cases as rulings and refraining from generalizing; then fashioning generalized principles or standards from this experience; and finally formulating regulations to implement the standard in the form of structured discretion. The article does not explore Professor Kennedy’s method of tracing the conflict between altruism and individualism, viz., a “dialectical or structuralist or historicist or the method of contradictions.” *Id.* at 1712. For interesting applications of rules/standard thought to the tax area see John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 Wash. L. Rev. 1 (1993); Colliton, *supra* note 1.


122. Some call for a two track approach: complex regulatory provisions for the generalist and average taxpayer backed up with an anti-abuse standard for the specialist and the sophisticated taxpayer; for all an anti-abuse provision must clearly target the avoidance it seeks to prevent. Olson, *supra* note 26, at 824. *Cf.* Lee, *Structured Discretionary Justice, supra* note 1; *Use and Misuse, supra* note 26, at 829.


124. *Discretionary Justice, supra* note 119, at 60.
evolution of the Section 355 regulations, which are but the later chapters in the Gregory story, strikingly illustrates this progression. Similarly the partnership anti-abuse regulations, also ultimately derived from this source provide an excellent illustration. The generalized statute cum-detailed regulations tax model closely parallels the thinking of Professor Davis as to "discretionary justice" in administrative law and in particular his concept of "structured discretion."

A rule may provide that over here at the right end the answer is always yes, and that over here at the left end the answer is always no; when it does that it confines discretion to the middle territory. But the rule may go on and structure the discretion in that middle territory. . . . For instance, it may provide that in exercising discretion the agency will consider three factors. That much is a partial structuring of discretion. Then the rule may state the result when the three factors pull together but provide that the result will be worked out from case to case when the three pull against each other. Such a rule structures discretion, leaving many questions open. A rule which does not generalize but which gives illustrations may help structure discretion.

Observe the parallel as life mimics art.

As the product of long administrative experience with section 355, the 1989 final regulations are a paradigmatic fusion of rules and standards implemented through factors that closely relate to the underlying policy or standard. De-emphasis of the active business test and the predominant weight given to the functional device standard continues from 1977 the


What we do wish to clarify is the test that should be used in determining whether a particular transaction constitutes a device to distribute earnings and profits under Code 355(a)(1)(B). The current leading authority on this issue is Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), aff'g, 55 T.C. 491 (1970). In that case, the court found a device to distribute earnings and profits even though the shareholders had not yet converted ordinary income to capital gains. The court took an expansive view of the device clause and changed by its interpretation the emphasis of the limitations on shareholder nonrecognition of gain or loss in Code § 355 and the Regulations thereunder. The First Circuit cited and adopted some of the suggestions in Whitman, Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code, 81 Harv. L. Rev. 1194 (1968). The Sixth Circuit took a similar view of the device clause in King v. Commissioner, 458 F.2d 245 (6th Cir. 1972), rev'g, 55 T.C. 677 (1970). Both cases are discussed at length in Lee, Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty, 27 Tax L. Rev. 453 (1972).

126. DISCRETIONARY JUSTICE, supra note 119, at 103.
proposals. But this time, the regulation drafters implemented the device standard through a balancing of non-per se factors evidencing device with factors evidencing non-device, including business purpose, tested against the underlying standard of preventing bailouts. Additionally, a nondividend equivalency test or "escape hatch" ordinarily trumps any device factors. Moreover, the drafters provided instructions as the weighing process. The active business test has been clarified and simplified in spots. The 1989 regulations rely heavily on a clarified business purpose requirement to deny tax deferral to undeserving transactions that do not otherwise violate the device restriction. The continuity of business interest requirement also has been strengthened in an effort to get at these transactions.

The 1989 final regulations increase the number and quality of examples for every aspect of the regulations and often explain in the "Preamble" the rationale of the further examples. Moreover, the text greatly expands the general principles, particularly as to the business purpose and device provisions, and the accompanying examples often refer to the applicable principle. All in all, this process constitutes a major step in the maturity of regulation drafting, through lessening the agency's unbridled discretion in favor of structured discretion. 127

We think that the more recent Section 1.701-2 anti-abuse regulation is in the same structured discretionary justice school of provisions with (a) a standard expressed through rules describing the intent of Subchapter K coupled with substantial reduction of the present value of the partners' aggregate federal (income) tax liability inconsistent with such intent; (b) a list of non-exclusive factors evidencing that the partnership was formed or availed of to violate such standard; and (c) numerous examples illustrating the relevant factors and the weight to be given them in various transactions both consistent and inconsistent with the intent of Subchapter K. "[The] examples contain the rules." 128

G. Conclusion

INDOPCO129 theoretically did not change the rules as to capitalization according to the conventional wisdom of the courts,130 Treasury/IRS131 and commentators.132 The catch is that few knew what

127. Lee, Structured Discretionary Justice, supra note 1, at 1035 (footnotes omitted).
128. Battle, supra note 18, at 806.
131. See Rev. Rul. 94-12, 1994-1 C.B. 36 (noting that INDOPCO did not "change the fundamental
those rules were\textsuperscript{133} beyond perhaps a few limited talismans,\textsuperscript{134} e.g., less than one-year benefit rule,\textsuperscript{135} general plan of rehabilitation,\textsuperscript{136} and

\begin{quote}
legal principles" of capitalization; Rev. Rul. 94-77, 1994-2 C.B. 19 (same); Tech. Adv. Mem. 94-02-004 (Sept. 10, 1993) (same); Tech. Adv. Mem. 95-35-011 (May 15, 1995) (same); Controversies Over Cost Capitalization Seen Increasing Following 'INDOPCO', DAILY TAX REP. (BNA), Feb. 9, 1993, at d22 ("It is somewhat surprising to see IRS pushing additional capitalization arguments on INDOPCO when all the decision did was confirm what IRS' view always has been.") (Statement of former IRS Acting Chief Counsel Peter Scott); id. ("If [IRS] truly believes that Indopco doesn't create a different result than would have happened before Indopco, I don't see why it's so hard to state that in a way that revenue agents will follow.") (Statement of former IRS Acting Chief Counsel Peter Scott); Brown Lists Factors That Could Be Used To See If Cleanup Costs Must Be Capitalized, DAILY TAX REP. (BNA), March 10, 1993, at d19 (Mar. 10, 1993).

\textsuperscript{132} See Lee, Capitalization Rules, supra note 2, at 670; See Carrington, supra note 7, at p. 25-29 § 25.03[1].

\textsuperscript{133} Brown Lists Factors That Could Be Used To See If Cleanup Costs Must Be Capitalized, DAILY TAX REP. (BNA), March 10, 1993, at d19 ("Part of the problem, according to [IRS Associate Chief Counsel (Domestic) Stuart] Brown, is that when the Service is attempting to set standards in the aftermath of Indopco, 'we discover that we don't know what the pre-Indopco standard was.'" Lee surmised that this would be the case which is why Lee, Capitalization Rules, supra note 2, at 669, quoted from Ecclesiastes 'There is nothing new Beneath the sun'; the earlier is not remembered (except in student pieces). But Professor Lee had the good fortune to meet Glenn Carrington at a Virginia Tax Study Group Seminar between his issuance of the asbestos and soil remediation TAMs. For the rest of this story see Lee, 1993 Hearings, supra note 2, at 1702.

\textsuperscript{134} See NCNB I, 651 F.2d at 953 (finding some arguments ignore matching principles "by reference to one or more claimed departures supposedly embodied in a series of verbalisms, talismans, and rules-of-thumb"); Lee, Clear Reflection of Income, supra note 2, at 25 (criticizing the frequent distortion of income caused by the separate, saleable asset test for expenditures that produce long term benefits).

\textsuperscript{135} Exceptions to capitalization acknowledged where expenditures result in benefits extending beyond one year. See, e.g., United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) (recognizing the practice of capitalizing expenditures with useful lives in excess of one year but refusing to arbitrarily apply the rule); Gen. Couns. Mem. 33,784 (March 29, 1968) (recommending that expenditures for advertising and salaries associated with securing new customers for utilities be deducted under § 162, despite the fact that resulting benefits may last beyond one year); Rev. Rul. 68-134, 1968-1 C.B. 63, and Rev. Rul. 59-249, 1959-2 C.B. 55 (overlap 2 tax years with 1-year truck tires purchased late in year does not prevent current deduction). Professor Cal Johnson disagrees with this analysis consistent with his insistence upon the ideal rule. Law Professor Offers Counter-Analysis to ABA INDOPCO Report, available in, LEXIS, Fedtax Library, TNT File, 97 TAX NOTES TODAY 30-27 (Feb. 13, 1997).

\textsuperscript{136} Tech. Adv. Mem. 95-47-002 (July 18, 1995) (destroyed vineyard "is an 'incidental repair,' it is subject to being incurred in conjunction with a general plan of capital improvement"). For a creative attempt by a taxpayer to attach start-up employee training to tangible assets, see Tech. Adv. Mem. 94-30-003 (April 22, 1994); Juliann Avakian-Martin, INDOPCO Guidance Likely to Cover Advertising, Repairs, Training, 56 TAX NOTES 545 (1992) (Carrington "let it slip that in that TAM, the cleanup costs were amortized to the piping system. That fact was blacked out when the TAM was released."); Carrington, supra note 7, at 25-29 (taxpayer in Tech. Adv. Mem. 93-15-004 operated a natural gas pipeline). Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987), correctly limited the "rehabilitation doctrine" to substantial capital improvements and repairs to the same specific assets (usually a structure in a state of disrepair). The IRS sought to add the recurring cost of repainting and
restoration to pre-deterioration status. Moreover, the majority of the cases, the Service at times and Congress actually followed the "separate asset" test overturned in *INDOPCO*. More importantly *INDOPCO* acknowledged that future benefit, although indicating capitalization may be necessary to avoid a "timing" mismatch of income and expense, is not determinative. For the most part the administrative development to the date of our Submission had been listing exceptions one-by-one to future benefit with only hints as to the underlying rules or standards.

(Contemporaneous costs of replacement of furniture and fixtures were depreciated under ACRS. The court allowed a current deduction for the repainting, etc. Probably these costs should have been treated as a freestanding amortizable deferred charge due to the substantiality and deferred maintenance aspects, except that repainting normally occurred every three years or so. In short overreaching by the Service resulted in distortion of income the other way much like the separate asset rule.) See Juliann Avakian-Martin, *Does The IRS Need To Clean Up Its Ruling On Cleanup Costs?*, 59 TAX NOTES 728 (1993) ("Lee was also impressed with the IRS's decision to permit the environmental cleanup costs to be added to the cost of facilities that have a useful life and thus recovered, rather than capitalized to the land. According to Lee, the Service uses the concept of "a general plan of rehabilitation" in an entirely new way to permit recovery of the cost. Lee said that if the government did not permit amortization of the cleanup costs, the taxpayer's income would be distorted. Lee added that the decision to permit this recovery appears to mark a new direction for the Service. Previously, the IRS would seek to maximize revenue — arguing when it could that the taxpayer could not amortize a capitalized cost. Citing *Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987) as an example, Lee said that courts have been reluctant to rule against the taxpayer when the Service advances its all-or-nothing argument. The decision to permit cost recovery is probably an attempt to respond to this reality, he said.").

Also the non-official rulings have begun to approach association of expenditures in a commendable new manner of creatively finding amortization periods. See infra note 140.

137. See supra Part I.
138. Id.
139. *INDOPCO*, 503 U.S. at 87 ("[A] taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."). Unfortunately, some courts interpreted similar language in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 354 (1971) ("the presence of an ensuing benefit that may have some future aspect is not controlling"), as permitting a deduction despite the presence of future benefits without regard to the potential for income distortion. The explanations for these exceptions generally involved administrative efficiency. See *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982) ("The administrative costs of conceptual rigor are too great."); *NCNB Corp I*, 651 F.2d at 942, 953 (discussing cases following the "more-trouble-than-its-worth exceptions" that ignore future benefit). Instead of assessing the effect of these exceptions on income, such focus placed undue emphasis on the presence of future benefits. Lee, *Capitalization Rules*, supra note 2, at 671; accord, Jeffrey Gates Davis, Note, *INDOPCO*, Inc. v. Commissioner: *National Starch Isn't the Only One "Stiffed" by the Supreme Court's Decision*, 20 PEPP. L. REV. 1455, 1466 (1993). The exceptions, proving the rule, demonstrate that at the heart of capitalization considerations lies the desire to minimize income distortion. Cf. Faber, supra note 7, at 625, 628-29, 633-35.

140. See Rev. Rul. 94-77, 1994-2 C.B. 19 (severance pay triggered by downsizing, but pursuant to pre-existing contract deductible), accord, Tech. Adv. Mem. 95-40-003 (June 30, 1995) (payments to employees in cancellation of employee stock options that are in excess of the amounts that would have
been paid if Corp X's stock price had not been influenced by a pending takeover are deductible as arising out of pre-takeover contract; Rev. Rul. 94-12, 1994-1 C.B. 36 (repairs); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising); Rev. Rul. 95-32, 1995-1 C.B. 8, Tech. Adv. Mem. 95-48-004 (August 9, 1995), and Tech. Adv. Mem. 95-13-002 (Nov. 28, 1994) (both permit a deduction for energy conservation program costs); Rev. Rul. 94-38, 1994-1 C.B. 35 (soil remediation); Priv. Ler. Rul. 96-07-016 (November 20, 1995) (lease termination payments added to cost of new lease); Priv. Ler. Rul. 95-50-011 (Sept. 13, 1995) (settlement agreement and legal fees as to class action securities fraud allegations of concealment of adverse material information about the taxpayer's business and financial condition artificially inflating stock price deductible because acts giving rise to the litigation were performed in the ordinary conduct of the taxpayer's business); Tech. Adv. Mem. 95-44-001 (July 21, 1995) (just-in-time manufacturing ("JITM") process constitutes radical redesign of existing manufacturing processes resulting in a fundamental change in the business processes transforming work force adapted property to a new or different use); Tech. Adv. Mem. 95-41-004 (June 30, 1995) (commissions for soliciting pre-need funeral contracts because contracts provided future benefits at least as entree to need-funerals, i.e., goodwill advertising); Tech. Adv. Mem. 95-35-011 (May 15, 1995) (prudency audit so regulating agency could determine whether the construction and completion of the facility was justified so that rates charged to consumers could be increased deductible because comparable to market studies and cost analyses used by unregulated industries to determine a competitive or fair price for the goods and services to be sold); Tech. Adv. Mem. 95-27-005 (March 15, 1995) (management paid bonuses to executives to pay for taxes on stock options exercised so they could invest in firm going private); Tech. Adv. Mem. 94-30-003 (April 22, 1994) (costs incurred by the taxpayer for obtaining an operating license from the Nuclear Regulatory Commission ("NRC") capitalized over 40-year life of license; employee training costs amortizable over same period); Tech. Adv. Mem. 94-27-002 (March 30, 1994) (payments made by railroad to settle civil antitrust litigation brought by coal slurry pipeline venture deductible because liability relates primarily to the daily conduct of rail road business; any long term benefit merely incidental); Tech. Adv. Mem. 94-24-002 (Feb. 9, 1994) (costs sea wall around storage tanks and of raising drilling platforms to offset temporarily subsidence of sea floor due to drilling capitalized); Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993) (costs of asbestos removal had to be capitalized); Tech. Adv. Mem. 94-10-008 (Dec. 13, 1993) (favorable financing not an asset used in taxpayer's mortgage securitization business); Tech. Adv. Mem. 94-02-004 (Sept. 10, 1993) (taxpayer payment of multi-year insurance policy as to directors paid in connection with merger but arising out of normal business operations — taxpayer historically purchased similar insurance on an annual "claims made" basis, multi-year to handle potential of future year claim— capitalized as freestanding amortizable intangible and not added to corporate structure); Tech. Adv. Mem. 94-02-006 (Sept. 24, 1993); Tech. Adv. Mem. 93-48-003 (Aug. 30, 1993), Tech. Adv. Mem. 93-33-005 (May 7, 1993) (entrance and exit fees as to acquisition of savings and loan or conversion to bank not deductible); accord Tech. Adv. Mem. 94-02-006 (Sept. 24, 1993) (Treasury later reversed itself as memorialized in the Conference Committee Report, 142 Cong. Rec. S11,909 (daily ed. Sept. 30, 1996)); Tech. Adv. Mem. 93-31-001 (April 23, 1993) ("In light of INDOPOCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1044-45 (1192), even though the opening of the additional boutiques constituted business expansion, rather than a new trade or business, the expenditures paid or incurred by Taxpayer regarding the opening of the additional boutiques might not be currently deductible."); Priv. Ler. Rul. 93-30-034 (May 5, 1993) (payments to underwriter for marketing by investment fund deductible); Tech. Adv. Mem. 93-26-001 (March 18, 1993) ("payments made to the executives and the directors were coincidental to the reorganization [and] had their basis in the longstanding employment relationship with target not the reorganization itself"); Tech. Adv. Mem. 93-18-003 (Jan. 21, 1993) and Tech. Adv. Mem. 92-53-002 (Sept. 22, 1992) (take-or-pay payments arising from cancellation of natural gas requirements contracts deductible); Priv. Ler. Rul. 92-40-010 (June 30, 1992) (multi-year covenant not to compete must be amortized over the period of the covenant [prior to
According to Professor Davis this is the proper first rule making step when the agency is not yet sure of the principles. Subsequent capitalization/expensing TAMs, however, more fully articulate principles.

This article maintains that in some capitalization areas the doctrine and policy are more evolved than the simple case-by-case rules and any regulations should reflect that. Thus, as elaborated in Section III below, proposed regulations should not only state the general principle of minimum distortion of income from timing but also should contain rules such as (1) a presumption of capitalization where an expenditure provides future benefits, with (2) exceptions for average lives of not more than 12 months, de minimis and regularly recurring expenditures and where depreciation is impractical, and (3) capitalization and amortization over uniform periods of substantial, irregularly recurring expenditures. The regulations should state in the context of timing distortions the clear reflection (minimum distortion) of income standard and these rules. Specific problem areas such as (1) business expansion costs, (2) advertising, (3) employee training costs (including just-in-time retraining), (4) repairs including cyclical overhauls, (5) pollution clean up expenses, and (6) writers prepublication costs should be addressed through examples based upon judicial precedents and the Service’s ruling experience.

Section 197]; Tech. Adv. Mem. 92-40-004 (June 29, 1992) (cost of removing and replacing asbestos insulation must be capitalized).

141. The best reading of the recent tea leaves not surprisingly has been by Glenn Carrington, supra note 7. Glenn, as Assistant Chief Counsel, Income and Accounting, had a major hand in the brewing and steeping of the post-INDOPCO administrative rulings tea. Peter Faber also provides a sound policy based reading consistent with the minimum distortion of income analysis advocated in this article and ultimately based upon or at least influenced by Boris Bittker’s work. Faber, supra note 7, at 635.

142. This point is discussed extensively in Part 1.


144. More experience could lead to final structured discretionary justice regulations which would set forth the factors that are to be applied, for example, in determining (1) de minimis and (2) how infrequently recurring and how much variation from average annual costs is permitted under the recurring exception.

145. At the time of Professor Lee’s 1993 testimony recommending that Congress authorize legislative regulations as to capitalization with the Service first developing a body of ruling experience which it would then distill into legislative regulations, he had not yet investigated the body of Service non-published rulings which provide both the necessary factual experience and legal reasoning supporting many of the rules proposed in our Submission and this article. At the time of the Submission Professor Lee anticipated that the final version of this article would apply the model to the areas mentioned in text as well as other areas. That turned out to be too many stories for one article to carry. Now Professor Lee is scheduled to participate in a discussion on capitalization at the Virginia Tax Study Group Seminar in March, 1997, and to give a speech in June at the 49th Annual Virginia Federal Tax Conference at Charlottesville, Virginia in June, 1997, that will attempt that project. That work is already beginning
Another fundamental capitalization principle mandates capitalization where necessary to avoid a character mismatch between a current ordinary deduction and related tax preferred income. The precedents and rulings there are less developed than the timing authorities. This article proposes that minimum distortion of income as to character at this time be addressed primarily through examples in the regulations applying the "origin of the claim" doctrine, particularly as to merger issues. The Solicitor General's Office attempted in argument and on Brief to make that argument to the Court in *INDOPCO*, but the Court perhaps understandably appears to have been fixated on the future benefit rationale. This article argues that this does not mean that *INDOPCO* precludes adoption of a character distortion rationale for denying a current deduction to a (hostile) takeover or any other merger. Rather, it means that the argument once received favorable policy review at a high level of tax administration and thus any future administrative development should very seriously consider it.

This article proposes that the more mature administrative law model of (1) general principle, (2) regulation rules implementing the standard, and (3) numerous examples culled from the existing administrative and judicial ruling experience (especially judicial experience in the case of the contemplated interpretative regulations) should be applied to timing distortion issues, where after deduction or capitalization the basic question is often to what "asset" should capitalized costs be allocated. A more bold approach will be needed as to amortization of such assets if capitalized. This article proposes the perhaps bold, but not unprecedented, approach of standard class lives based upon minimum distortion of income (more broadly equity and the Cohan rule of approximation).

to be in progress. In the meantime good discussions of the areas are presented by Carrington, supra note 7; Faber, supra note 7.

146. See generally Lee & Murphy, *Capital Expenditures*, supra note 2, at 509-27.


148. Kent Jones at times seemed to merge and thus obscure the doctrines. Additionally Justice Blackmun was the author of the leading cases adopting the future benefit rationale and capital transaction for capital expenditures, *Idaho Power and Lincoln Savings and Loan and United States v. General Bancshares Corp.*, 388 F.2d 184, 191 (8th Cir. 1968) (Blackmun, J.), respectively, which naturally Kent Jones played to.

149. Professor Lee must once again acknowledge a "vested interest" here. The Solicitor General's Brief and Assistant Jones' argument were solidly grounded on Professor Bittker & Lokken's income tax treatise as well as Professor Bittker & Eustice's corporate tax treatise. Professor Lee is most proud of his collaboration with Professor Bittker on the former and of some of his capitalization work having made Professor Jim Eustice's long and short lists. (Perusal of Lee's work here will show how much he followed in their footsteps).
A similar bold approach was considered in Government Counsel Memorandum 34,959150 and is buttressed by the tax policies underlying the statutory rules of (a) 5 year amortization for start up costs under Section 195 and (b) 15 years for purchased intangibles under Section 197. As to character distortion, the evolution of the cases and rulings as the "origin of the claim" suggests that the second stage of general principle (of minimum distortion of income from character mismatch) and examples and mere conclusions.

III. ROUGH JUSTICE EXCEPTIONS TO FUTURE BENEFIT CAPITALIZATION

The rough justice exceptions to future benefit capitalization can be categorized as (a) de minimis (insubstantial) or short-lived, (b) recurring steady state, (c) no depreciation deduction available although benefit is temporally limited, and (d) where the burdens of capitalization and depreciation outweigh the revenue benefits of more clear reflection of income through such capitalization/depreciation. The starting point for minimum distortion of income as to timing of deductions is that business/investment expenses that typically don't provide on the average a benefit much beyond a year (say truck tires151) should be currently deductible in the year of purchase. Other expenditures providing longer benefits should be capitalized unless (1) they are relatively small (say hand tools, and professional journals152 and sometimes calculators) or (2) regularly recurring (say repainting every three years or so153 or steady

---

We believe that the Service is not inalterably bound to abide by a strict capitalization rule when dealing with minor, recurring-type small items. It is clearly within the Commissioner's discretion under section 446(b) to allow expensing of such items [under $100] as long as income is clearly reflected under such method. We believe that the Court of Claims in Cincinnati was using this rationale in reaching its decision. And, although we do not purport to agree entirely with the Cincinnati decision, we believe it lends support to our view that the Commissioner need not regard section 263 as truly immutable.

Id.

---


152. Treas. Reg. § 1.162-12(a) (as amended in 1972); cf. Rev. Proc. 95-33; 1995-28 I.R.B. 7 (".05 De minimis rule. If the § 481(a) adjustment is less than $25,000, the taxpayer may elect to take the adjustment into account in the year of change instead of over the adjustment period otherwise prescribed by section 5.04 of this revenue procedure. A taxpayer that makes this election must attach to its original Form 3115 a statement indicating that it is electing the de minimis rule pursuant to section 5.05 of this revenue procedure.").

153. Official Gives Update on Series of Guidance on Tax Accounting Issues, DAILY TAX REP. (BNA), March 11, 1993, at d6 ("As Wolfsen pointed out, if [the taxpayer] had cleaned the PCBs every year, it would have been deductible. But if you've waited four or five years, it's not. I gotta draw the
state institutional advertising\textsuperscript{154}) in which case current deduction would also be in order. The test justifying the first three rules is a more-trouble-than-it's-worth balancing of burdens and benefits. The story of the taxation of writer's prepublication costs reveals that future benefit costs which cannot meet the first three tests may still qualify under this administrative convenience balancing test.\textsuperscript{155} There income forecast depreciation can work such a hardship that capitalization/depreciation of writer's prepublication costs is more trouble than it's worth.

\textbf{A. De Minimis or Short Lived Benefit Expenditures}

\textbf{1. De minimis}

Cincinnati, New Orleans & Texas Pacific Railway v. United States\textsuperscript{156} was the first decision to allow the current deduction of an expenditure benefiting future years under a distortion of income analysis. There the government argued that: (1) since the expenditures at issue admittedly had a useful life in excess of one year, they had to be capitalized under the predecessor to Section 263\textsuperscript{157} as a "betterment"; and, (2) the method of line. I've got to say, 'If you do it every second year, you're fine. If you wait six years, it's not.' That's a tough one. I haven't resolved in my mind," he said." (Statement of Glenn Carrington, Ass't Chief Counsel, Individual and Tax Accounting); accord, Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome, 93 TAX NOTES TODAY 102-10 (May 12, 1993) ("The TAM found that the cleanup expense was not merely incidental because the costs had been accumulating over many years, and that allowing the deduction of the entire cleanup costs in a single year would excessively distort the income in that year. Carrington admitted that the bulk of the cleanup cost would have been deductible had it been incurred as part of a regular maintenance program."). See generally Lee, Clear Reflection of Income, supra note 2, at 15-20; Lee, Capitalization Rules, supra note 2, at 679-82; accord, Note, An Analysis of INDOPOCO, Inc. v. Commissioner, 54 OHIO ST. L. J. 1505, 1516-18 (1993). Four years is probably the cutoff. Tech. Adv. Mem. 96-18-004 (May 3, 1996) (costs of "major engine inspection" performed about every four years must be capitalized; engines are removed from the aircraft and inspected, part by part. Components not meeting FAA standards are reconditioned or replaced. Typical costs range from $25,000 and $80,000; in comparison new engines cost from $350,000 to $800,000; and the cost of a new aircraft ranges from $1 to $7 million).

\textsuperscript{154} See authorities cited in Lee, Clear Reflection of Income, supra note 2, at 15-20; Lee, Capitalization Rules, supra note 2, at 679-83.

\textsuperscript{155} As discussed in Part 1 Professor Lee has a work in progress addressing this area.

\textsuperscript{156} 424 F.2d 563 (Ct. Cl. 1970). See generally Gunn, supra note 2, at 454-57. Much of the following discussion is taken from Lee, Clear Reflection of Income, supra note 2, at 15-18.

\textsuperscript{157} Section 263 generally denies a current deduction for expenditures for new buildings or permanent improvements or betterments. I.R.C. § 263 (1997). Commentators believe that the capitalization requirement is broader than any particular section of the Code. See, e.g., Gunn, supra note 2, at 450; accord 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.4.1, at 20-67 (2d ed. 1989).
accounting provisions (the predecessor to Section 446)\textsuperscript{158} were subordinate to the capital expenditure and depreciation provisions.\textsuperscript{159} The Court of Claims (now the Federal Circuit) disagreed, reasoning that capitalization, depreciation, and the requirement that the taxpayer's method of accounting clearly reflect income were all so "inextricably intertwined"\textsuperscript{160} that the ultimate question was whether the taxpayer's (tax) accounting method clearly reflected its income, and not whether the benefits generated by the expenditures extended beyond the tax year, although that was a relevant inquiry.\textsuperscript{161} The Court of Claims relied most heavily on the insubstantiality of the expenditures in relation to both the taxable income and the balance sheet of the taxpayer, concluding that the taxpayer's method did clearly reflect its income.\textsuperscript{162} Critical to the court's conclusion was a costs/benefits analysis under which the burden of capitalizing and depreciating each purchase with benefits extending beyond the tax year would be heavy; "at the same time, the clearer reflection of income would be exceedingly slight if there were any at all."\textsuperscript{163} Such cost/benefits analysis lies at the core of the notion of "rough justice" over theoretical purity.

The Tax Court similarly pointed in \textit{Sharon v. Commissioner} to the regulation permitting a farmer to currently deduct the full cost of inexpensive or short-lived tools in the year of payment despite their capital nature, as supporting the current deduction of the minor costs of a license by an attorney admitted to one state bar to practice in another state notwithstanding its future benefits.\textsuperscript{164} In short, determining net income

\textsuperscript{158} Section 446(a) and (b) provides that the taxpayer's income is to be computed under his regular method of accounting unless he fails to employ a method or the method used does not clearly reflect income. I.R.C. § 446(a)-(b) (1997). In either case, income will be computed under such method as does clearly reflect income in the opinion of the Secretary of the Treasury. \textit{Id.}

\textsuperscript{159} \textit{Cincinnati, New Orleans & Texas Pac. R.R. v. United States}, 424 F.2d at 567-68. The useful life was assumed to be ten years. \textit{Id.} at 571; \textit{Gunn, supra} note 2, at 456 n.55.

\textsuperscript{160} \textit{Cincinnati}, 424 F.2d at 569.

\textsuperscript{161} \textit{Id.} at 568. In this determination of clear reflection of income, "the one year rule will be given adequate, though not conclusive, weight." \textit{Id.} The taxpayer's method of accounting for these items was required by the Interstate Commerce Commission. \textit{Id.} at 565. Courts tend to give considerable weight to the requirements of applicable regulatory accounting in determining clear reflection of income. See \textit{id.; NCNB Corp. v. United States}, 684 F.2d 285, 292-93 (4th Cir. 1982) (\textit{en banc}) ("NCNB II"), overruled INDOPCO, 503 U.S. 79 (1992); see also Harold Dubroff, M. Connie Cahill \& Michael D. Norris, \textit{Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles}, 47 ALB. L. REV. 354, 396-97 (1983).

\textsuperscript{162} \textit{See Cincinnati}, 424 F.2d at 571-72; \textit{Gunn, supra} note 2, at 456-57.

\textsuperscript{163} \textit{Cincinnati}, 424 F.2d at 572.

\textsuperscript{164} 66 T.C. 515, 527 (1976), \textit{aff'd}, 591 F.2d 1273 (9th Cir. 1978), \textit{cert. denied}, 442 U.S. 941 (1979); \textit{accord Diffley v. Commissioner}, 48 T.C.M. (CCH) 547, 549 (1984); \textit{Galazin v. Commissioner}, 38 T.C.M. (CCH) 851, 853 (1979); Treas. Reg. § 1.162-12(a) (as amended 1960). Similarly, the regulations provide that "[a]mounts currently paid or accrued for books, furniture, and professional
annually with minimum distortion of income entails a cost\benefits balancing analysis under which taxable income is not distorted by currently deducting a cost producing future benefit so long as such cost is insubstantial or the future benefit is short-lived, particularly if capitalizing and then amortizing such cost will be burdensome. As Commissioner Goldberg put it, “a modification that saves the government a dollar, but costs the taxpayer two dollars, is a ‘bad deal’ and . . . ‘we can’t make those kinds of deals.’”\footnote{165}

An exception is where revenue is not the goal of the provision as much as public perception of the tax system such as the substantiation and other anti-abuse rules under Section 274, designed to end publicity about the “it’s deductible” in the 1960’s, two-martini lunches and foreign conventions in the 1970’s, and country club dues and spousal travel in the 1990’s.

A pair of Tax Court memorandum decisions by Judge Leo Irwin, \textit{Galazin v. Commissioner}\footnote{166} and \textit{Klutz v. Commissioner},\footnote{167} involving deduction versus capitalization and amortization of the cost of a calculator, probably reflect more of a doctrinal turf battle between the Tax Court and the then Court of Claims and taxpayer intransigence than disagreement with \textit{Cincinnati} itself. In \textit{Galazin} Judge Irwin read \textit{Cincinnati} as resting on two legs: “the expenditure be relatively small in size and relatively large in number.”\footnote{168} \textit{Galazin} nevertheless allowed a current deduction for the cost of a used calculator on the grounds it was relatively minor ($52.45) and the Commissioner conceded that the calculator was relatively short-lived (two years). In contrast, the calculator in \textit{Klutz} cost $75 and with a useful life conceded to be five years. Judge Irwin required capitalization. The real problem in \textit{Klutz} was that the taxpayer appears to have been a tax klutz exhausting the court’s patience.\footnote{169}

\footnote{165. Joe Spellman, \textit{On The Road Again: Goldberg Pushes His Simplification Plan}, 48 TAX NOTES 1214, 1215 (1990).}
\footnote{166. 38 T.C.M. (CCH) 851; T.C. Memo 1979-206.}
\footnote{167. 38 T.C.M. (CCH) 724; T.C. Memo 1979-169.}
\footnote{168. \textit{Id.} In the earlier \textit{Klutz}, Judge Irwin merely noted that in \textit{Cincinnati}, “the relative size of the expenditure is only one factor taken into account for purposes of determining whether the assets may be currently deducted.” \textit{Id.} In any event, reflection on \textit{Sharon} leads to the conclusion that a lot of costs is not a prerequisite for deducting minor costs as not income distorting. \textit{Id.}}

\footnote{169. It is unclear whether this case is a result of confusion or stubbornness on the part of petitioner. He has been audited nearly every year since 1962. Also, he has apparently been apprised of the necessity of maintaining adequate records. However, in 1973, he failed to do so. This lack of substantiation is the crux of respondent’s case.}
Effectuation of "rough justice" under a minimum distortion of income standard would dictate a carve-out from a strict minimum distortion rule for relatively small expense items. General Counsel Memorandum 34,959, resulting from the study of the decision in Cincinnati,171 expensing items other than railway ties costing less than $500 ($1,563 in 1990 dollars), examined the taxpayer's reliance upon the Interstate Commerce Commission's minimum capitalization rule172 to justify deducting the costs of small items.173 This Gen. Couns. Mem. noted that the general capitalization rule of Section 263 was not "immutable," but that departures may be justified in "prescribed and limited circumstances."174 This principle led the Gen. Couns. Mem. to conclude that the Service should provide for all taxpayers a minimum capitalization rule as to purchases of tangible personal property (generally $100 per item in 1972 dollars175 or $313 in 1990 dollars) with safeguards to prevent distortion of taxpayers' income.176 (This is largely covered now as to moderate purchases of depreciable tangible personal property generally by taxpayers with smaller income or at least smaller capital purchases which can be expensed under Section 179.) Gen. Couns. Mem. 34,959 reasoned that Section 461's directive that a taxpayer take into account income and deductions in the proper tax year under her or his "method of accounting" was subject to the Section 446 proviso that such method clearly reflect income.

Thus, while we believe those provisions provide authority for the Commissioner to prohibit deductions where such is necessary to prevent a

---

170. Klutz, 38 T.C.M. 724.  
171. 424 F.2d 563.  
172. It allowed regulated taxpayers to currently deduct expenditures incurred in acquiring items with a cost of less than $500 under Section 162. Gen. Couns. Mem. 34,959.  
173. Id.  
174. Id. (noting that Treas. Reg. §§ 1.162-3 and 1.461-1(g)(3) "provide recognition that expenditures that are capital in nature may be deducted if this treatment does not materially distort income").  
175. "In addition, if a taxpayer's accounting method allows expending of more costly items, even though they have a useful life in excess of one year, and such method is generally accepted by the accounting profession for that industry and produces no distortion of income, use of such method should be permitted." Gen. Couns. Mem. 34,959. "A taxpayer that elects to expense currently small items acquisitions should be deemed to have elected to treat such items as "current assets", and to the extent any amount realized on their disposition represents an amount deducted previously it should be treated as ordinary income under the tax benefit rule." Id.  
176. Gen. Couns. Mem. 34,959. Note that the recommended minimum capitalization rule was for deduction of small items less than $100 rather than the Interstate Commerce Commission's $500 rule. Id. Today that the lesser amount would not exempt capitalization of minor items such as office supplies/equipment with useful lives of less than three years. Id.
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.\textsuperscript{177}

The difficulty in the “insubstantiality” test lies not in its theory, which
is recognized by certain statutory provisions, but rather in determining
“insubstantiality” as to the particular taxpayer and the tax year. While
the cases explicitly relying on the doctrine have involved a $20-$500 range, the
Claims Court has viewed $15,000 as insubstantial (at least compared to
$300,000).\textsuperscript{178} Perhaps if the amount is large enough in the abstract it must
be capitalized even if it is not so great compared to total revenues or
expenses. \textit{Wolfsen Land and Cattle} suggested that absolute amount of the
expenditure mitigated towards capitalization.\textsuperscript{179}

\section*{2. Short-lived Benefits}

In Southland Royalty Co. v. United States\textsuperscript{180} the taxpayer, an oil and
gas company, currently deducted the cost of an oil and gas reserve survey
used in current operations, with an uncertain and short useful life.\textsuperscript{181} The

\begin{footnotesize}
\begin{enumerate}
\item[177.] \textit{Id.}
\item[178.] \textit{Compare Cincinnati,} 424 F.2d 563,\textit{ with} Cleveland Elec. Illuminating Co. v. United States,
7 Cl. Ct. 220 (1985).
\item[179.] Wolfsen Land \& Cattle Co. v. Commissioner, 72 T.C. 1, 17 (1979) (“redredging every 10
years cost as much as original construction—the magnitude of the expenditures themselves” is relevant
(Dec. 17, 1992) (“In determining whether a repair is incidental, courts look to the nature of the work in
relation to the taxpayer’s operations, and not solely to the cost of the work performed.”) \textit{with} Tech. Adv.
Mem. 94,24,002 (Feb. 9, 1994) (“The taxpayer argues that the expenditures at issue are minor relative
to the cost of its oil field, and thus, these expenditures are incidental. However, we believe that the
scope of work performed was massive in view of the overall operations. For example, the elevation [of
a seawall around an offshore oil facility] project involved 72 sub-contractors from 10 different countries,
15,000 people, over 100 jacks and 200 hydraulic units, and took 16 months to complete. The barrier
wall took 7 months to construct and 17 ships were required to tow these two-ten-story structures into
place. [The required towing strength was record-breaking, 180,000 horsepower.] Further, the value of
these expenditures relative to the cost to replace the facility is also not incidental. For these reasons, we
do not consider these expenditures incidental. . . . The total elevation project cost approximately
$471,000,000 and the barrier wall cost approximately $547,000,000. The taxpayer estimates that the
current cost to replace the facility is $5,000,000,000.”). Professor Lee is most pleased to have brought
\textit{Wolfsen Land \& Cattle} into the National Office’s repertoire.
\item[180.] 582 F.2d 604, 616-18 (Cl. Ct. 1978) (Surveys of the kind at issue, while providing some
future benefits (three to four years), were used in current operations to make income projections, develop
short- and long-term budgets, arrange financing, and prepare reports to shareholders and regulatory
authorities). Much of the following discussion in text is taken from Lee, \textit{Clear Reflection of Income,}
\textit{supra} note 2, at 18-20.
\item[181.] \textit{Id.} at 616. Misidentification of cost with nonamortizable assets has been a longstanding
problem. Gunn, \textit{supra} note 2, at 446.
\end{enumerate}
\end{footnotesize}
government disallowed the current deduction for the survey, but disavowed prior survey decisions that capitalized such survey costs as part of some underlying property, instead arguing that the cost must be capitalized because the survey itself had a useful life lasting beyond the taxable year. The Court of Claims allowed the deductions because they were "functionally part of, and indistinguishable from, expenditures for ordinary management planning," noting that the reserve survey was not used to determine whether oil drilling was feasible, prior to acquiring the mineral interest. If the company had obtained the mineral interest, the survey cost would have constituted part of the cost of such interest (under the acquisition cost doctrine). The court looked to "matching expenditures to the income resulting from a capital transaction" as a function of capitalization, but found amortization inappropriate because the surveys were subject to change at any time and were updated every few years, and hence, capitalization without amortization would distort the taxpayer's income.

Tech. Adv. Mem. 96-45-002 provides an excellent analysis of the short-term future benefit factor particularly as supported by Sun Microsystems.

Further support for not requiring pre-opening costs to be capitalized under section 263 is found in the fact that the costs appear to generate predominantly short-term benefits. In general, expenditures to produce current income are deductible currently even though some incidental future benefit may result. See Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs generally deductible); Iowa-Des Moines National Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979), aff'g 68 T.C. 872 (1977); Three-in-One Oil Co. v. United States, 35 F.2d 987 (Ct. Cl. 1929) (advertising that increases sales is not a capital expenditure); A. Pinkenberg's Sons, Inc. v. Commissioner, 17 T.C. 973 (1951); Rev. Rul. 74-318, 1974-2 C.B. 14.

182. Southland, 582 F.2d at 616-17.
183. Id. at 617, n.20.
185. Southland noted that it was:

The useful life of the [oil and gas reserves] survey is very uncertain; as the trial judge found, the estimates in a reserve study are subject to change at any time and have to be updated every few years to take account of subsequent developments [such as the effect of pumping out oil and gas]. 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.

Southland, 582 F.2d at 618 (footnote omitted); see also Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433, 436 (8th Cir. 1979) ("Where the prospective benefit is very slight, capitalization is not easily supported.").

(advertising to sell cars deductible); Rev. Rul. 69-510, 1969-2 C.B. 23
(cost of cars given to customers as a prize deductible); Rev. Rul. 56-181,
1956-1 C.B. 96 (advertising as part of opening new sales territories
deductible). In A. Finkenberg's Sons, an installment dealer was required
to currently deduct promotion and advertising costs to obtain new
customers because there was a direct relationship between amounts
expended and income. Current deduction was required as "[a] substantial
part of the thrift club expenses produced immediate results which are
impossible to segregate from prospective results." 17 T.C. at 982-983.
Thus, expenditures that result in immediate sales generally are deductible
currently even if some incidental future benefits also result.

The importance of current sales is also demonstrated by two cases
decided after INDOPCO. Fidelity Associates, Inc. v. Commissioner, T.C.
Memo. 94-142 (1994); Sun Microsystems, Inc. v. Commissioner, T.C.
Memo. 93-467 (1993). Commissions paid to salespersons for obtaining
sponsors were held to be currently deductible in Fidelity. The Tax Court
reached this result even though the sponsorship agreements were for
two-year periods and sponsors could elect to pay the taxpayer over two
years. The court reasoned that the contractual right to receive payments
over two years, standing alone is not a sufficient reason to classify the
commissions as capital expenditures. In reaching this result, the court
noted that dealers are specifically authorized to deduct commissions by
section 1.263(a)-2(e). Similarly, in Sun Microsystems, the Tax Court
allowed a current deduction for the cost of stock warrants issued to the
buyer of computer workstations as an incentive to induce the purchase of
the workstations. The court reasoned that the possible development of a
long-term customer relationship was an "incidental future benefit" when
compared with the immediate benefits of selling the workstations. Fidelity
and Sun Microsystems show that whether immediate sales result from an
expenditure remains an important factor after INDOPCO in determining
whether the expenditure is deductible currently under section 162 or must
be capitalized under section 263.

B. Steady State Recurring Costs

Several decisions analyzed the current deduction of recurring expenses
benefiting several tax years as not distorting the taxpayer's income. In
Davee v. United States, 187 the taxpayer conducted a market research
service using continuous surveys compiled from nation-wide panels of
representative physicians. This data was assembled in the form of periodic
publications distributed to American pharmaceutical and ethical drug
manufacturers. In 1962, taxpayer initiated essentially the same operation in

187. 444 F.2d 557 (Ct. Cl. 1971).
France, paying a French management consulting firm over $12,250 in 1962 and $2,350 in 1963 to obtain French sources of such data. The Court of Claims noting nearly $10,000 for the same services from 1962 to 1963, stated that “[i]t is reasonable to conclude in this case that the expenditures made by Davee [the taxpayer] in 1962 were largely nonrecurrent and, therefore, non-deductible, and those made in 1963 were recurrent and deductible.”

The Service has for far longer than Professor Lee knew back then favored a recurring expense safe harbor pointing to various judicial opinions. In a host of unpublished rulings and a few published rulings the

---

188. Id. at 567.
189. See reasoning in Gen. Couns. Mem. 35,116, pp. 18-20, 28-9 (Nov. 14, 1972) (costs of establishing a credit card system) (citing Davee, 444 F.2d at 557) (In examining Briarcliff in light of Davee, supra, we believe it worthy of note that the expenditures described as capital in Briarcliff would generally be incurred on a nonrecurring basis. It is therefore evident that although Briarcliff did not rely on Davee or employ its rationale in reaching its decision, the two cases are consistent and serve to supplement each other. Both are useful in arriving at the proper conclusions for treatment of expenses in marginal cases.); and Gen. Couns. Mem. 39,483 (March 5, 1986) (the “L’Eggo” or package design GCM) (citing Davee, 444 F.2d 551). More recently the outstanding analysis of capitalization and indication of approval of a balancing test in Tech. Adv. Mem. 96-38-002 (June 3, 1996), may reflect the impact of the submissions pursuant to Notice 96-7. That TAM also cited Encyclopaedia Britannica, 685 F.2d at 217, for “[t]he distinction between recurring and nonrecurring business expenses [as providing] a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be.”

See also Mountain Pager Products Corp. v. Commissioner, 287 F.2d 957 (2d Cir. 1961) (nonrecurring nature of expenditures a factor in determining that capitalization was appropriate); Rev. Rul. 89-23, 1989-1 C.B. 85 (recurring or nonrecurring nature of costs is an important factor in distinguishing capital expenditures from currently deductible costs); Rev. Rul. 73-463, 1973-2 C.B. 34, amplified by Rev. Rul. 94-70, 1994-2 C.B. 17 (distinguishing stock issuance expenses of an open-end investment company from other stock issuance expenses because the purpose of the open-end investment company is to raise capital on a continuing basis in its day to day operations). Thus, the recurring nature of costs is an important factor to be considered in determining whether an amount is to be capitalized or currently deductible.

190. Rev. Rul. 89-23, 1989-1 C.B. 85, 87 (explaining current deductibility of advertising costs “either because they are of a recurring nature or because their benefit does not extend beyond the tax year,” citing Davee, 444 F.2d 551); Rev. Rul. 73-463, 1973-2 C.B. 34, 35 (semble) (“the unique circumstances which permit shareholders of an open-end investment company to withdraw their capital from the company on demand leads to the conclusion that continuous capital raising efforts by the company after the initial stock offering period is an essential part of its day to day business operations.”);
Service has stated that the recurring or nonrecurring nature of the costs with future benefits serves as a useful basis for distinguishing ordinary business expenses from expenses that are in the nature of capital expenditures, regardless of the type of expense at issue including institutional advertising. At the same time, a survey of older rulings reveals that the Service has gone back and forth on capitalization. For instance, in Gen. Couns. Mem. 33,784, considering Rev. Rul. 68-561, the Service addressed bonus payments or cash allowances paid by utilities to contractors, builders, and home owners to encourage construction of, or conversion to, all electric (or all gas) homes, apartments, motels, etc., proposing a current deduction as advertising costs. The Chief Counsel disagreed, concluding that “where the acquisition of new customers can be attributed directly to particular expenditures, those expenditures must be capitalized since they have resulted in the acquisition of a benefit extending into subsequent years, i.e., the increased earning capacity to be generated from the new customers obtained.” The Memorandum suggested amortization over the useful lives of the buildings benefitted by the incentives. Significantly, Gen. Couns. Mem. 33,784 also addressed capitalization of other payments by the utilities to its staff in administering the bonus payment program and for an accompanying advertising promotion. The Chief Counsel’s office expressed, as it turned out justifiable, concern as to how capitalization of such advertising costs and a portion of the utilities’ salaries to administrators would fare in the courts due to administrative difficulties with amortization of such capitalized costs. Next, Tech. Adv. Mem. 69-05269-380A, in

---

192. Gen. Couns. Mem. 33,784 (March 29, 1968) (the primary question presented by the proposed ruling is whether or not the “incentive payments” (“bonus payments” or “cash allowances”) made by the utility-taxpayers in the instant cases are advertising expenses deductible as ordinary and necessary business expenses or are capital in nature and have value extending substantially beyond the taxable years in which they were paid or incurred.”), considering Rev. Rul. 68-561, 1968-2 C.B. 117; accord Gen. Couns. Mem. 34,558 (July 31, 1971), considering Rev. Rul. 71-469, 1971-1 C.B. 120. Increased earning capacity also finds some case-law support Mid-State Prod. Co. v. Commissioner, 21 T.C. 696, 714 (1954). Professor Lee has always thought that tack proved too much. See John W. Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 TAX L. REV. 347, 462 (1974) (Lee, “Section 183”). In Part 1 we traced that thought through Bittker’s Treatise to Judge Posner’s Encyclopaedia Britannica.

194. Id.

As to the remaining items referred to above we have some reservations as to whether we could support capitalization of such expenses in a court test, although we recognize that the Houston Natural Gas case appears to lend support to the position
considering improvement and maintenance of a utility’s transmission and
distribution system limited the recurring exception to payments “realized and
exhausted within the taxable year.” 196 This would in effect eliminate the
steady-state recurring expenditure exception to future benefit capitalization.

In 1972, in Gen. Coun. Mem. 35,116, the Chief Counsel’s Office
considered a taxpayer’s establishment of its own credit card system followed
by its subsequent unrelated conversion into a national credit card system. 197 Costs included a feasibility study, implementation costs incurred prior to the initial issuance of the credit cards, and conversion
costs. 198 The Chief Counsel rejected the taxpayer’s contention “that its
taken in the proposed G.C.M. The items relating to salaries of representatives and to
advertising costs do not appear to be as closely connected to the acquisition of benefits
to be realized over a period lasting substantially beyond one year as do the bonus
payments. In the case of salaries, the expenditures could be said to be in payment for
the services currently being rendered by the utility’s representatives. Certainly the
connection with any further benefit to be realized in the form of increased
consumption of electricity is somewhat tenuous. Moreover, it would be difficult to
establish a direct connection between the advertising expenses and increases in the
future consumption of electricity. Because of the difficulty inherent in establishing
this connection, several cases have held that the expenditures should be charged off
to expense in the year that they were paid rather than capitalized. E.g., Consolidated
Apparel Co., 17 T.C. 1570 (1952), rev’d on another issue 207 F.2d 580, 53-2 USTC
¶9586 (1953); F.E. Booth Co., 21 B.T.A. 148 (1930); Richmond Hosiery Mills, 6
B.T.A. 1247 (1927), aff’d 29 F.2d 262 (5th Cir. 1928), cert. denied 279 U.S. 844
(1929). We are also somewhat concerned that the proposed position requiring
capitalization of salary and advertising expenditures could logically be extended to
other businesses and industries where traditionally an expense deduction has been
allowed.

Another objection to requiring that the salaries and advertising costs be capitalized
is the difficult task of determining the useful life of the asset acquired. The proposed
G.C.M. suggests that the maximum useful life in the case of incentive payments would
be the useful life of the building involved. Since the salaries and advertising costs do
not appear to be related to any particular building such a guideline could not be used
in this area.

In regard to the allowance or discounts that grants to its employees who convert
their homes to electric heating, we believe that these items could just as easily be
construed as designed to benefit the employees rather than to increase the future
consumption of electricity.

Id. at 17-19.

same conclusions or at least considered the same precedents in Lee, Section 183, supra note 193, at 461-
64.
198. Gen. Couns. Mem. 35,116. Implementation acts incurred prior to the initial issuance of
credit cards included:
banking and credit card operations constitute one ‘trade or business’ for purposes of Code § 162(a).”\(^9\) The ruling under consideration proposed allowing a current deduction for (1) administrative costs and staff salaries for permanent employees assigned to the credit card operation; (2) the cost of the promotional materials for credit cards; (3) (television, radio, newspaper and other) advertising expenditures incurred in issuing both credit cards; and (4) a cardholder establishment fee (the first three of which would seem to follow from Gen. Coun. Mem. 33,784).\(^\text{200}\) The Chief Counsel disagreed with the proposed ruling, but concurred that expenses of establishing subsequent credit card accounts and of periodic renewal of established credit card accounts were deductible under Section 162(a) in the year incurred.\(^\text{201}\) Analyzing the classic start-up cost authorities, Gen. Coun. Mem. 35,116 concluded that the taxpayer “entered into a new and additional trade or business when it engaged in the activity of issuing credit cards and performing credit card services.”\(^\text{202}\) It explained Briarcliff Candy on the basis of the recurring nature of the expenses (although it noted that the Second Circuit had that argument before it and failed to address it in the opinion).\(^\text{203}\) In 1975, the National Office rulings division addressed a Cleveland Electric Illuminating fact pattern, concluding in Tech. Adv. Mem. 75-090-994-40A on the basis of same/new business precedents discussed in Gen. Couns. Mem. 35,116, that the training costs as to the taxpayer’s first nuclear power plant were “start-up costs . . . [:] those unusual one-time costs incurred in commencing a new venture. The costs are incurred with the expectation that any benefits will be derived in future periods, rather than during the period in which the costs are incurred. Such expenses must be capitalized under section 263.”\(^\text{204}\) It held that the nuclear power electricity generating plant was a new business different from the taxpayer’s existing fossil fuel generating plant.\(^\text{205}\)

---

(1) payroll and related costs incurred to solicit and obtain participation by merchants in its program; (2) administrative costs and staff salaries for permanent employees assigned to the operation; (3) cost of printing credit cards, mailing costs and cost of promotional materials enclosed; (4) television, radio, newspaper, and other advertising; (5) initiation fee to join * * * association * * * and (6) costs of decals and other display items distributed to merchants.

---

\(^9\) Id.


\(^\text{202}\) Id. at 11. See supra note 193.


\(^\text{205}\) Id.
At the approximately same time the Service was considering the start-up costs/same business expansion fact patterns, it also examined tax shelter transactions where it similarly took a strict doctrinal approach, emphasizing even more the distortion of income principle underlying the capitalization/amortization concept.\textsuperscript{206} The distortion of income analysis is particularly good and looks as our Submission did at the general principle at work across several doctrinal sets of rules.\textsuperscript{207}

The Service in its private rulings initially relied upon the start-up cost and related doctrines to deny current deduction of business expansion costs.\textsuperscript{208} Then explicitly in response to the 1970s failure in the courts of the Service’s credit card establishment as start-up cost contentions, in 1980 Gen. Couns. Mem. 38,410,\textsuperscript{209} implicitly but not explicitly reversing Gen. Couns. Mem. 35,116,\textsuperscript{210} adopted the separate asset doctrine as to establishment of bank credit card systems and with it the notion that a geographic expansion in the same field did not create a separate asset.\textsuperscript{211}


\textsuperscript{207} Id. (The Service takes the position that a distortion of income results if a taxpayer deducts expenditures in years other than the year in which income attributable to these expenditures is realized. “G.C.M. 36,824, *** 1-312-76 (Aug. 27, 1976); see also Rev. Rul. 60-358, 1960-2 C.B. 68. Put another way, in order to assure clear reflection of income, expenditures cannot be currently deducted if they are expected to contribute more than incidentally to the realization of income in subsequent taxable years. G.C.M. 36,824, supra, at 2; see also O.M. 18,282, *** 1-341-75 (Sept. 30, 1975), at 7-8; O.M. 17,736, *** 1-4333 (July 26, 1972), at 10-11. [The Service has taken a similar position in requiring amortization of prepaid expenses in order to prevent a material distortion of income. See, e.g., Rev. Rul. 68-643, 1968-2 C.B. 76, considered in Prepaid interest, I-3207 (Nov. 25, 1968); Rev. Rul. 75-152, 1976-1 C.B. 144, considered in Gen. Couns. Mem. 35,458, *** I-408-73 (Aug. 30, 1973); see also Commissioner v. Boylston Mkt. Ass’n, 131 F.2d 966 (1st Cir. 1942.) In the present case has deducted currently expenditures (i.e., the costs incurred in producing the films) in years other than those in which income attributable to these expenditures (i.e., payments received under the Production Agreements) is realized. Consequently, the practice of currently deducting these payments does not clearly reflect income.”) (footnote combined in bracketed language with text; emphasis added). This was a shelter; for the opening salvo against abusive tax shelters, especially the inflated purchase price variant. See Gen. Couns. Mem. 36,577 (Feb. 26, 1976) (a position paper on “abusive” tax shelters), with attached O.M. 18426 (Feb. 2, 1976), where the Chief Counsel considered such a transaction then in litigation as part of its real estate tax shelter program. The O.M. repeatedly cited Lee, Section 183, supra note 192, and more significantly addressed many of the issues it raised. When Professor Lee discovered this in 1992 he could not have been more pleased.


\textsuperscript{209} Gen. Couns. Mem. 38,410 (June 18, 1980).


\textsuperscript{211} Gen. Couns. Mem. 38,410 (June 18, 1980).

The costs incurred by the taxpayer in securing governmental regulatory approval to operate the branch facilities created or enhanced for the taxpayer a separate and
A host of business expansion technical advice memoranda followed.\footnote{212}

distinct asset, which constituted a capital expenditure. Such costs, including for example, the application filing fees, legal costs, market feasibility surveys, could not be deductible under section 162. Gen. Couns. Mem. 35,116. The other costs in this case did not create or enhance this asset, or any other asset, and accordingly, constituted deductible expenses under section 162.

\textit{Id.} at 15-16.


For a cost to be capitalized under section 263 of the Code, it must create, enhance, or be part of the cost of acquiring or defending a separate and distinct asset or property interest with a useful life that extends substantially beyond the year in which the cost is paid or incurred. Thus, more than a mere future benefit or advantage must be created. \textit{See Lincoln Savings and Loan}, supra.

In \textit{Briarcliff Candy}, supra, this rule did not require capitalization of advertising and promotional expenses attributable to a program of developing new retail outlets for the taxpayer’s products. Similarly, in \textit{Colorado Springs National Bank}, supra, capitalization of these expenses was not required when incurred in connection with the taxpayer’s participation in a bank credit card system. In both cases, the desired future benefit was not considered a separate and distinct asset or property interest. It follows therefore, that the advertising and preopening rental expenses in this case are not separate and distinct additional assets, and accordingly may be currently deducted by the taxpayer.

Nor is there any basis on which capitalization may be required of the merchandise distributed to new depositors. The taxpayer is merely expanding its existing business. No separate or distinct asset is created thereby. Rather, the distribution of small appliances and similar merchandise of small or nominal cost to the taxpayer is merely a promotional effort to attract new accounts and deposits. Thus, like the advertising expenses, the costs of the promotional items are expenses of continuing and developing the taxpayer’s existing business. Accordingly, these expenses are currently deductible as ordinary and necessary business expenses under section 162(a) of the Code.

No opinion was expressed as to treatment of application fees, professional fees, market surveys, and allocated internal costs incurred in connection with obtaining regulatory authorization for the new branch locations, citing \textit{North Carolina National Bank v. United States} in the district court. \textit{Accord}, Tech. Adv. Mem. 84-23-005 (Feb. 8, 1984) (expenditures for (a) salaries and travel expenses of managers and opening team and of newly-hired employees during their training, and (b) advertising, polygraph tests, and rental of a space for training and interviewing as to 26 restaurants operated in various cities throughout the United States under the corporate taxpayer’s tradename operated within its corporate form are not as “start up” costs, which are not incurred in an established business operation when the new activities are similar to current business activities. ‘Start up’ costs, however, may be incurred by an existing business if the new activities are distinguishable from those currently conducted by the business . . . No separate asset is created when the Company merely expands the identical business to a new geographical location.).

Tech. Adv. Mem. 81-41-033 distinguished between permit and promotional costs of establishing new branch facilities by an existing savings and loan association, with the former being capitalized as part of the costs of a separate asset, the permit. The latter promotion costs were currently deductible on the theory that the branch did not constitute a separate, new business.

With Government victories in Central Texas S&L and particularly in Cleveland Electric Illuminating, the Service reversed course yet again, rejecting once more the separate asset doctrine in 1986 in Gen. Couns. Mem. 39,483 requiring capitalization of package design costs (the L'Eggo TAM) and rationalizing Briarcliff Candy and its bank credit card progeny in terms of recurring expenses which the Service had long-followed as a rough demarcation between capital and ordinary.

The business activity of the taxpayer remained the same after the branch facilities were opened. It involved extending credit to customers and receiving deposits. That activity was conducted in the same manner at the main office and at the branch facilities. The taxpayer only geographically added to the locations at which it operated its pre-existing business.

As a result, the costs in this case were not “start-up” costs requiring capitalization. Furthermore, some of the costs were incurred during the 30 day promotional campaigns, after the branch facilities were opened. Such costs are indistinguishable from other costs resulting from the current operation of a business. In the Richmond Television Corporation case, there was no dispute that costs incurred after the license was obtained were ordinary and necessary in nature, and thus deductible.

Similarly, Tech. Adv. Mem. 83-03-012 (Oct. 7, 1982), modifying Tech. Adv. Mem. 82-04-061 (Oct. 28, 1981) (which reached the same result), held that geographic expansion to a new plant did not result in costs of developing operating procedures, testing new equipment, and recruiting and training a work force creating or enhancing a separate asset so that they were currently deductible); accord Tech. Adv. Mem. 84-23-005 (Feb. 8, 1984) (same as to 28 branch restaurants so long as operated by same entity) ("No separate asset is created when the Company merely expands the identical business to a new geographical location."). Id.


The blackhole here of capitalization without amortization was covered over at least partially by Rev. Proc. 90-63, 1990-2 C.B. 664, which provides three alternative “exclusive” methods of accounting for package design costs: (1) capitalization without amortization, (2) design-by-design capitalization and sixty-month amortization, and (3) pool-of-cost capitalization and forty-eight-month amortization. See generally ISP Package Design Cost Settlement Guidelines, available in LEXIS, Fedtax.
Important in distinguishing capital expenditures from ordinary expenses is the recurring or nonrecurring nature of the costs. *Davee v United States*, 444 F.2d 551 (Ct. Cl. 1971). Some advertising expenses can be currently deductible either because they are of a recurring nature or their benefit does not clearly and identifiably extend substantially beyond a year. However, nonrecurring promotional or advertising expenses resulting in benefits to the taxpayer extending beyond the year the expenses are incurred are properly regarded as a capital investment. *Liberty Insurance Bank v Comm'r*, 14 BTA 1428 (1929); *Northwestern Yeast Co.*, 5 BTA 232 (1926); *Alabama Coca-Cola Bottling Company v. Comm'r*, TCM 1969-123; *** GCM 35116, I-4895 (Nov. 14, 1972), modified on another issue by ** GCM 38400, I-4178 and I-4895 (June 18, 1980). See *Cleveland Electric Illuminating Co. v. US*, 7 Cl. Ct. 220 (1985), which held that advertising to lessen public's fear of nuclear plants had to be capitalized.

Package design development costs are not akin to deductible advertising expenditures because they are not a recurring expense and they result in an asset that has a useful life of many years. A package design is developed when a product is first introduced and, although it may be modified occasionally, it is not usually changed on a regularly recurring basis. Further, the package design remains valuable for many years as the producer tries to establish both an enticing and uniquely recognizable package.217

Ironically, the ultimate resolution of the package design controversy was a compromise, suggested by the Assistant Chief Counsel Glenn Carrington as a model for resolving the general capitalization controversy.218 This Article agrees. Revenue Procedure 90-63 provides three
exclusive alternative methods of tax accounting for taxpayers changing such method as to package design costs: (1) capitalization without amortization, (2) design-by-design capitalization and sixty-month amortization, and (3) pool-of-cost capitalization and forty-eight-month amortization. In a 1993 Industry Specialization Paper on Package Design Costs the Service adopted this approach for settlement of cases in which audits raised this issue.

Following the fall of the separate asset test in the Service's rulings approach seven years before INDOPCO's final rejection, the National Office began to take strict approaches on the same business/new business issue which tended to push the issues more to Section 195 where the Service also flip-flopped on when a business begins for purposes of Section 195. In Tech. Adv. Mem. 93-31-001 the National Office suggested that in light of INDOPCO business expansion costs might not be currently deductible. Tech. Adv. Mem. 96-45-002 subsequently provided extensive analysis of the deductibility of start-up costs of new stores opened in the same business across the United States. Geographic separation of the stores was not discussed. Rather the Tech. Adv. Mem. properly focused on the recurring nature of the store opening costs and short-term future benefits. The published ruling, Revenue Ruling 96-62, in digest fashion considered only the employee training costs emphasizing the ordinary course of the

A second option would be to publish an analysis similar to that for package design, under which taxpayers would capitalize the costs and write them off over a period of five years or 10 years, Carrington said. However, IRS is concerned that many taxpayers would not buy into that system, he said. "It may help people in the very gray area and other people would continue to do what they're doing and it won't be useful," he said.

Asked whether IRS believes it has regulatory authority to "arbitrarily" require capitalization over a fixed period, such as five years or 10 years, Carrington responded, "It would be arbitrary, but we've done arbitrary — reasonably arbitrary — things in the past."

Third, IRS is exploring the adoption of the presumption that taxpayers would capitalize the expenditures if they already would capitalize them under the rules under generally accepted accounting principles, according to Carrington.

Id.

taxpayer's business. This connotes recurring, but not near so clearly as Tech. Adv. Mem. 96-45-002. More's the pity.

Professor Lee has argued for the past decade that current deduction of steady-state regularly recurring costs does meet the clear reflection of income standard under a balancing of (a) simplicity and avoidance of administrative costs of such deduction with (b) the more clear reflection of income from instead capitalizing and depreciating such costs. A recent excellent analysis of the doctrine so holding is contained in Tech. Adv. Mem. 96-38-002 which extensively quotes Judge Richard Posner's famous steady-state rationale in Encyclopaedia Britannica.

We can think of a practical reason for allowing authors to deduct their expenses immediately, one applicable as well to publishers though not in the circumstances of the present case. If you are in the business of producing a series of assets that will yield income over a period of years—which is the situation of most authors and all publishers—identifying particular expenditures with particular books, a necessary step for proper capitalization because the useful lives of the books will not be the same, may be very difficult, since the expenditures of an author or publisher (more clearly the latter) tend to be joint among several books. Moreover, allocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code desiderates, because the taxable income of the author or publisher who is in a steady state (that is, whose output is neither increasing nor decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book—on each book expenses and receipts will be systematically mismatched—but the same on average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.

Recurring payments alone may not justify an immediate deduction when the benefits obtained from the expenditures lack a similar recurring pattern. If a substantial useful life remains when the taxpayer next incurs

223. Rev. Rul. 96-92, 1996-53 I.R.B. 6. The implications of the hints in this ruling are discussed in Part 1. TEl appreciates that the ruling can be used by a knowledgeable advocate to retain a current deduction for a number of [recurring] expenses. Timothy J. McCormally, Rev. Rul. 96-62: A Lump of Coal or a Nicely Wrapped Present?, 74 TAX NOTES 797 (Feb. 10, 1997). Mr. McCormally is General Counsel and Director of Tax Affairs for Tax Executives Institute.


226. Encyclopaedia Britannica v. Commissioner, 685 F.2d 212, 217 (7th Cir. 1982).

227. Id. at 215 (dictum). Implicitly Judge Posner was hypothesizing an aggregate approach to recurring future benefit costs.
the recurring expense, the recurring expense is not incidental. The objective of minimizing income distortion seeks to match expenses with the income they produce.\textsuperscript{228} Mismatching occurs when expenditures of a fairly constant amount produce benefits that are disproportionally realized in future years: immediate deductions understate income in early years when the benefits occur in later years. In these situations, the duration of the future benefits properly requires taxpayers to consider capitalizing the costs as directed by \textit{INDOPCO}.\textsuperscript{229}

The Eighth Circuit encountered this mismatching problem of recurring expenditures with substantial benefits bunched in later years in \textit{Black Hills Corp. v. Commissioner}.\textsuperscript{230} In \textit{Black Hills}, several coal mining companies formed an entity designed to indemnify any of its members for their employees' black lung disease claims.\textsuperscript{231} Each member paid this separate entity a relatively constant annual premium, based on that mining company's individual exposure, calculated as the present value of projected liabilities throughout the anticipated life of the mine.\textsuperscript{232} In the event that a company closed a mine before its anticipated closing date, that mining company faced an "early termination charge" equal to the difference between the total projected annual premiums due and the premiums actually paid.\textsuperscript{233} Despite the relatively constant payment schedule, the mining companies expected claims primarily during the last year of a mine's operation.\textsuperscript{234} This delay occurred because miners often continue to work after contracting the disease.\textsuperscript{235} The discrepancy in timing between the premium payments and actual claims produced a reserve intended to satisfy the resulting claims in the mine-closing year.\textsuperscript{236}

\textsuperscript{228} See Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974).
\textsuperscript{229} INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992) ("[A] taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is [an] immediate deduction or capitalization.").
\textsuperscript{230} 73 F.3d 799 (8th Cir. 1996).
\textsuperscript{231} \textit{Id.} at 800-01. The mining companies formed this entity to comply with the Federal Coal Mine Health and Safety Act of 1969 that required mines to carry commercial insurance or qualify to self-insure against compensation, medical, and other beneficial payments to employees that contract black lung disease. \textit{Id.}
\textsuperscript{232} \textit{Id.} at 801-02. The initial premiums included components for anticipated future liability and for claims expected to arise from past operations. \textit{Id.} at 802. Both of these components were adjusted annually to account for fund income, expenses, claims, and balances on nonrefundable terminated accounts. \textit{Id.}
\textsuperscript{233} \textit{Id.} at 801.
\textsuperscript{234} \textit{Id.}
\textsuperscript{235} \textit{Id.} at 800-01.
\textsuperscript{236} \textit{Black Hills}, 73 F.3d at 801.
Contrary to the taxpayer’s insurance premium characterization, the Eighth Circuit determined that the taxpayer failed to shift the risk of loss produced by an early mine closing to the separate entity.\textsuperscript{237} Upon the early closing of a mine, the mining company needed to make an additional payment—the early termination charge—to cover any liabilities not funded by the prior premium payments.\textsuperscript{238} This payment structure left the risk of loss on the individual mining companies.\textsuperscript{239} The excess of the annual premiums over the year’s actual losses, therefore, represented a prepayment for the mine closing year.\textsuperscript{240} By failing to diminish its risk exposure, each mining company could expect future benefits in future periods as these prepayments satisfied its ultimate liability for claims from its mines.\textsuperscript{241} Thus, the recurring nature of the premium payments alone could not justify an immediate deduction when the benefits were not expected until future periods.\textsuperscript{242}

1. Recurring How Often?

Professor Lee has long surmised that a four year cycle goes beyond pushing the envelope on currently deducting steady-state recurring costs to tearing it open. His students can recite that substantial case law and administrative authority supports expensing costs recurring every three years\textsuperscript{243} (in a non-tax shelter context— the classic illustration is repainting every three years).\textsuperscript{244} Similarly Gen. Couns. Mem. 34,102 reasoned that

\begin{footnotesize}
\begin{enumerate}
\item[237.] Id. at 807.
\item[238.] Id.
\item[239.] Ibid.
\item[240.] Id.
\item[241.] Ibid. The court also accepted the Tax Court’s determination of significant future benefits obtained from a refund provision and a guaranteed option to renew the contract. Id.
\item[242.] This simultaneous existence of recurring expenditures and benefits does not imply that “income” must be produced in the traditional sense of the word. Recurring expenses may be incurred despite the lack of any actual income. For example, a company can incur routine selling expenses without actually making a sale to generate any income. See Cabintaxi Corp. v. Commissioner, 63 F.3d 614, 619 (7th Cir. 1995). The typically continuous nature of these sales expenses justify an immediate deduction because they are intended to generate income in the current year. See id.
\item[243.] Professor Lee must admit that Darryl like his other co-submitters is an exceptional tax student with the added insight from studying most of the substantive documents cited in our Submission and drafting many of the footnotes. But Lee has more objective proof in old exam answers tackling Moss and Cleveland Electric-based hypotheticals raising similar borderline issues of cyclical and regularly recurring costs. Then to Professor Lee’s delight, he found a GCM discussing capitalizing and amortizing as a deferred charge or expensing of redredging costs repeated every 3 years. See note 245 infra.
\item[244.] Cf. Wilbur’s Estate v. Commissioner, 43 T.C. 322, 327 n.6 (1964), acq. 1965-2 C.B. 7.
\end{enumerate}
\end{footnotesize}
[a]fter further consideration of the problem we 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 redredging is accomplished on an annual basis. However, classification becomes suspect where silt is removed every three years as in *** or one-third of the operation is accomplished every year as in Commodore's Point. 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. Moreover, leaving Rev. Rul 68-483 unchanged removes the necessity for withdrawing our longstanding acquiescence in Commodore's Point.

In view of the foregoing we offer no objection to publication of Rev. Rul. 68-483 without the clarification suggested in G.C.M. 33994. G.C.M. 33994 is accordingly modified.245

Further, after Wolfsen Land and Cattle recurring every ten years indisputably requires capitalization; and some reasoning in Service unpublished rulings, and the five year depreciation of the costs of repairing irrigation gates in Wolfsen Land and Cattle as well as a lot of statutory guideposts such as Sections 195, 248, etc., support capitalization and depreciation where a five year cycle is present.246 Four years, which is


246. Wolfsen Land & Cattle, 72 T.C. at 13 n.4 (depreciating as intangible over 5 years cyclical costs of repairing irrigation ditch gates every five years). Congress beginning with Section 248 of the 1954 Code (60-month amortization of formation costs of corporation) followed by Section 709 (same for partnership) and Section 195 (60-month amortization of start-up costs) show a Congressional pattern of providing 60-month amortization for self-created intangibles where case law did not readily provide deduction or depreciation. Purchased intangibles under Section 197 have a much longer amortization period of 15 years due to pay-go revenue neutrality constraints. There case law was an all-or-nothing crap shoot, nothing or pretty short depreciation if customer-list, etc., treatment could be achieved. Government Accounting Office, Tax Policy, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets (Aug. 9, 1991), available in LEXIS, Fedtax Library, TNT File, 91 TAX NOTES TODAY 169-1 (Aug. 31, 1991)

([T]he current tax treatment of intangible assets is based on the original income tax law and decades of conflicting court decisions. . . . The vague definition of goodwill, as well as taxpayers' latitude in determining useful life, has led to frequent disputes between taxpayers and IRS. Some of these disagreements have been resolved in the courts, where the decisions have been influenced by the most convincing evidence. This situation has resulted in inconsistent treatment of similarly situated taxpayers.).
the cycle for FAA required reconditioning of aircraft engines involved in Tech. Adv. Mem. 96-18-004, thus constitutes the hard question. Glenn Carrington, then Assistant Chief Counsel (Income Tax & Accounting) and known as an expert on capitalization, is quoted by the BNA Daily Tax Report as providing "[i]n his personal opinion" a similar framework for analyzing deductibility of recurring expenses:

As Wolfsen pointed out, if [the taxpayer] had cleaned the PCBs 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. . . ."247

2. Recurring Less Frequently and Freestanding Depreciable Intangible

What if the cycle is longer than four years or whatever is the ceiling on recurring? The distortion of income which results from adding a recurring cost to a longer-lived or nonamortizable asset, under the rationale that it constitutes an acquisition cost of the business as a whole, can be avoided by relying on the basic financial accounting concept of treating the expense itself as an amortizable asset or deferred charge.248 Assets, for financial accounting or balance sheet purposes, include both the economic resources of the enterprise and certain deferred charges that are not resources. If an expenditure may not be expensed in its entirety in the year paid, the cash assets of the enterprise are reduced and the portion of the expenditure that cannot be currently expensed is treated as a separate, noncash asset on the balance sheet.249 Thus, the NCNB I court noted that:

In order more accurately to reflect income, both in the present period and in future accounting periods, the carried-forward "assets" of an enterprise include, without regard to whether they are tangible or

How much better it would have been had the Commissioner followed the Chief Counsel's rough justice solution of Cohan approximations. Gen. Couns. Mem. 34,262 (Jan. 30, 1970), considering Rev. Rul. 74-456, 1974-2 C.B. 65. Professor Lee too has long favored Cohan approximations as an answer to recurring and other temporally limited expenditures without a definite life as an alternative to the income distorting horns of the capitalization (without depreciation) versus expensing dilemma. Lee, Clear Reflection of Income, supra note 2, at 38-41.


249. NCNB Corp. v. United States, 651 F.2d 942, 949 (4th Cir. 1981) [hereinafter NCNB I], rev'd, NCNB II, overruled, INDOPCO.
intangible, certain expenditures for benefits whose cost has already been incurred but the outlay for which is nevertheless most properly matched against some future period's revenues which the benefits will help produce.\textsuperscript{250}

In short, in financial accounting the expenditure itself may be treated as a separate asset or deferred charge to be expensed, or in tax terms "depreciated" or "amortized," in future tax periods.\textsuperscript{251} In the start-up and business expansion areas, such amortization of recurring costs as a free-standing asset, without regard to whether incurred in starting up a new business or expanding an existing business, provides a "golden mean" avoiding the all-or-nothing extremes of the talismanic separate, saleable asset (current deduction) or preparatory (capitalization without amortization) approaches.\textsuperscript{252}

The Tax Court in \textit{Wolfsen Land & Cattle}\textsuperscript{253} treated a recurring expenditure with a limited life as such a separate, amortizable, intangible asset to avoid the distortion of income that would have followed from associating the expenditure with the nonamortizable asset it enhanced. \textit{Wolfsen Land & Cattle} considered the deductibility of substantial expenditures, which the taxpayer incurred every ten years, for draglining an earthenwork irrigation system with an indefinite life.\textsuperscript{254} These substantial expenses resulted from the taxpayer's allowing the system to deteriorate until it became almost dysfunctional, rather than annually repairing and maintaining it.\textsuperscript{255} The court noted:

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 [sic] income. Yet to deny even an amortization deduction for an expenditure with a specific demonstrable beneficial life on the ground 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.


\textsuperscript{252} Id. at 8.

\textsuperscript{253} Id. at 8.

\textsuperscript{254} Id. at 8.

\textsuperscript{255} Id.
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.

The treatment of certain recurring expenses as a separate asset, even though such expenses are incurred in the acquisition of a nonamortizable asset, is not inconsistent with *Idaho Power*.

The Supreme Court in *Idaho Power* required (1) capitalization of the "depreciation" allocable to equipment the taxpayer used to construct capital improvements and (2) addition of the capitalized amounts to the basis of such improvements.

The Court sought to prevent the distortion of income that would result from currently deducting "depreciation" costs properly allocable to assets that in the future would produce income themselves. The Court also sought to maintain tax parity between a taxpayer that did its own construction work and a taxpayer that purchased the work from an independent contractor, which in turn charged its construction equipment depreciation to the taxpayer as an element of the total cost of the services. However, allocation of a temporally limited expenditure to the basis of a substantially longer-lived asset, or an asset with no determinable life, produces distortion of income. If a recurring expenditure—such as employee training in a workforce with high turnover—is added to the nonamortizable basis of a new or expanded business, a distortion of income is produced; this is not the situation in *Idaho Power*. Distortion will also exist when an expenditure with a shorter-term benefit is incurred in connection with the acquisition of an asset with a longer term. In *Idaho Power* the expenditures in question benefited the depreciable assets, created with the machinery,

---

256. Id. at 13 (footnote omitted). Gunn, *supra* note 2, at 446, perspicaciously suggested just this approach. The *NCNB I* panel came close to this approach. *NCNB I*, 651 F.2d at 942.

257. The Seventh Circuit intimated a conflict between distortion of income analysis and *Idaho Power*. Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 215, 217 (7th Cir. 1982) (Posner, J.) (discussing Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) (Blackmun, J.)). Lee, *Clear Reflection of Income*, *supra* note 2, at 34-36, argues that the resolution is to treat the costs as the acquisition costs of an amortizable deferred charge rather than as the acquisition cost of the business or some other long lived asset. Thus employee training costs at a new plant should have been treated as the cost of the work force itself rather than of the plant or an operating license associated with it. *Id.*

258. 418 U.S. 1.

259. Id. at 14.

260. Id.

over their entire useful life, in effect creating a construction cost of the assets.

The deferred charge or separate asset approach is consistent with basic tax concepts such as the "separate basket" approach to transfers of a going business and to "component" depreciation. Under the firmly established "separate basket" rule, the sale or acquisition of a business is not treated as the transfer of a single asset; rather, the business is fragmented into its components, with each asset given separate treatment on both the sale and purchase side. Accordingly, even under an acquisition cost approach, start-up as well as internal and external business expansion costs should be separated into their components for "tax parity" purposes, with those items providing benefits for a shorter period than the useful life of the business (which usually is indefinite) being treated as separate assets to be expensed or amortized according to clear reflection of income principles. For instance, if a taxpayer purchases an ongoing business that possesses short-lived recurring assets (usually already expensed by the seller), e.g., tools, supplies, or recurring marketing surveys, then the purchaser—under the "basket of assets" fragmentation approach, involving transfers of a going business—will be allowed to deduct currently the external cost of such items in the year of purchase. Technically, perhaps, the deduction may be considered depreciation or amortization of the cost in its entirety in the acquisition year because its determinable life is one year and as such can be amortized fully within one year under section 167. Accordingly, treatment of internal costs for short-lived recurring expansion or start-up expenditures as a separate asset, to be expensed or amortized under clear reflection of income principles, does not conflict with Idaho Power.

262. Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945). Judge Learned Hand concluded that "upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition [of 'capital assets' in the predecessor to § 1221(I)]." Id. This principle is now codified in Section 1060. See I.R.C. § 1060.


265. See Lee, Clear Reflection of Income, supra note 2, at 50 n.219.
3. Recurring How Often? Aggregate Basis

Courts and the Service have ruled that some variation in annual amounts with annually recurring costs can occur without precluding a current deduction.266 The Court of Claims in Cincinnati, in approving a de minimus exception to the future benefit/capitalization presumption explicitly applied an aggregate approach.267 The critical question is whether current deduction of an expenditure will result in more than minimal distortion of income.268 If not, and the burden of capitalization

266. Moss v. Commissioner, 831 F.2d 833, 842 (9th Cir. 1987)(tax consequences should not be drastically altered minor variations in the hotel taxpayer's pattern of annual capital replacements and repairs. "Given that the Hotel must completely remodel its interior every three to five years in order to remain competitive, there may be sound business reasons why the taxpayers or management may wish to accomplish the bulk of capital replacement in a particular year rather than spreading it out evenly over each year in the cycle."); see Tech. Adv. Mem. 92-37-006 (April 24, 1992) (recurring costs for prudence audit varied year to year); Tech. Adv. Mem. 81-36-001 (Feb. 27, 1980) (recurring without "disproportionate changes"); Tech. Adv. Mem. 74-013-1140A (Jan. 31, 1974) (sharp decrease in annual expenditure indicates that under Davee non-recurrent).


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 the onus.

Id. (emphasis supplied).

268. The seminal commentary in the area of capital expenditures developed the thesis that "a determination of whether capitalization of an expenditure is necessary to clearly reflect income . . . [should be] substituted for the usual process of determining whether the expenditure produces an asset," and that expensing small items does not distort the taxpayer's income, Gunn, supra note 2, at 452; accord Lee & Murphy, supra note 2. Gunn bottomed his analysis here on Judge Tannenwald's opinion in Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283-84 (1967) ("sections 263 and 446 are inextricably intertwined. A contrary view would enscase 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 respondent's revenue-collecting responsibilities"); accord, Cincinnati, 424 F.2d 563, and Southland Royalty Co. v. United States, 582 F.2d 604 (Ct. Cl. 1978); Gen. Couns. Mem. 34,959 (July 25, 1972) (recommended minimum expensing rule as not distorting income). Professors Bittker and Lokken suggest in their treatise on federal income taxation that, in the final analysis, the way to decide whether costs should be expensed or capitalized is to focus on which approach more clearly reflects income. "[T]he best remedy . . . is to focus on whether income will be better reflected by deducting or by capitalizing the amount in question. This . . . has the virtue of emphasizing the basic objective of the relevant statutory provisions rather than primary guideposts." See Bittker, supra note 157, at 20-67.

Gunn also raised the possibility that capitalization is not appropriate in this context when amortization is not available. Gunn, supra note 2, at 492-95; cf. Note, Deductibility of Start-Up Expenditures Under Section 162-The "Clear-Reflection-of-Income" Test, CORNELL L. REV. 618, 621 n.21, 625 n.42 (1976) (proposing as an alternative factor to future benefit the question whether the expense is recurring, in the context of distortion of income; but principally arguing that reliance upon
and amortization will be heavy, the expenditure should be currently
deducted in its entirety in the year made.\textsuperscript{269} Such minimal distortion is
produced by the current deduction of an expenditure with future benefits
where (1) the expenditure produces future benefits that are (a) short-lived,
(b) de minimis, or (c) recurring steady state costs (with a useful life
corresponding with the replacement cycle) or (2) capitalization-cum-
depreciation is not administrable by taxpayers or the Service.

The timing standard and implementing rules advocated below are
supported, with one exception, by case law and various National Office
documents as well as the Solicitor General Office's Brief and argument in
INDOPCO (as to the current deduction legs of the model). That exception
arises as to the amortization leg—uniform amortization periods for classes of
self-created intangibles. This article argues that such a uniform amortization
period is within the Commissioner's authority to require that the taxpayer's
method of tax accounting (which includes expensing and capitalization
practices) "clearly reflect income". The guiding standard should be
minimum distortion of income, effecting "rough justice" rather than more
exact matching of income and expense which would entail more
administrative difficulty.

The small taxpayer's burden of establishing that an item is currently
deductible would also be lessened by a small item exception to
capitalization. This notion is especially true since most smaller businesses
with limited resources rely upon the relatively expensive judgment of
outside professionals, the scope of whose services are limited by concepts
of materiality, concerning the classification of expenditures for tax
accounting purposes.\textsuperscript{270}

\textsuperscript{269} See Cincinnati, 424 F.2d 563; see also Iowa-Des Moines Nat'l Bank v. Commissioner, 592
F.2d 433, 436 (8th Cir. 1979); Southland Royalty v. United States, 582 F.2d at 618. Some tribunals
stress heavily the "burden" of capitalization/amortization in attempting to distinguish between current and
\textit{NCNB I}, 651 F.2d at 961 (vacated panel opinion). These courts focus on the "burden" rather than
determining the total period benefitted (useful life).

\textsuperscript{270} The economic burden placed on the small taxpayer to have every expenditure analyzed as
to whether it provided benefits beyond one year would certainly warrant at least some exception for
minor expenditures for such taxpayers.
C. Current Deduction if Amortization Unavailable

The Court of Claims (now the Federal Circuit) correctly believes that capitalization, depreciation, and clear reflection of income are "inextricably intertwined," with the ultimate question being the success of the taxpayer's method of tax accounting in clearly reflecting income.271 Not surprisingly, therefore, the Court of Claims held in Southland that capitalization without amortization was inappropriate where the recurring expenditures produced highly variable and relatively short-lived benefits,272 because such capitalization would distort the taxpayer's income. The distortion of income arising from capitalizing an investigatory or start-up expenditure — with future, but temporally limited, benefits — incurred while expanding an existing business and then adding such cost to the basis of a nonamortizable asset also clearly motivated the courts considering the bank credit card and branch progeny of Briarcliff to adopt the "separate, saleable asset" rule.273 This definitional rule overruled by INDOPCO called for current deduction of expansion costs, notwithstanding future benefits, if no separate, transferable asset is created or enhanced by the expenditure.274 An unarticulated premise was that a saleable or transferable asset usually will have a determinable life and, hence, be amortizable.275 "Current deduction under the separate, saleable asset test of recurring expenditures producing short- or variable-term benefits does not distort the taxpayer's income. Hence, the test often results in 'rough justice.' "276

Nevertheless, a current deduction of temporally limited expenditures does produce less distortion of income than capitalization without amortization.277 However, under the model, the answer is to supply amortization through liberal approximation of useful life, rather than a current deduction that is more income distorting than amortization over the approximate period benefited. Often the lack of amortization arises from a failure to allocate properly the capitalized cost. The early start-up cases

271. Cincinnati, 424 F.2d at 569 (relying on the decision in Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283-84 (1967)). See generally Gunn, supra note 2, at 453-54.
272. Southland, 582 F.2d at 618.
277. A commentator has suggested that a current deduction should be allowed "whenever capitalization would distort income more than current expensing." Note, Commissioner v. Lincoln Savings & Loan Association: "Separate and Distinct Asset" As a Condition Sufficient for Capitalization, 2 VA. TAX REV. 315, 333 (1983). If this is the only choice, we agree.
allocated the capitalized expenditure to non-amortizable assets,\textsuperscript{278} triggering some distorted, antithetical doctrine\textsuperscript{279} and much critical commentary.\textsuperscript{280} Only recently have the courts properly suggested that such expenditures should be examined category by category under traditional capitalization factors.\textsuperscript{281} The Service initially permitted in Tech. Adv. Mem. 75-909-9440A\textsuperscript{282} amortization of capitalized new plant employee training costs over the life of the building in which the workforce was employed.\textsuperscript{283} Contemporaneously Tech. Adv. Mem. 75-042-81070A\textsuperscript{284} also capitalized "start-up costs" of a new plant in an existing business of manufacturing and selling lumber, plywood, particleboard, hardboard, shakes and shingles and other basic building materials creating an intangible asset—"an operational fiberboard plant." The Memorandum classified employee training costs for the new plant as not currently deductible "since they are essentially non-recurring expenditures necessary to commence initial operations.\textsuperscript{285} These costs similarly must be capitalized as part of the cost of establishing the operational fiberboard plant."\textsuperscript{286} Subsequently during the period the Service followed the separate asset doctrine, a Tech. Adv. Mem. allowed a current deduction for the costs of developing operating procedures, testing new equipment, and recruiting and 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.\textsuperscript{287} The Tech. Adv. Mem. did not consider either the employee training costs or the operation at a new location as creating a separate asset.\textsuperscript{288}

\begin{itemize}
  \item \textsuperscript{278} Lee, \textit{Clear Reflection of Income}, supra note 2, at 45.
  \item \textsuperscript{279} Lee, \textit{Clear Reflection of Income}, supra note 2, at 45-46, 51-57.
  \item \textsuperscript{280} Lee, \textit{Clear Reflection of Income}, supra note 2, at 3-4 n.2 (authorities cited therein).
  \item \textsuperscript{281} Sealy Power, Ltd. v. Commissioner, 46 F.3d 382, 400 (5th Cir. 1995); Lee, \textit{Clear Reflection of Income}, supra note 2, at 27-8 n.112. Cf. Cabintaxi Corp. v. Commissioner, 63 F.3d 614, 619 (7th Cir. 1995) (Posner, J.).
  \item \textsuperscript{282} Tech. Adv. Mem. 75-909-9440A (Sept 9, 1975).
  \item \textsuperscript{283} Chief Counsel was inclined to follow a proposed ruling by Technical that the costs of a joint venture to operate a first nuclear power energy generating plant were pre-operating costs and should be capitalized and amortized over the life of the facility, but declined to rule due to a pending GCM as to credit cards Gen. Couns. Mem. 35,116 (Nov. 14, 1972). Gen. Couns. Mem. 37,500 (April 5, 1978) (training cost not deductible, it must be capitalized and depreciated on a straight-line basis).
  \item \textsuperscript{284} (April 28, 1975).
  \item \textsuperscript{286} \textit{id.} at 6-7 (emphasis supplied).
  \item \textsuperscript{288} The expenditures in the present situation can not be characterized as "start up" costs. "Start up" costs are not incurred in an established business operation when the new activities are similar to current business activities. "Start up" costs, however, may
With the Service's abandonment of the separate asset test, the issue of allocation arose again. Technical Advice Memorandum 94-30-003 took a much more sophisticated approach, properly treating permit costs and employee training costs incurred by a public utility as to a new and first nuclear power electricity generating facility as separate intangibles apart from the plant itself. Technical Advice Memorandum 94-30-003 inadequately distinguished judicial precedents (and failed to consider earlier contrary Service rulings) capitalizing the costs of permits and licenses to specific related tangible assets on the grounds that they related "to construction and not to the right to operate a business." (The earlier decisions were wrong.) It properly concluded that both the direct permit costs and the costs of training the new workforce were separate amortizable assets, but incorrectly ruled that the proper period for amortization for both intangible assets was 40 years "because the NRC license [to operate a nuclear powered electricity generating plant] is limited to 40 years, the Taxpayer's business will terminate in 40 years." Conventional wisdom holds that if an intangible such as a permit or license is renewable with reasonable certainty or as a matter of course, such intangible does not have a definitely determinable useful life and thus can not be amortized. On the other hand, the Service and courts

be incurred by an existing business if the new activities are distinguishable from those currently conducted by the business. This request does not concern an existing business that began a new activity unrelated to its prior business. Rather Company in its new facility is manufacturing the same basic products produced in all its other plants.

Based on the facts in this case it is our opinion that the training cost here involved did not create or enhance a separate and distinct asset requiring the taxpayer to capitalize such cost under section 263 of the Code.

290. Id.
291. Lee, Clear Reflection of Income, supra note 2, at 4 n.3; 31-8.
often stretched to find that renewal was not likely, probably reflecting the unarticulated notion that a current deduction produces less distortion than capitalization without amortization. The TAM did not address whether the NRC permit was renewable, but experience in other regulated areas suggests that the NRC permits usually will be renewed. In short, in capitalizing recurring costs such as employee training, the Service seeks to find some asset with a more determinable life to serve as a surrogate for the life of the business. The above nuclear plant operating permit and the new plant itself are examples. Another illustration is the mysterious piping in the soil remediation TAM. So much better is the analysis in Tech. Adv. Mem. 96-45-002: "These costs include the cost of stocking the stores with inventory and supplies, staff training, store promotional costs, utilities, rent ... [T]he recurring nature of the these costs suggests that they should not be capitalized under section 263." The TAM further pointed to the predominantly short-term benefits produced as supporting a current deduction. It also noted "that the cost of training employees generally is deductible under section 162." Therefore it allowed expensing of classic business expansion/start up in the same business costs. The
published digest ruling, Revenue Ruling 96-62, narrows the discussion down to just that point of employee training costs.300

**D. Other Administrative Difficulties**

While Professor Lee was preparing this an earlier draft of article, a colleague brought to his attention an IRS audit of another colleague's prepublication costs as to non-academic books. Researching that area disclosed that application of the balancing test of burdens and benefits of capitalization can support a current deduction of costs with long-term future benefits even where the expenses are neither small nor recurring and depreciation is in theory available, e.g., costs of researching and writing by a one-shot author. Where the depreciation rules are unduly burdensome, as in the case of income forecast depreciation for an individual writer, the current deduction or some sort of safe harbor is in order, as discussed in a work in progress but not in our submission pursuant to Notice 96-7.

**V. SAFE HARBOR AMORTIZATION**

If a taxpayer can show that the benefits produced by the expenditure are temporally limited, although she may not be able to estimate that life with reasonable accuracy, logically she proves entitlement to a deduction equal to some percentage of the cost of the expenditure creating the intangible.301 Often useful life of a self-created intangible cannot be estimated with reasonable accuracy,302 therefore, the taxpayer cannot prove

---

301. More recently the Tax Court requires a "reasonable basis" for approximation. See Norgaard v. Commissioner, 939 F.2d 874, 879-80 (9th Cir. 1991) (Tax Court correctly refused to permit deduction of estimated gambling losses from reported and unreported gambling income. "Neither winnings nor losses can reasonably be estimated in the absence of a credible basis for doing so."). As the Ninth Circuit stated in a case where proof was similarly lacking, "to allow the Cohan doctrine to be invoked by the taxpayers would be in essence to condone the use of that doctrine as a substitute for the burden of proof. See also Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). This the court will not do." Colman v. Commissioner, 540 F.2d 427, 431-32 (9th Cir. 1976). Cf. Norgaard v. Commissioner, 939 F.2d 874, 879 (9th Cir. 1991) ("the rule of Cohan cannot be applied in the presence of unquantified, unreported winnings unless both winnings and losses are estimated."); Lerch v. Commissioner, 877 F.2d 624, 627-29 (7th Cir. 1989) (refusing to apply Cohan rule where taxpayer could have but failed to present evidence to support the claimed deductions); Epp v. Commissioner, 78 T.C. 801, 807 (1982). Tax shelter cases probably helped cause this "shift". See infra note 311. Sounds like what got the Board of Tax Appeals reversed in Cohan in the first place. Hagen Investments, Inc. v. Commissioner, 92-1 U.S. Tax Cas. ¶50,030 (10th Cir. 1991) (mem.). See John Lee, Section 482 and the Integrated Business Enterprise, 57 VA. L. REV. 1376, 1390, 1397-99, 1407 (1971).
302. Further, the "not insignificant burden" of proving that the taxpayer's work-force-in-place intangible asset has an ascertainable useful life, and is a separate and distinct asset from other
exactly what percentage of the cost should be ratably deducted (e.g., ten percent if the useful life were in fact ten years or three percent if the useful life were in fact thirty-three years). This situation calls for approximation of the useful life of the deferred charge under the doctrine of Cohan v. Commissioner.\footnote{303} Under Cohan, if the taxpayer proves to the fact finder that deductible expenditures are incurred in some amount, it must "make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making."\footnote{304} Thus, where the taxpayer proved that an intangible asset (an easement) was indeed a wasting asset, the Eighth Circuit in \textit{Northern Natural Gas Co. v. O'Malley} held that some amortization deduction is mandated under Cohan.\footnote{305} The court read a similar, but harsher, requirement as to the limited life of an amortizable intangible, imposed by a prior regulation,\footnote{306} as not requiring proof of the exact number of years the easements would continue. "We believe that all that is required is definite proof that the asset is one definitely undergoing exhaustion. The evidence clearly establishes that the rights-of-way will be useful for taxpayer's purposes for only a limited period . . . [T]he
uncertainty relates to the length of the period."307 Several decisions to the contrary have required the taxpayer to prove a reasonable basis for a Cohan approximation, particularly where the taxpayer's sole evidence as to amount was his testimony.308 Moreover, depreciation has been denied due to a failure in establishing an asset's useful life even though the asset would physically deteriorate or someday be retired from service.309

Although only rarely so acknowledged, the Cohan rule is an equitable one310 under which a court, unable to be precise in its findings, dispenses "practical justice," i.e., "rough justice," as best it can.311 The trier of fact is convinced that the taxpayer incurred some part of the claimed expenditure. Therefore, she allows a rough estimate of the allowable deduction. Similarly, useful life for depreciation under one view need not be established with certainty. Only a "reasonable approximation" or even a "rough estimate" is required.312 Application of distortion of income

307. O'Malley, 277 F.2d at 135.
309. See, e.g., Burlington Northern, Inc. v. United States, 676 F.2d 566, 582 (Cl. Ct. 1982) (Kashiwa, J., dissenting) (describing the majority's finding that the assets involved were durable but would nonetheless become obsolescent); cf. Coleman v. Commissioner, 540 F.2d at 431-32.
311. See Dowell v. United States, 522 F.2d 708, 711 (5th Cir. 1975) (dictum); John L. Ashe, Inc. v. Commissioner, 214 F.2d 13, 16 (5th Cir. 1954); Robinson v. Commissioner, 10 T.C.M. (CCH) 571 (1951). Several courts have required a reasonable basis for judicial estimation under Cohan. See supra note 301. Generally courts have not permitted an "equitable" allocation not based on credible evidence. E.g., Union Stock Farms v. Commissioner, 265 F.2d 712, 723-24 (9th Cir. 1959); Professional Servs. v. Commissioner, 79 T.C. 888, 919 (1982); Honigman v. Commissioner, 55 T.C. 1067, 1081 (1971). See also Groff v. Commissioner, 48 T.C.M. (CCH) 77 (1984). A major difficulty in determining the approach followed by a particular opinion — equity or reasonable basis — is that judges are unlikely to admit that they are making Cohan approximations without any ascertainable basis. For instance, one dissenting opinion charged the majority with making a Cohan approximation without any ascertainable basis, or even a citation to Cohan, and hence clothing the court with the "power of an equity court" that it did not possess. Ward v. Commissioner, 20 T.C. 332, 345-46 (1953) (Withey, J., dissenting).
analysis to the issue of current deduction versus capitalization and amortization supports the liberal use of Cohan to effect uniform amortization periods.

Commentators readily suggested prior to Section 197 that the courts could approximate under Cohan the amount of the purchase premium which is amortizable and the appropriate amortization period. In reality, however, the Tax Court has found it relatively easy to make Cohan approximations only where the question was an allocation between a covenant not to compete and non-amortizable goodwill. Where, however, the question was allocation to non-amortizable going concern value review courts have on occasion required some rational basis for the Cohan approximation. Moreover, the Tax Court has come to recognize the administrative as well as equitable problems with approximation.

Chief Counsel's Office once considered, prior to enactment of Section 197, the advisability of establishing safe harbors for depreciation of purchased intangibles on the grounds that judicial use of Cohan approximations encouraged excessive litigation. Moreover, in Notice 88-62 the Service provided elective 3-year safe harbor (50%/25%/25%) amortization of writer's prepublication costs. The tax treatment of package design costs is similar. Technical Advice Memorandum 86-11-005 determined that package design costs of a unique container for women's hosiery products (the "L'Eggo" package) had to be capitalized but did not qualify for the since repealed Section 177 elective 60-month amortization of trademark and trade name costs. The taxpayer admitted that the costs created an asset with a life longer than 1 year, but argued that

320. Tech. Adv. Mem. 86-11-005 (Nov. 26, 1985), considered Gen. Couns. Mem. 39,483 (March 5, 1986) ("Package design development costs are not akin to deductible advertising expenditures because they are not a recurring expense and they result in an asset that has a useful life of many years. A package design is developed when a product is first introduced and, although it may be modified occasionally, it is not usually changed on a regularly recurring basis. Further, the package design remains valuable for many years as the producer tries to establish both an enticing and uniquely recognizable package.") (Emphasis supplied).
the costs were currently deductible as “akin to advertising expenses.” 321
The taxpayer also conceded that the package designs did not qualify as
amortizable “trademarks” under then Section 177. Then Revenue Procedure
90-63 322 offered taxpayers three alternative methods of accounting for
package design costs; (1) capitalization, (2) design-by-design capitalization
and 60-month amortization, and (3) pool-of-cost capitalization and 48-month
amortization.

General Counsel Memorandum 34,959 323 in recommending a “rough
justice” expensing of all [tangible] items under a set ceiling relied upon the
notion that Section 461’s directive that a taxpayer take into account income
and deductions in the proper tax year under its “method of [tax] accounting”
(which includes expensing and capitalizing practices 324) was subject to the

321.
322.
323.
324.
1997] RESTATING CAPITALIZATION STANDARDS 1557
Section 446 proviso that such method clearly reflect income: Chief Counsel concluded that such a clear reflection of income standard authorized the Commissioner "to prohibit deductions where such is necessary to prevent a distortion of taxable income . . . [and] to permit certain deductions where a deduction is seemingly proscribed by a particular provision of the Code." We believe that this reasoning supports the proposed de minimis and regularly recurring exceptions and this article argues the proposed capitalization with standard amortization periods for larger non-regularly recurring costs.

V. CONCLUSION

In Notice 96-7 the Internal Revenue Service requested written comments concerning

(1) whether general guidance clarifying the fundamental principles of capitalization would aid in resolving capitalization issues; (2) what specific approaches, principles, or issues guidance should address; and (3) whether safe harbor amortization periods should be provided for certain capitalization expenditures and what data supports any suggested periods.

Having thought about these very issues for years and testified on these very points Professor Lee thought that this Notice looked like it was written just for him. It was not. It more likely was written for TEI. Professor Lee vehemently disagrees with Chief Counsel Stuart Brown that there is no "magic formula" for a global approach. There is strong evidence that Chief Counsel never intended to issue a global response, but only a narrow ruling or so and a broader Tech. Adv. Mem. or two. No regulation project was opened as to this area in 1996. On the other hand, the business expansion TAM was excellent and it and the training costs ruling permit TEI members

determining taxable income, and the rules governing the timing of items of income, deduction, or credit which depend upon the taxpayer's method of accounting. Treas. Regs. § 1.446-1(e)(2)(ii)(a) provides that a material item is any item which concerns the "timing" of income or deductions. Correspondingly, changes which do not affect timing are not changes in method. Id. § 1.446-1(e)(2)(ii)(b). Treas Reg. § 1.446-1(a) states that "the term 'method of accounting' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item." A taxpayer's practice of capitalizing or expensing certain items constitutes a method of accounting. E.g., Rev. Rul. 95-74, 1995-2 C.B. 36 (Nov. 13, 1995); Rev. Rul. 95-32, 1995-1 C.B. 8; Gen. Couns. Mem. 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. Id. 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.").

and other sophisticated large taxpayers to resolve favorably most questioned partial future benefit costs where current deduction would not distort their income. The 1997 Business Plan calls for guidance as to start-up costs, although again no regulation project has been opened. Conversion of the business expansion TAM into a broad ruling setting forth the standard of minimum distortion of income and the factors of small, recurring and near-term future benefits might be a sufficient incremental step. But if Professor Lee hears that the Service is applying a broad future benefits capitalization to small taxpayers, represented by generalists at best, before at least published rulings setting forth such factors and preferably regulations along the lines advocated in this article are issued; he will reluctantly join those calling for a broad limitation rider applying to all future benefit costs traditionally deducted by small taxpayers prior to INDOPCO, until regulations are promulgated. It is very unfair to expect Main Street, much less rural route taxpayers to find answers in TAMs. This is what Professor Lee believes former Commissioner Mortimer Caplin meant in the Virginia Tax Conference Planning Session in November 1996 when he exclaimed “no TAMs,” when we were describing the scope of a tax conference topic entitled “INDOPCO Comes to Main Street.” As far as the split between National Appeals and Associate Chief Counsel, the Service should bear in mind former Chief Judge Lapsley W. Hamblen, Jr’s admonition at the same meeting—“Audit doesn’t have to try them.”