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DOPING OUT THE CAPITALIZATION RULES AFTER INDOPCO

by John W. Lee

The words of Koheleth son of David, King in Jerusalem.

... Only that shall happen
Which has happened,
Only that shall occur
Which has occurred;
There is nothing new
Beneath the sun!

Sometimes there is a phenomenon of which they say, "Look, this one is new" — it occurred long since, in ages that went before us. The earlier ones are not remembered; so, too, those that will occur later will no more be remembered than those that will occur at the very end.

(Ecclesiastes Chapter 1, Verses 9 through 11 (Tanach, a new translation of the Holy Scriptures according to the traditional Hebrew text).)

I. INTRODUCTION

As we all know now, the Supreme Court in INDOPCO, Inc. v. Comm'r\(^1\) at long last rejected the "separate saleable asset" doctrine under which expenditures with substantial future benefits could be currently deducted so long as they did not create or enhance a separate asset. The Tax Executives Institute (TEI) charged that "IRS field agents have been running wild, using the ruling to deny all manner of deductions."\(^2\) TEI was concerned about challenges to the deductibility of advertising, employee training, and repair and maintenance expenses,\(^3\) all of which often provide future as well as current benefits. Fortunately, the Service plans to address the application of INDOPCO to

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COMMENTARY / SPECIAL REPORT

these items before year end under its "1992 Business Plan." Service representatives have correctly stated that the Supreme Court did not change the longtime standards for distinguishing currently deductible expenses from capital expenditures except to overrule the "separate saleable asset" doctrine. And in Rev. Rul. 92-80, the Service, with scant analysis of such standards, concluded that INDOPCO "does not affect the treatment of advertising costs as business expenses which are generally deductible under section 162. . . ."

The Supreme Court in INDOPCO, Inc. v. Comm'r at long last rejected the 'separate saleable asset' doctrine.

This article reviews those standards and makes recommendations as to administrative guidelines for post-INDOPCO resolution of current deductibility/capitalization-cum-amortization of expenditures with present and future benefits. The most important lessons in this area over the past 25 years or so are: (1) If an expenditure by a new business, such as employee training, provides future benefits for a shorter period than the life of the business, its plant, or operating permit, the capitalized expenditure should not be added to the basis of the business, plant, or permit, but instead should be treated as a freestanding self-created intangible amortizable over the shorter period benefited (where section 195 does not apply); (2) if an expenditure, such as advertising, provides current and future benefits and is regularly incurred in roughly the same amount year-after-year, or almost every year, it should be currently deductible if capitalizing and amortizing would be burdensome; and (3) if an expenditure, such as repairs, provides current and future benefits but is not substantial in comparison to total replacement cost of the repaired item, it should be currently deductible. Not only are these "rough justice" approaches supported by more than mere straws in the wind in the existing case law (and commentary), but ignoring them brought about the widespread adoption of the separate asset doctrine in the first place.

II. PURPOSE OF CAPITALIZATION

The purpose of capitalization under section 263 (and the resulting basis increase under section 1016) is largely timing: to "prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital assets become income producing." The same purpose is also effected by the "ordinary" expense requirement of section 162, and the "clear-reflection-of-income" requirement of section 446. In short, the function of the capitalization requirement coupled with amortization is to avoid distortion of income.


5Avakian-Martin, "IRS To Move Carefully in Releasing INDOPCO Guidance," 92 Tax Notes Today 152-3 (July 27, 1992). INDOPCO in essence merely held that the reading of Lincoln Savings as establishing "creation or enhancement of an asset" as a prerequisite to capitalization was incorrect. Lincoln Savings stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance . . . a separate and distinct" asset should be capitalized under section 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under section 263. . . .

Nor does our statement in Lincoln Savings . . . that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure. Although the mere presence of an incidental future benefit — "some future aspect" — may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. INDOPCO, 112 S. Ct. at 1044-45 (footnotes omitted).


7Sections 263(a)(1) and (a)(2), respectively, prohibit a current deduction under sections 162 or 212 for (a) any amount paid out for new buildings or for permanent improvements made to increase the value of any property, and (b) any amount expended in restoring property or in making good its exhaustion for which a depreciation, amortization, or depletion allowance is or has been made. Treas. Reg. section 1.263(a)-1(a)(2). Section 1016(a)(1)(a) adjusts a property's basis upward for the cost of capital improvements and similar items chargeable to capital account. If the property is used in a trade or business or held for investment, such adjusted basis may then be "recovered" through: (a) depreciation or amortization over the property's useful life, if subject to exhaustion through use in the taxpayer's business or section 212 income-producing activity; or (b) deduction from the amount realized in computing gain or loss under section 1001 upon a subsequent sale or other taxable disposition of the property.

8Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1973); accord, INDOPCO, 112 S. Ct. at 1042-43.

The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery. While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise . . . . Sections 167(a) and 336(a); Treas. Reg. section 1.176(a) . . . . Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.

III. BLACK LETTER RULES

A. One-Year Rule of Thumb

Early cases frequently required capitalization because the benefits of the expenditure lasted longer than the yearly accounting period. This doctrine resulted in the classic definition of a capital expenditure as a cost securing an advantage to the taxpayer that has a life of more than one year. Otherwise, capital expenditures were deductible under this rationale if the useful life of the property was less than one year. More recently, the one-year rule of thumb has been properly viewed as "intended to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with the benefit enduring for a period in excess of one year." But generally, where an expenditure provides substantial future benefits, current deduction understates the taxpayer's current income and overstates future income.

The function of the capitalization requirement coupled with amortization is to avoid distortion of income.

Exceptions to future benefit capitalization make the rule. Distortion of income should be the lodestar, not merely future benefit. Misfocus on future benefit alone led some courts to describe the exceptions permitting current deduction of expenditures providing current and future benefits (such as repair, educational costs, or a sales salary) as due to "considerations of expediency" or "considerations of pragmatism and uncertainty." Such "analysis" appeared inspired by the Supreme Court's noting in Comm'r v. Lincoln Savings & Loan Ass'n that the presence of an ensuing future benefit was not controlling because many concededly deductible expenses have prospective effect beyond the tax year.

The real problem with the future benefits test in practice was the tendency to add the capitalized cost of, say, employee training in a new business to the basis of a nonamortizable asset such as the business itself or an indefinite life permit. For example, in the leading presection 195 start-up cost decision, Richmond Television Corp. v. United States, the contested start-up costs consisted largely of broadcasting staff training expenses, primarily expenses of training a staff for two years (to operate a television broadcasting station) incurred prior to receipt of an FCC TV broadcasting license and, hence, commencement of commercial TV broadcasting. The government primarily argued that the training of the broadcasting staff created a capital asset in the form of a reservoir of skills with continuing benefits over the period of years. Consequently, charging against the first year's income the large outlays required to acquire the staff would produce a gross distortion of the taxable income for that year. The Fourth Circuit accepted the government's creation of a capital asset benefitting future years and distortion-of-income argument as an alternative holding. The Supreme Court remanded for con-


17 403 U.S. 345, 354 (1971) (The court did not enumerate any such deductible future benefit expenditures). Lincoln Savings & Loan considered the deductibility of a payment by an S&L to a reserve fund held by a federal agency. In deciding whether the payment was a contribution to an asset or an expense, the court said:

What is important and controlling, we feel is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under section 162(a) . . . .

403 U.S. at 354. While concluding that the contribution to the reserve fund was capital, the court specifically rejected the argument that the expenditure was not deductible simply because it had an effect beyond one year.

18 345 F.2d 901, 905-07 (4th Cir.), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965).

19 Brief for Appellant at 12-13, Richmond Television Corp. v. United States, supra. See generally Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347, 458 (1974). And capitalizing those costs and adding them to the basis of a nonamortizable broadcasting license wouldn't?

20 Doubly unfortunately, Richmond Television first proceeded to survey several investigatory and start-up-cost decisions, concluding that: "The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money for preparation for entering that business, he still has not 'engaged in carrying on any trade or business' within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it is organized." 345 F.2d at 907 (footnotes omitted). Thus was born the start-up-cost doctrine in its modern guise.
The real problem with the future benefits test was the tendency to add the capitalized cost to the basis of a nonamortizable asset such as the business itself or an indefinite life permit.

Similarly, the Claims Court, in Cleveland Elec. Illum. Co. v. United States,22 added the capitalized cost of training employees for a nuclear powered electricity generating plant to the basis of the nonamortizable operating permit. This approach itself produces distortion of income when recurring expenditures (e.g., staff training expenses) are added to a nonamortizable asset, such as an indefinite-life operating permit. Moreover, using this approach with a new business requiring a license creates a conceptual quandary — how to justify the current deduction of similar training costs by an ongoing business in expansion. (This would cause a fatal conceptual flaw in section 195 as drafted.)23 An example of this problem is allowing current deduction of staff training costs for a new branch in expanding the same business, while requiring capitalization of start-up costs for identical staff training for a new branch in a different location or a new business. Cleveland Electric Illuminating faced precisely this problem: deductibility of employee training expenses for the initial work force at a new coal-fired generating plant similar to its existing generating plants and of training expenses for the initial work force at its first nuclear powered generating plant. The Claims Court attempted to distinguish the two expenses on the grounds that the new business (nuclear power generating plant) start-up costs for new employee training were substantial, provided future benefits, and constituted a one-time expenditure. (The latter appears factually wrong in light of industry experience and Nuclear Regulatory Commission rules requiring continuous retraining.) The court distinguished the employee training costs for this “new” business generating plant from the employee training costs for “same” business generating plant because the same business (fossil fuel power generating plant) expansion costs for new employee training were not so substantial, replacement employees at it would receive similar training, and the employee turnover rate was projected as 10 percent per year at the coal-fired plant.24 In addition, the Claims Court found that no new operating permit was required for the new plant in the same business, an immediate benefit was present, and any division of the cost according to immediate and future years was thought impractical. The Claims Court permitted immediate deduction for the employee training costs at the new coal-fired generating plant while capitalizing the employee training costs at the new nuclear-powered generating plant.

Other employee training costs for nuclear power generating plant cases disclose, however, that employee turnover at such plants also is high and employee retraining costs are substantial. For instance, the Tax Court in Madison Gas & Electric Co. v. Comm’r25 found that 1/7 of an operator’s time at an atomic powered generating plant subject to the Nuclear Regulatory Commission (then the Atomic Energy Commission) is devoted to retraining of the same scope and extent as the original training (operators’ licenses are good for only two years and the NRC requires continuous retraining); turnover at the plant was high due to an extremely competitive job market and “because of physical and psychological problems resulting from the pressure of the position” — the “Silkwood” factor —; and 34 percent of the training expenditures over a 10-year period were attributable to employees no longer employed at the end of the period. Given such a pattern, adding the initial operator training expenditures to the NRC license to operate the plant, which was indefinite and thus nonamortizable, distorted the taxpayer’s income in Cleveland Electric. The court derived from Richmond Television and its progeny the “theory that where a business requires substantial start-up expenditures before it can begin operations, which are not directly for the purchase of tangible assets and which will not ordinarily be recovered out of revenues for the same year, the capital investment is in the business as a whole rather than merely in tangibles,

21382 U.S. 68 (1965). On remand, the Fourth Circuit found that the FCC broadcasting license was not amortizable because it was readily renewable. Richmond Television Corp. v. United States, 354 F.2d 410, 412 (4th Cir. 1965). The court made two more errors here: (1) the pool of trained employees should have been treated as a freestanding amortizable intangible; and (2) where permit costs are recurring, they should be amortized over the period between permit renewals since that is the only period they benefit.


24Why was the nuclear generating plant not merely a new way of carrying on the same business? See Colorado Springs Nat’l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974).

2572 T.C. 521, 543-544 (1979), aff’d, 633 F.2d 512 (7th Cir. 1980) (the capitalization and amortization issue not raised by the taxpayer).
and it includes the start-up costs." The Claims Court should have set up the "new business" nuclear-powered generating plant employee training costs (or perhaps only the excess over the average amount of recurring retraining and replacement training costs, with the latter amount currently deductible) as a freestanding asset amortizable over a period based on projected employee turnover and retraining rates. The fossil fuel generating plant maintenance costs similarly should have been set up as a separate asset amortizable, probably, over 10 years. Alternatively, both should have been currently deductible if, in fact, any allocation of cost to present and future years was impractical. (On examinations, most of my students choose this option.)

B. Origin-of-Claim

Both Richmond Television and Cleveland Electric may be closer to purchased intangibles than self-created intangibles in that both involved reimbursing another entity for the employee training costs. Although in theory, self-created and purchased intangibles as to a trained work force should be treated alike, neither Congress nor the courts seem so inclined.

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The Supreme Court, in Woodward v. Comm'r, applied an "origin-of-the-claim" standard to capitalize litigation expenses incurred by the taxpayers pursuant to state law requiring shareholders voting in favor of a certain corporate action to purchase all of the stock of the "dissenters" at its then value — the litigation was over that value. The taxpayers argued that a primary-purpose test applied, under which capitalization was required only if the taxpayers' primary purpose in incurring expenditures was to defend or perfect title to their own stock. The Supreme Court disagreed. The Fifth Circuit extended an origin-of-the-claim analysis to business expansion costs, at least where a separate location is acquired. Central Texas Savings & Loan Ass'n v. United States analyzed a state branch S&L permit as a "separate asset" with which it associated under the "origin-of-the-claim" rubric both the permit's application costs and market survey costs. The court denied any amortization deduction, pointing out that section 195 was not yet applicable. Tested against a distortion of income analysis, the result in Central Texas Savings & Loan was partly right and partly wrong. The permit application costs were properly capitalized and added to the cost of the nonamortizable permit or branch (provided that the permit did not have to be periodically reviewed), but the survey costs (unless nonrecurring and used only in the acquisition of the new branch permit but not in its subsequent

26Woodward v. Comm'r, 397 U.S. 572, 576-78 (1970). Professor Gunn has suggested that the policy underlying the "origin-of-the-claim" doctrine is that to allow a deduction for expenditures integrally related for the capital asset while taxing related gain from the ultimate disposition of such asset as capital gain without a reduction for the expenditure results in a distortion of the character of the taxpayer's income as a practical effect through the allowance under the late 1954 code of 160-percent deduction (60-percent deduction under the late 1954 code for capital gains and 100-percent deduction for expenditure). See Gunn, supra at 447 n.20; accord, Lee & Murphy, supra at 484. In 1992, the practical effect of the deduction would be about 110 percent (the maximum capital gains rate of 28 percent vs. the maximum permanent ordinary rate of 31 percent). Gunn's hypothesis has case-law support. For instance, Towanda Textiles, Inc. v. United States, 180 F. Supp. 373, 384 (Ct. Cl. 1960), held that "[e]xpenditures necessarily incurred to realize a capital gain reduce the amount of that gain and partake of the nature of the gain to which they relate." The Court of Claims cited Arrowsmith v. Comm'r, 244 U.S. 6 (1917), which, under this reading, would require capital treatment of expenditures in a subsequent tax year integrally related to a prior capital transaction on the theory that otherwise the taxpayer would obtain an additional tax benefit through coupling an ordinary deduction with a capital gain. See also Munn v. United States, 455 F.2d 1028, 1033 (Ct. Cl. 1972) (if an expense is incurred in the process of acquisition or disposition, "the expenses simply take the character of the asset to which they relate. . ." Brown v. Comm'r, 529 F.2d 609, 613 (10th Cir. 1976) (under Arrowsmith look at all events in the transaction and here payment due to section 16(b) suit is related to proceeds given earlier beneficial tax treatment). In United States v. Hilton Hotels Corp., 397 U.S. 580 (1970), a companion case to Woodward, the court also required capitalization of expenses arising from an appraisal proceeding brought by shareholders of a controlled subsidiary, dissenting to its merger with the parent. The taxpayer had relied heavily on the fact that immediately upon registering their dissent, title to the shares of the dissenters was vested in the subsidiary, but the court could not see why the order of fixing price and conveying title should make any difference.


2834731 F.2d 1181 (5th Cir. 1984).
operations) should then have been treated as a separate asset and currently deducted or amortized depending on the duration of benefits. Instead, the Fifth Circuit (1) talismanically applied the acquisition cost doctrine derived from Richmond Television and its progeny to the (presumably recurring and limited-life) market survey costs, then (2) mechanically associated them with an indeterminable-life asset (the permits), and thereby (3) precluded amortization. This recreated the no-man’s-land of distortion of income through no deduction current or through amortization that, as discussed below, led to the adoption of the separate saleable asset test in the first place. The Supreme Court in INDOPCO hinted that the Fifth Circuit’s opinion was on the right side of the conflict between the circuits over the separate saleable asset test. As discussed below, the proper issue is whether the “asset” in such expansion and similar cases is the business as a whole, the license/branch, or a separate “freestanding” (amortizable) intangible.

C. The Separate and Distinct Asset Doctrine

The Lincoln Savings reference to future benefit as not controlling, and looking to whether the payment served to create or enhance for the taxpayer “what is essentially a separate and distinct additional asset,” led to a line of cases seeking to avoid Richmond Television’s no deduction/nor amortization distortion of income by granting an equally flawed immediate deduction. (This time, two wrongs did not make a right.) The Second Circuit, in Briarcliff Candy Corp. v. Comm’r, read Lincoln Savings as effectuating a radical shift in emphasis: directing the inquiry from whether the benefit of the expenditure extended over several tax years to where it created or enhanced an essentially separate and distinct additional asset. This formulation of the test for capitalization/current deduction was strongly criti-

cized by Professors Gunn and Lee and finally overruled by the Supreme Court in INDOPCO, Inc. v. Comm’r.

Lincoln Savings led to a line of cases seeking to avoid Richmond Television’s no deduction/nor amortization distortion of income by granting an equally flawed immediate deduction.

The separate and distinct asset approach was readily applicable where a taxpayer acquiring, for example, a new business, purchased land, vehicles, or equipment or constructed a new building. The real conceptual problem as to intangibles created in business expansion (or start-up costs for that matter) was determining what constituted the separate asset: the business as a whole or a separate (amortizable) intangible. On the one hand, a number of cases involved what normally would be ordinary and necessary business expenses but which were treated as part of the cost of acquisition of a capital asset. In many cases, such costs, if recurring or of finite benefit, should be set up as a separate amortizable intangible. On the other hand, the “separate, saleable asset” precondition for capitalization was overinclusive, permitting a current deduction for (1) substantial expenditures benefitting an extended period of time although creating no transferable asset, e.g., a computer program expected to last five years, and (2) acquisition costs of a license with an indefinite life. A current deduction in such instances produces more distortion of income than capitalization as a free-standing asset amortizable over the benefitted period.

41See Gunn, supra at 446, 492; Lee, supra 6 Va. Tax Rev. at 14, 27-38, 30-8.
42See, e.g., Shainberg v. Comm’r, 33 T.C. 241 (1959) (cleaning expenses to prepare shopping center for grand opening and insurance premiums paid during construction period were made in connection with acquisition of a capital asset); Schultz v. Comm’r, 50 T.C. 688, 696 (1968) (insurance cost, storage charges, and taxes paid during four years aging period of whiskey purchased as investment were part of acquisition price of four-year-old whiskey).
43Lee, supra 6 Va. Tax Rev. at 32-38.
44See, for example, in First Security Bank of Idaho v. Comm’r, 684 F.2d 1050 (8th Cir. 1979), the majority permitted deduction of the cost of a computer program lasting five years used in establishing a bank’s credit card operation as a business expansion cost.
45NCNB (II), 684 F.2d 285 (4th Cir. 1982), en banc.
In addition to its functional weaknesses, the separate, saleable asset test was weak conceptually, based upon a limited and oft-criticized reading of Lincoln Savings. As the Claims Court pointed out in Cleveland Electric Illuminating Co. v. United States, the "separate and distinct asset" referent in Lincoln Savings only meant that in the particular case before the Court the taxpayer’s acquisition of such an asset was decisive.46 Furthermore, a host of examples could be found where capital treatment is required although no separate and distinct asset was created or enhanced.47 For instance, start-up costs, minimum educational expenses, and new (i.e., different type), job-seeking expenses must be capitalized under the majority of authorities although arguably a separate and distinct asset was not acquired.

Despite conceptual failings, prior to INDOPCO the ‘separate saleable asset’ doctrine enjoyed great, but not universal, success in the business expansion area.

Despite all of these conceptual failings, prior to INDOPCO, the “separate saleable asset” doctrine enjoyed great but not universal48 success in the business expansion area. A large number of early business expansion cases involved establishment of credit card systems by banks. The decisions universally held that the credit card system enabled a bank to carry on an old business in a new way and, hence, constituted the expansion of an existing business rather than start-up costs of a new business.49 These decisions also rejected the government’s argument that the start-up costs of the credit card system were not ordinary expenses because they generated future economic benefits, on the basis of Lincoln Savings,50 which they read as establishing iron rules that the presence of an ensuing benefit that may have some future aspect is not controlling; the question is whether a separate asset was created or enhanced. The bank credit card progeny of Briarcliff Candy found that participation in a credit card system did not create a property right convertible into cash,51 and most of them in establishing the “separate, saleable property right” bright-line test for current deductibility of certain business expansion costs contained common elements.

The expenses were recurring (and in Briarcliff Candy increased annually in amount over a long period), and thus were similar to many preopening expenses. Moreover, as Judge Posner pointed out in Encyclopedia Britannica, “[t]he distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can be feasibly capitalized and those that cannot.”52 The most important common factor, however, was the view that a current deduction of a recurring expense with some future benefits was preferable to its capitalization without amortization — “rough justice.” The Second Circuit in Briarcliff Candy merely charged Congress “to furnish clear standards and guidelines as to what intangible assets are deductible under section 162 and what are not.”53 The leading bank credit card decision, Colorado Springs National Bank v. United States54, however, sharpened the thrust:

The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or saleable. They are recurring. At the most they introduced a more efficient method of conducting an old business. The government suggests no way in which they could be amortized. The government’s theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer’s financial situation. If an expenditure, concededly of temporal value, may be neither expenses nor amortized, the adoption of technological advances is discouraged.55

In summary, the first application of the separate, saleable asset doctrine worked well (steady-state recurring expenditures). When mechanically extended, however, as is the nature of a bright-line test, the doctrine itself produced distortion of income and, in time, countervailing authorities,56 as well as further

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46"It does not state... that if the separate and distinct asset test is not met the payment is a necessary and ordinary expense." Cleveland Elec., 7 Cl. Ct. at 225.
47Gunn, supra at 446, 447 n.20; Lee & Murphy, supra at 544-46.
48I certainly would not say, as have other commentators, that “[w]ith only one limited exception, the other courts followed Briarcliff Candy...” Javaras & Maynes, “Business Expansion and Protection in the Post-INDOPCO World,” Tax Notes 971, 973 (May 18, 1992).
50See 837 F.2d 775 (2d Cir. 1987).}
51Encyclopedia Britannica, Inc. v. Comm’r, 685 F.2d 212, 217 (7th Cir. 1982).
52See Briarcliff Candy, 475 F.2d at 783.
53See Briarcliff Candy, 475 F.2d at 783.
54505 F.2d 1185 (10th Cir. 1974).
55505 F.2d supra at 1192. Judge Posner has applied an economic efficiency argument to the other side of the coin (current deduction):
56See Briarcliff Candy, 475 F.2d at 783.
57Encyclopedia Britannica, Inc. v. Comm’r, 685 F.2d 212, 217 (7th Cir. 1982).
58See Briarcliff Candy, 475 F.2d at 783.
59See 837 F.2d 309, 313 (7th Cir. 1988).
60Lee, supra 6 Va. Tax Rev. at 56-57. Thus, it lost the prime advantage of a bright-line mechanical rule — predictability.
conceptual distortions and inevitable conflicts in line-drawing as to what was the same business. Some decisions liberally determined the breadth of the taxpayer's existing business, while the Tax Court took a quite narrow approach.58

NCNB Corp. v. United States59 ("NCNB II") held that Lincoln S & L superseded Richmond TV as to proper application of the one-year rule. The full Fourth Circuit placed itself squarely in the camp of cases allowing expenditures for the expansion of an existing business, following Briarcliff Candy Corp. and the bank credit card cases. Still another reason the Fourth Circuit in NCBN II used to buttress its en banc opinion was that the panel opinion would have rendered section 195, providing for amortization of start-up costs, meaningless, for it would have obliterated the reference point in the statute of the expansion of an existing trade or business.60 Additionally, the rehearing opinion pointed to the Supreme Court's opinion in Comm'r v. Idaho Power Co.,61 which stated that where a taxpayer's generally accepted accounting method is made compulsory by a regulatory agency and clearly reflects income, it is almost presumptively controlling for federal income tax purposes. In NCBN, the banking regulatory agencies required national banks to charge to current operations all expenditures related to the development and expansion of banking services, including credit card programs and, apparently, branching. Finally, NCBN II pointed out that the expenditures in question were in effect recurring because the bank holding company's business was operating a statewide network of branch banks; and to maintain this network, NCBN had to constantly evaluate its market position through various means and the bank had to regularly open and close branches and make similar studies.62 To the extent that the en banc opinion in NCBN II read Lincoln Savings as providing for current deductibility whenever expenses having prospective benefit do not create or enhance a separate asset, it was in error. Not only was the particular statement dictum, but more significantly, as discussed above, there are grounds for capitalization other than creation or enhancement of a separate capital asset. One of these is clear reflection of income.63 This lacuna in the en banc decision is perhaps most clearly exposed by the subsequent Eleventh Circuit opinion in Ellis Banking discussed below. More significantly, other cases in bank geographic expansion and then expansion of other businesses began to find that the new location itself or new branch constituted a separate asset without a definite life, which attracted the capitalization of sometimes recurring expenses and thus produced the same distortion of income of no current deduction and no amortization either.

In Ellis Banking Corp v. Comm'r,64 the taxpayer, a bank holding company, wanted to expand to new

58In Duffy v. United States, 690 F.2d 889 (Ct. Cl. 1982), the Court of Claims, in determining the trade or business of the taxpayer for purposes of the expansion of an existing business versus, start-up of a new business test, relied upon the fact that the taxpayer had "employed" two controlled corporations to implement his own personal business of owning and operating a motel, to conclude that the taxpayer had been engaged in the development, construction, and operation of hotels so that a commitment fee paid to a potential lender for the purpose of having funds made available for construction of a motel could not be characterized as a start-up cost because the business was already ongoing when the expense was incurred. The District Court in Baltimore Air Coil Co. v. United States, 333 F. Supp. 705 (D. Md. 1971), allowed a parent corporation to deduct grounding costs, trainee salaries, travel expenses, employee moving expenses, and minor administrative expenses incurred in opening a subsidiary in a different state. The district court reasoned that the subsidiary, which filed a consolidated tax return with its parent, acted as an agent for and on behalf of its parent, and, while informed, admittedly a separate entity, in substance was but one enterprise with the parent. Therefore, the parent was entitled to deduct the expenditures paid on behalf of the subsidiary. Cntra Bennett Paper Corp. v. Comm'r, 78 T.C. 458 (1982), aff'd, 699 F.2d 450 (8th Cir. 1982) (per curiam).

59The leading "same" or "existing business" expansion decisions were found in the Fourth Circuit, which in essence held that all real estate ventures, whether residential, commercial, or industrial, constituted the same business for purposes of currently deducting start-up-like business expansion expenditures. See Malinowski v. Comm'r, 578 F.2d 520 (4th Cir. 1978) ("it is not the size of the undertakings but their similarity as business activities — whether the questioned activity represents simply the normal expansion of the existing business or whether it is within the 'compass' of the existing business — which is determinative of whether the questioned activity represents a new and unrelated business venture for purposes of applying section 162."); accord York v. Comm'r, 261 F.2d 421 (4th Cir. 1958). The Eleventh Circuit pointed out that the Fourth Circuit in York "never considered the possibility that the expenditure might be capital in nature, focusing solely on the requirement of section 162 that the taxpayer be in the trade or business." Ellis Banking Corp. v. Comm'r, 688 F.2d 1376, 1380 n.9 (11th Cir. 1982).

The Tax Court consistently took a narrow approach as to real estate. See Sheban v. Comm'r, 29 CCH T.C.M. 727 (1970); Presault v. Comm'r, 34 CCH T.C.M. 685 (1975); O'Donnell v. Comm'r, 62 T.C. 781 (1974). The Tax Court took a broader approach outside of real estate as to what constituted the taxpayer's business and expansion. See, e.g., Brown v. Comm'r, 39 CCH T.C.M. 397 (1979) (computer monitoring program new and more efficient and more frequent to carry on "LD" tutoring service, expenses were recurring, e.g., telephone, promotion, and travel); Equitable Life Ins. Co. of Iowa v. Comm'r, 336 CCH T.C.M. 1184 (1977) (recurring SEC registration expenses as to new annuity contract deductible because recurring expense of new product in old business).

60Congress is thus under the impression that expenditures for market studies and feasibility studies, as at issue here, are fully deductible if incurred by an existing business undergoing an expansion. An interpretation by us to the contrary would render section 195 meaningless for it would obliterate the reference point in the statute — the expansion of an existing trade or business.

61NCNB III, 684 F.2d at 291.


63684 F.2d 293-94.


The most important common factor was the view that a current deduction of a recurring expense with some future benefits was preferable to its capitalization without amortization — "rough justice."

In summary, the business expansion cases adopted the separate asset doctrine because the Service sought to leave expansion costs in the "black hole" of permanent capitalization. Other courts, in reaction to the perceived distortion of currently deducting long-lived assets, then turned to the acquisition cost doctrine. The "golden mean" of amortizing business expansion costs propelled by NCBN en banc decision, if incurred in expansion through branching rather than through purchasing existing banks and operating them as branches, but believed that the Fourth Circuit en banc decision was in error.67

D. Repair versus Maintenance

Treas. Reg. section 1.162-4 provides that the cost of incidental repairs, which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be currently deducted as an expense, provided that the cost of acquisition or the gain or loss basis of the taxpayer’s plant, equipment, or other property is not increased by the amount of such expenditures. Repairs in the nature of "replacements," to the extent that they arrest deterioration and appreciably prolong the life of the property, must either be capital-

ized and depreciated under section 167, or charged against a depreciation reserve, if any. Similarly, Treas. Reg. section 1.263(a)-1(b) requires capitalization of amounts (a) adding to the value, (b) substantially prolonging the useful life of the taxpayer’s property, e.g., plant or equipment, or (c) adapting such property to a new or different use.

The repair versus improvement case law developed a gloss very similar to the Central Texas S&L/Cleveland Electric broad capitalization approach under which the otherwise deductible cost of a repair is capitalized if the repair was part of an overall pattern of rehabilitation. The most sound rationale for the general rehabilitation rule is that execution of a plan of rehabilitation constitutes the acquisition of a new capital asset so that all the related expenses must be capitalized. So viewed, the plan of rehabilitation rule is analogous to the rule that an expenditure that is part of the acquisition cost of a capital asset must be capitalized even though standing alone or incurred after the process of acquisition is complete would be deductible. Even so, it ignores the "separate basket" approach to allocation of purchase price and the pre-ACRS analogy of component depreciation.

The Ninth Circuit, in Moss v. Comm’r, correctly limited the "rehabilitation doctrine" to substantial capital improvements and repairs to the same specific assets (usually a structure in a state of disrepair). In Moss, the taxpayer-motel capitalized "hard remodeling" costs of beds, chairs, tables, and lamps, and depreciated them over a seven-year useful life while currently deducting "soft remodeling" costs for new carpeting, drapes, and bedspreads amounting to about 20 percent of the cost of the hard remodel. The Service sought to add the costs of the "soft" remodel to the structure of the building and amortize them over a 30-year useful life. The taxpayer carried out both hard and soft remodels of each motel room every three to five years on a rotating cycle so that the contested soft remodel costs of the newly acquired motel, which had been allowed to deteriorate, were only twice the annual soft remodel costs. The Ninth Circuit permitted deduction of the entire soft remodeling costs. This is another example of judicial overreaction to the Service’s income-distorting adjustment. Depreciating soft remodeling costs that would be repeated in three to five years over 30 years would have produced overstatement of income in the early years. But expensing such costs in year one surely produced understatement of income in year one. The fact that year one costs were double the average stretches the regularly recurring.

67See United States v. Wehrli, 400 F.2d 686, 689-90 (10th Cir. 1968).
68See California Casket Co. v. Comm’r, 19 T.C. 32, 37-8 (1952) (acquisition of building with express intention of completely renovating an alternate to conform to specific requirements of business required capitalization of all integral parts of plan).
69Wilbur’s Estate v. Comm’r, 43 T.C. 322, 327 n.6 (1964), acq. 1965-1 CB 15 (the last coat of paint in construction of a new building must be capitalized). See also Jones v. Comm’r, 24 T.C. 563 (1955), aff’d, 242 F.2d 616 (5th Cir. 1957).
70Javaras & Maynes, supra at 975. It was the same injustice as to start-up costs that compelled me to first begin writing in this area two decades ago.
steady state notion. The least income distorting approach would have been to capitalize the soft remodeling costs and amortize them over, say, four years. (But again, many of my students opt for current deduction on examinations.)

The rule that expenditures that materially add to the value of the property must be capitalized is frequently indistinguishable from the doctrine that an expenditure creating or enhancing a tangible asset with a useful life of more than one year must be capitalized. Thus, expenditures by a hotel for carpets, rugs, padding under carpets, refrigerator, rehabilitation of heating and plumbing and related work, toilet covers, cloth material, dishwasher, adding machine, roofing and sheet metal contracts, cooking ranges, potato peeler, and tile work on kitchen walls and showers were capitalized because "[s]ome were for repairs of a permanent nature which materially added to the value of the property and appreciably prolonged its life as an operating hotel; and others were for replacements of furnishings and equipment having a useful life in excess of one year."

Any effective repair adds to the value of the property as compared with its value immediately prior to the repair. Therefore, the proper view is the Tax Court’s test: whether the expenditure materially enhances the value, etc., as compared with its status prior to the condition necessitating the expenditure. Use of the cheapest expedient to correct a defect in lieu of more costly replacement or restoration is indicative of repair. The Service has declined to apply this test for whether the expenditure increases the value where (1) the property has not progressively deteriorated, (2) subjective factors, such as an asbestos-free workplace, have to be considered in valuing the property after the improvement (removal of asbestos), and (3) compliance with local requirements permits continuous operation within regulatory guidelines.

The regulations require capitalization of "repairs in the nature of replacements" if they arrest deterioration and appreciably prolong the life of the property, while "incidental repairs" may be currently deducted. As a practical matter, the result usually is capitalization of major replacement items. Nevertheless, structural alterations sometimes are deductible. Generally, such structural expenditures are allowed where they only restore the property to the condition prior to the event causing the expenditure. The regulation’s use of the term "incidental repairs" has led often to a determination of whether a major portion of the property has been replaced.

Alterations adapting a building or a particular piece of equipment so that it can function in a different manner constitute a capital improvement. The rationale is that adaptation of a piece of equipment or an entire property to the taxpayer’s use is analogous to his/her purchase of a new asset in which event the purchase price would have to be capitalized. Indeed, this rationale would often cover the rehabilitation cases which usually involve adapting a building to a different or higher use. But even so, under "component" depreciation such a separate, freestanding asset approach as to intangibles could be taken. (Note: "component" amortization might not be available if the purchase results in use of ACRS by the purchaser; ACRS prohibits the component method.)

Most, but not all, of the problems in the repair area would be resolved, if the courts explicitly adopted the criterion that an expenditure for repair must be capitalized wherever it is sufficiently substantial in relation to the taxpayer’s entire business and sufficiently nonrecurring that to deduct it would produce distortion of his/her income. However, as a practical matter, courts to date have not followed this approach even though precedents exist, e.g., the regulation’s expensing of small tools, books, and furniture by professionals discussed above.

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77See Treas. Reg. section 1.263(a)-(b).
78Hotel Kingkade v. Comm’r, 180 F.2d 310, 312 (10th Cir. 1950). Query implications of Moss.
81See Hudlow v. Comm’r, 30 T.C.M. 894 (1971) (instead of removing existing floor and perform a complete restoration, taxpayer simply covered what was there by pouring in concrete, “which was more in the nature of a cheap, expedient, fix-up job, and less in the nature of a permanent and enduring improvement. . .”).
82Commentators criticized the Service’s narrow reading of deductible repairs as not appreciably increasing the value of the repaired property and especially its reasoning that because the asbestos’ removal costs created long-term benefits, including “safer working conditions for employees, reduced risk of liability for owners and investors, and generally increased marketability,” they constituted capital expenditures. Sheppard, “Is the IRS Abusing INDOPCO?”, 86 Tax Notes 1110 (Aug. 31, 1992).
and the more explicit recognition in *Sharon v. Comm'r*,87 *Cincinnati-New Orleans & Texas Pacific RR v. United States*,88 *Southland Royalty Co. v. United States*,89 *Encyclopedia Britannica, Inc. v. Comm'r*,90 and *Waldheim Realty and Investment Co. v. Comm'r*,91 as discussed below. With the renewed emphasis on future benefit and attention to repairs, however, a new day may be dawning. In contrast, the above-noted asbestos-removal TAM, in its shotgun approach, also rested on the permanency of the one-time asbestos removal. "Removal is a one-time expenditure that results in a significant change to the property and is not remedial."

**IV. THE PROPER APPROACH**

Classic depreciation of tangible property (prior to accelerated depreciation and especially ACRS) and current amortization of intangible property conceptually consist of allocating a capitalized cost (usually ratably) to the tax years to which it contributes to production of income, i.e., its useful life. Capitalization coupled with amortization is therefore necessary to prevent the distortion (here, understatement) of the taxpayer's net income that would result from deducting the entire cost currently of an expenditure "properly attributable, through amortization, to later tax years when the capital asset becomes income-producing." The critical question is whether current deduction of an expenditure benefitting future years will result in more than minimal distortion of income. If not, and the burden of capitalization and amortization will be heavy, the expenditure should be currently deducted in its entirety in the year made. The first case explicitly suggesting such an approach is *Cincinnati N.O. & Tex Pac. RR v. United States*.92 The taxpayer operated a railroad supervised by the Interstate Commerce Commission (ICC), which required that financial statements be prepared according to its "General Instructions of Accounting Classifications." From January 1, 1921, to January 31, 1940, they provided a "minimum rule" that railroads account for purchases of property (other than track) of less than $100 by charging them to operating expenses rather than to a capital account. In 1940, the ICC raised the minimum rule ceiling from $100 to $500. The government asserted that since the items accounted for by the minimum rule admittedly had a useful life longer than one year, they necessarily constituted permanent improvements or betterments, and, therefore, must be capitalized ipso facto without consideration of any other factors. The Court of Claims noted that this position would require that the method-of-accounting sections of section 446 be subordinated to the capital expenditure and depreciation sections of the code.93 To the contrary, the court held that the capitalization, depreciation, and method-of-accounting provisions are "inextricably intertwined" and must be utilized in conjunction in deciding the ultimate issue of the success of the taxpayer’s method in clearly reflecting income.

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.

The burden on plaintiff, if the minimum rule is not to be followed for income tax purposes, would be heavy; at the same time, the clearer reflection of income would be exceedingly slight if there were any at all.94

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The critical question is whether current deduction of an expenditure benefitting future years will result in more than minimal distortion of income.

Subsequently, the Court of Claims in *Southland Royalty Co. v. United States*,95 again focused on the amount of distortion and hardship to the taxpayer as well as the inappropriateness of amortization as critical to current deductibility of recurring short-lived oil and gas survey costs.96

Decisive for the deductibility of the expenses incurred for the Gillespie report is that they are functionally part of, and indistinguishable from, expenditures for ordinary management planning. . . Here the Government does not argue that there is some underlying tangible or intangible asset to which the survey costs may properly be added. . . Neither is amortization appropriate. The useful life of the survey is very uncertain[ . . . ] 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. . . . [T]he fact that expenditures provide benefits more than one year into the future is merely a factor for consideration and "does not mean that, by a Pavlovian reflex, they must always be non-deductible. . . ."97

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88424 F.2d 536 (Cl. Ct. 1970).
89582 F.2d 604 (Cl. Ct. 1978).
90685 F.2d 212, 217 (7th Cir. 1982).
91245 F.2d 823 (8th Cir. 1957) (current deduction of regularly prepaid multiyear business insurance did not distort income).
92424 F.2d 563 (Cl. Ct. 1970); see generally Gunn, supra. This decision was foreshadowed by the Eighth Circuit, in *Waldheim Realty & Investment Co. v. Comm'r*, 245 F.2d 823, 827 (8th Cir. 1957), which similarly determined that there was no distortion of income for purposes of the predecessor to section 446(b) where the taxpayer regularly deducted prepaid premiums on multiyear insurance policies because "it is extremely doubtful whether any substantial difference would result over a period of years."
93Sections 263 and 167.
94424 F.2d at 572.
95582 F.2d 604, 616 (Cl. Ct. 1978).
96A student once informed me that oil and gas surveys are recurring because other drilling and pumping in the area and movement of underground water changes the underground reserves.
97882 F.2d at 616-18 (footnote omitted).
Such minimal distortion is produced by the current deduction of an expenditure with future benefits where the expenditure: (1) is not substantial in relationship to the taxpayer’s overall income for the year or its useful life is short (as illustrated by Cinn. N.O. and Southland Royalty above); (2) recurs regularly or annually in roughly equivalent amounts (as illustrated in Encyclopedia Britannica); or perhaps (3) cannot be clearly associated with either current or future tax years.  

Judge Posner noted an apparent tension between the current deduction of recurring, steady state expenditures and Idaho Power’s mandate of capitalization of costs identified with the acquisition of specific capital assets. Reconciliation of the two lies in the “separate basket” approach to purchase price allocations. The acquisition cost doctrine is compatible with the timing-minimum-distortion-of-income principle only so long as the expenditure made in connection with the acquisition of a capital asset does not produce benefits for a shorter period than the asset to whose basis it is added. If, however, the expenditure’s benefits last for a shorter period than the useful life of the capital asset acquired, capitalization of the expenditure and its addition to the basis of the asset acquired itself produces distortion of income through depreciation or amortization over a longer period than that benefited by the expenditure, or at worst, by no amortization at all. The solution to the potential conflict between current deductibility of recurring steady state expenditures and the acquisition cost doctrine lies in which “asset” is acquired. For in addition to the “origin-of-the-claim” doctrine, avoiding such distortion of income also requires the use of a judicially approved accounting concept: treatment of the expenditure itself as a separate, freestanding asset, a “deferred charge” in financial or “book” accounting terms, and then amortization of its cost over the period benefitted, as the Tax Court innovatively did in Wolfson Land & Cattle Co. v. Comm’r.

What Judge Posner overlooked in Encyclopedia Britannica is that in acquiring a capital asset consisting of a mass of assets, the purchase price is allocated separately to each asset or class of assets. This principle is seen in the purchase of a business, now governed by section 1060, and in the purchase of a depreciable asset such as a building in the optional pre-ACRS component depreciation. Of course, in Idaho Power, the benefit from transporting the construction workers extended over the life of the structure they built so that

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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 publishers (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 disdieres, 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 in 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.

There is another point to be noted about the distinction between recurring and nonrecurring expenses and its bearing on the issue in this case. If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period (conventionally one year, United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968)) in which the expenditure is made, the result will be to force the capitalization of virtually every business expense. It is a result courts naturally shy away from. See, e.g., Briarcliff Candy Corp. v. Commissioner of Internal Revenue, 475 F.2d 775, 785 (2d Cir. 1973). It would require capitalizing every salesman’s salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. The administrative costs of conceptual rigor are too great. The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be. Whether the distinction breaks down where, as in the case of the conventional publisher, the firm’s entire business is the production of capital assets, so that it is literally true that all of its business expenses are capital in nature, is happily not a question we have to decide here, for it is clear that Encyclopedia Britannica’s payments to David-Stewart were of a non-normal, nonrecurring nature.

Encyclopedia Britannica, 685 F.2d at 213-17 (Judge Posner). The recurring/nonrecurring and “steady state” concepts underlay the bank credit card cases and Briarcliff Candy as well as Southland Royalty. See Lee, supra 6 Va. Tax Rev. at 18-20. Implicitly Waldheim Realty rested in part on this notion.

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[T]here is a residuum of current expenditures which will have some future benefit but which “cannot, as a practical matter, be associated with any other period” and allocation of which “either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose. These also are currently deductible. An example might be the salary of a high corporate officer whose time is not practically allocable between present operations and future projects. NCNB (I), 651 F.2d at 961-62 (footnotes omitted and second quote not closed in original).

For a detailed discussion of these financial accounting terms in the context of amortization of business expansion costs as a freestanding asset see NCNB I, 651 F.2d at 948-50.

1972 T.C. 1, 11-13 (1979)(treatment of decennial dredging of irrigation ditches with 50-year life as “a free-standing intangible asset with an amortizable 10-year life”). Professor Gunn had also suggested this solution to intractable capitalization problems. Gunn, supra at 445-46; accord Lee, supra 6 Va. Tax Rev. 30-41.
the depreciation had to be added to the structure itself. (And the same was true on the facts of the particular nonrecurring expenditures in *Encyclopedia Britannica*, as Judge Posner noted.) But where the intangible, such as training the initial work force or start-up advertising, provides benefits for a shorter period than the broader capital asset of the business or permit, it should be set up as a freestanding amortizable asset — a deferred charge. If the period benefitted is short or highly variable, so that amortization over a period of years is difficult or impossible, and the expenditure is at least "steady-state" recurring, then the cost treated as a separate asset should be deducted in its entirety in the year made.\(^{102}\) The Tax Court obliquely approved this latter notion in its approval of the result, but not the reasoning, of a start-up decision approving the deduction in the year made of recurring, operating expenses such as wages, utilities, and advertising incurred in the same year that a nursing home received its license and commenced operations before such receipt. "We think the expenses in *Manor Care* were clearly pre-operating in nature [and, hence, not deductible under section 162]. However, to the extent the expenditures created assets with determinable useful lives benefiting taxable years following the start of business operations, such amounts would be deductible during those taxable years in the form of amortization deductions irrespective of when they were paid."\(^{103}\) Deduction of the start-up costs in their entirety in year one\(^{104}\) thus rested on treatment of the expenditures as freestanding intangibles, rather than being added to the basis of the business as a whole or to the permit and on the reasonable amount of depreciation being the entire expenditure because it did not provide benefits beyond the year made. Query whether the latter was true as to the advertising. The better basis there of current deduction is the recurring, steady-state concept.

A panel of the Fourth Circuit in *NCNB Corp. v. United States*\(^{105}\) considered the deductibility of expansion costs of an existing banking business, which were analogous to start-up costs of a new business. These costs were incurred in selecting an area of the state for expansion, planning future branches in that area, turning such general plans into concrete courses of action, obtaining the approval of the Comptroller of the Currency, and involved internal (e.g., salaries, depreciation, and amortization) and external (e.g., fees paid to the Comptroller, attorney's fees, amounts paid to outside consultants for marketing studies) costs. The taxpayer argued that, because expenditures did not create a separate capital asset or a property interest and because they were involved in expanding an old business, they were currently deductible under authorities such as *Briarcliff Candy Corp. v. Comm'tr*,\(^{106}\) and the bank credit card cases, such as *Colorado Springs National Bank v. United States*.\(^{107}\) The taxpayer argued that, therefore, the only possible grounds for capitalizing the expenditures would be a rule requiring capitalization of all expenditures that produce for the enterprise a future benefit, which, it argued, was rejected in *Lincoln Savings*.\(^{108}\)

**Where an intangible provides benefits for a shorter period than the broader capital asset of the business or permit, it should be set up as a freestanding amortizable asset.**

*NCNB I* rejected *Briarcliff Candy* and its bank credit card progeny and did not read *Lincoln Savings* as requiring capitalization only where there is a separate asset. Nor did the panel take the position that all expenditures benefitting future years must be capitalized. Rather, it held that where a current deduction of expenditures would distort income, as would generally be the case where expenditures benefit present and future years (the panel overly hastily categorized various exceptions as rules of convenience), the expenditure must be capitalized. Otherwise, clear reflection of income would not result. Such capitalization was in the eyes of the panel "compelled by the statutory requirement of a method of accounting which will 'clearly reflect income' by recognizing in the same tax year both growth revenues and the cost of producing those revenues."\(^{109}\) Probably, the most innovative holding of the *NCNB I* panel opinion was to reject the all-or-nothing approach of the prior case law (current deduction or capitalization without amortization) and allow a partial current deduction plus a deduction over future years, i.e., amortization, to the extent that the taxpayer could show that the expenditures were properly allocable to the present and future years.\(^{110}\) Prior cases, ...
where capitalizing analogous start-up costs, had allowed no deduction, only a basis increase which could not be recovered by depreciation since the business generally had no definitely determinable life.

The most innovative holding of the NCNB I panel was to reject the all-or-nothing approach of the prior case law and allow a partial current deduction plus a deduction over future years.

The panel decision in NCNB I would have allowed a Cohan-type approximation to match revenue and expenses. "If the [lower] court finds the taxpayer did make some use of the Metro Studies in its current-revenues-producing operations, then even if no better than a rough guess is possible, some allocation should be made, and the resulting fact of the amortization allowance may be taken as a current deduction."111 The clear reflection of income approach adopted by the panel in NCNB had been called for by commentators.112 The assumption of the panel that revenues could be traced to particular expenditures, however, is extremely questionable. Moreover, the Cohan rule of approximation technically appears to be unavailable in refund suits where the taxpayer must prove the correct amount of tax payable to prevail.113 Ironically, NCNB I was a refund suit. Commentators were quick to point out that the NCNB I panel approach would render section 195 unavailable as to start-up expenditures, as well as investigatory costs, due to the section's incorporation of deductibility by an existing business as a standard for amortization.114 Now they make the same complaint as to INDOPOCO.115

The Fourth Circuit en banc reversed the panel decision on the basis that no separate saleable asset was created and overruled the future benefits leg of Richmond Television, the earlier Fourth Circuit precedent establishing the start-up doctrine. The Supreme Court in INDOPOCO in turn saw NCNB (en banc) as conflicting with the Third Circuit opinion in National Starch, which it affirmed. Unfortunately, the Supreme Court also pointed to Central Texas Savings and Loan as "inquiring whether establishment of new branches 'creates a separate and distinct asset' so that capitalization is the proper tax treatment."116 Almost 20 years ago, Professor Gunn pointed out that a fundamental error in the cases was increasing the basis of the wrong asset, generally nondepreciable such as the business or an indefinite permit, rather than treating an expenditure creating future benefits of a finite duration as the asset itself, i.e., an amortizable, freestanding deferred charge. It is to be hoped that we will not have to go through another round of increasing the wrong basis with resultant distortion of income. The courts' flexibility in avoiding distortion of income as business expansion costs should lie in (a) approximating or estimating useful lives of the costs as freestanding intangibles under Cohan v. Comm'r,117 or (b) determining that a current deduction produces minimal distortion of income.118

The en banc opinion in NCNB II may be reconcilable with a distortion-of-income approach since it found the expenditures in effect to be recurring. Regularly recurring expenditures, provided that they are not substantially greater in one year than in another, do not present a distortion-of-income problem when they are

116112 S. Ct. at 1042 n.3. 11739 F.2d 540 (2d Cir. 1930).
118In Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir. 1974), the court relied heavily on Briarcliff Candy and allowed a current deduction under section 162(a) for all of a taxpayer's preoperational expenditures in connection with beginning participation in a national credit card system. Although the expenditures were of a sort which would frequently recur (thus suggesting that any benefits obtained had a determinable useful life) and although the taxpayer had recognized some revenues from the credit card program during the tax year in question, the Commissioner suggested to the court no way in which the expenditures might be amortized, and thus deductible partially in that tax year, nor, indeed, did he suggest that they might ever be deductible. Id. at 1192. Rejecting a scheme under which "an expenditure, concordantly of temporal value, may be neither expensed nor amortized," the court allowed the current-expense deduction. Id. (emphasis added). . . .

In connection with multi-year intangible benefits, however, the Commissioner generally allows amortization to begin once the remaining useful life of the asset in question can be estimated with reasonable accuracy. See Treas. Reg. section 1.167(a)-3. The taxpayer in the instant case is, therefore, not faced with the Catch-22 from which the Tenth Circuit believed that it had to rescue Colorado Springs National Bank. NCNB Bank (I), 651 F.2d 959-60.
deducted currently even though they benefit present and future years. This approach also would reconcile current deductibility of advertising expenses, which generally benefit present and future years, with the distortion-of-income approach.

Regularly recurring expenditures, provided that they are not substantially greater in one year than in another, do not present a distortion-of-income problem when they are deducted currently.

Summarizing, the freestanding asset model entails a two-step analysis: (1) look at whether current deduction of an expenditure will distort the taxpayer’s income (because the expenditure provides future benefits and is neither sufficiently insubstantial nor recurring to be nondistorting if currently deducted); if so, (2) estimate the period benefitted by the expenditure, i.e., the useful life, and amortize the expenditure as a freestanding asset over that period. 119

Admittedly, this model ignores “time-value of money” notions. 120 The proposal was originally directed to the courts, which decline to adopt such notions as a common-law doctrine. 121 Congress is the better target for such pleas and it is inclined to leave self-created intangibles of a going concern alone as evidenced by sections 195 and 263A and proposed section 197. This article is primarily directed to Treasury and the IRS, and they will be well-advised to ignore time-value considerations as well in accordance with their stated goals of making “do with ‘rough justice’ and accept[ing] that life is messy rather than be[ing] motivated by a quest for theoretical purity. General principles are often better than detailed rules.” 122

V. SPECIFIC RECOMMENDATIONS

A. Employee Training Expenses

Where employee training expenses are regularly recurring in roughly the same amount either as retraining or replacement training, the expenditures should be currently deductible. Fluctuations of up to 20 percent 123 from the average should also be currently deductible. In the case of initial employee training in a different business before the active business commences or if after but greatly exceeding average retraining and replacement training costs, five-year amortization should be permitted either under section 195 or by analogy. 124 (Of course, section 195 no longer works as a matter of theory after the overturning of the separate asset doctrine, 125 but Treasury and the Service should positively state that they will permit section 195 elections as to recurring, short-lived, or insubstantial startup expenditures and perhaps even investigatory costs incurred prior to commencement of the different active business.) Similar five-year amortization should be allowed for initial training expenses substantially above the average retraining, etc., costs in expanding the same business. Given that most taxpayers are surely currently deducting such expenses, even if erroneously, revenue neutrality should not demand that the proposed section 197 amortization period be used.

B. Advertising

As a conceptual matter, deduction of general goodwill advertising, even of specific goods or services, should be treated much the same as employee training costs with a focus on recurrence and steady state. Politically, however, limitation of current deductibility of most advertising costs is contraindicated by Ways and Means Chairman Dan Rostenkowski’s, D-Ill., specific exclusion of advertising costs from the purview of proposed section 197. 126 Therefore, it might be advisable to allow current deduction of advertising expenses that substantially exceed the average level or the level in succeeding years. This is the approach implicitly taken in Rev. Rul. 92-80, which simply states that advertising costs are “generally deductible” under section 162 “even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising.”

Where advertising primarily is to help acquire a specific capital asset and its benefits will be coterminous with the life of such asset, it should be treated as an acquisition added to such asset. The key issue is whether the advertising benefits are coterminous. Unfortunately, Rev. Rul. 92-80 may obscure analysis of this problem. It stated the issue as whether the advertising “is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or

123 This percentage was chosen on the basis of the five-year amortization model discussed below.
124 It is likely not administratively feasible to determine on a case-by-case basis the actual retraining and replacement training rates and the actual useful life of the training costs at least for smaller businesses. Where it probably is feasible, say, at the $100 million or more level in corporate assets, requiring actual establishment of useful lives is not objectionable. Those 10,000 corporations report almost 80 percent of the corporate sector revenues and most are in continual audit. This level could even be raised to the 5,000 corporations with $250 million or more in assets which report almost 75 percent of the corporate sector income.
125 See note 114, supra.
126 “Unofficial Transcript of October 2 Ways and Means Committee Hearing on Amortization of Intangibles,” 91 Tax Notes Today 208-26 (“Some persons have questioned whether this bill was intended to open the door for reconsidering tax deductions for advertising expenses. Let me be clear. The answer is, no.”) (Statement of Chairman Rostenkowski).
goodwill advertising," in which case the costs of such advertising must be capitalized. The ruling accurately described the advertising costs in Cleveland Electric\textsuperscript{127} as "incurred to allay public opposition to the granting of a license to construct a nuclear power plant." But the policy-based reason that the advertising costs should be capitalized and added to the basis of the permit is that they were not recurring, were substantial, and, because their benefit can not be separated from the permit itself, constituted an acquisition cost of the permit.

C. Repairs

Deductibility of repairs has been the most frequently litigated of these mixed present-future benefit areas, but the case law has evolved less here than in the other areas. Here, Treasury/IRS could provide the most help by establishing safe harbors for repairs. The most useful would be one based on a percentage of depreciation allowance similar to the "repair allowance" under the old Asset Depreciation Range (ADR) system.\textsuperscript{128} There, the safe harbor went as high as 15 percent for trucks, but most seemed to cluster around 10 percent, with much lower percentages for heavy manufacturing equipment and especially for buildings. Here, too, a distinction between big and little taxpayers might be useful. Also, temporary 1992 standards might be advisable, with more detailed and accurate categories later based on actual historical experience of classes of taxpayers.

\textsuperscript{127}Cleveland Electric, 7 Cl. Ct. 230-32.
\textsuperscript{128}See Withdrawn Treas. Reg. section 1.167-11(d)(2) and Rev. Proc. 72-10, 1972-1 C.B. 721.