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

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Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations

(Part One)

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* 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.

Professor Lee has been working on ordinary deduction versus capitalization issues for over two decades, initially from a practitioner concern about the “black hole” of capitalization without amortization. See John Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 TAX L. REV. 347, 452-74, 486 (1974); John Lee, Pre-Operating Expenses and Section 174: Will Snow Fall? 27 TAX LAW. 381, 391-403 (1974). Over the years Lee’s understanding broadened particularly as to the policies and ideal standards supporting capitalization and the rules that should allow current deduction or amortization. He owes much to the inspiration of Professor Alan Gunn. Alan Gunn, The Requirement That a Capital Expenditure Create or Enhance an Asset, 15 B.C. INDUS. & COMM’L. L. REV. 443 (1974). See John Lee & Nina Murphy, Capital Expenditures: A Result in Search of a Rationale, 15 U. RICH. L. REV. 473, 474-75, 524-25, 537-38, 541-43, 546 (1981), the article version of Professor Lee’s collaboration on the capitalization section of BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 20-67 (1st ed. 1981). Lee also owes much to the many judicial "straws in the wind" as the bench has struggled over the past 3 decades with these issues, conversations and dialogues over the years with colleagues, friends and students in and out of class, and most recently research in the Government Counsel and Technical Advice Memoranda (TAM) grappling with capitalization and depreciation. Special debt is owed as well to those who have criticized various earlier versions of the "rules" discussed here. In order to vouchsafe his credentials for testifying in this area, Professor Lee sketched the prior impact of his work on capitalization legislation and regulation before the House Ways and Means Subcommittee on Select Revenue Measures’ second of three Hearings on Miscellaneous Revenue Matters [including soil remediation], 103rd Cong. 1701-02 (1993). See also John Lee, Start Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics, 6 VA. TAX REV. 1, 73-74 & 73 n.315 (1986), which his executive editor, Frank Riley, aptly described as a [long] mea culpa for [once] perceived flaws in Section 195.

The Submission of a rough draft version of this article to the Internal Revenue Service was dedicated to the last class in the Law School’s masters in taxation program established in 1954. This article is, of course, dedicated to Boris Bittker, without whose inspiration it and preceding articles would never have been written. I am also grateful for the funding afforded by a Summer Research Grant from the College of William and Mary and the research assistance of Anne Norris Graham.

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I. INTRODUCTION

Section 162(a) allows a current deduction for the ordinary and necessary expenses of carrying on a trade or business.\(^1\) The "ordinary" expense requirement of Section 162 precludes a current deduction for a capital expenditure, as does Section 263's prohibition of a current deduction for payments for "new buildings or for permanent improvements or betterments made to increase the value of any property."\(^2\) Instead such capital expenditures are added to its basis under Section 1016. If the "property" is depreciable, such basis is recovered through depreciation deductions under Sections 167 or 168 over the period benefitted\(^3\) (or some

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1. I.R.C. § 162(a) (1994). All section references unless otherwise noted are to the Internal Revenue Code.
3. Prior to [the Economic Recovery Tax Act of 1981] depreciation was based on the concept that the cost of an asset should be allocated over the period it is used to produce income. In general, property is depreciable if it is (1) used in a trade or business or for the production of income, and (2) subject to wear and tear, decay or decline from natural causes, exhaustion, or obsolescence. In general, depreciation is limited to the cost or other basis of the property, less a reasonable estimate for salvage value. S. Rep. No. 97-144, at 39 (1981).


More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living.

Small businesses and farmers particularly have a vital stake in a more liberal and constructive depreciation policy. They are especially dependent on their current earnings or short-term loans to obtain funds for expansion. The faster recovery of capital investment provided by this bill will permit them to secure short-term loans which would otherwise not be available.

Id. The same story, magnified several fold, underlies the 1981 enactment of the Accelerated Cost Recovery System (ACRS) (now Modified Accelerated Cost Recovery System (MACRS)) under Section 168. Liddle v. Commissioner, 65 F.3d 329 (3d Cir. 1995)

Congress believed that prior depreciation rules and regulations did not provide the investment stimulus necessary for economic expansion. Further, Congress believed that the actual value of the depreciation deduction declined over the years because of inflationary pressures. In addition, Congress felt that prior depreciation rules governing the determination of useful lives
other usually shorter statutory period\(^4\)). Costs capitalized to non-depreciable property are recovered upon destruction or abandonment of such property prior to the end of such life as a loss under Section 165.\(^5\) Classic

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were much too complex and caused unproductive disagreements between taxpayers and the Commissioner. Thus, Congress passed a statute which "de-emphasizes the concept of useful life.

\textit{Id.} at 334. Whether such encouragement works is another, hotly debated story.

4. Clearly the ACRS and MACRS economic lives are shorter than the economic lives. In the case of real estate for instance ACRS started off with a useful life of 15 to 18 years and the current MACRS lives are 27.5 and 39 years for residential and non-residential real estate. I.R.C. § 168(e)(1) (1994). The Department of Treasury estimated the actual economic life of real estate improvements at over 60 years. 2 U.S. DEP'T TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH—GENERAL EXPLANATION 161 (1984) [hereinafter 2 TREASURY I]. Similarly, aircraft (engines) have a MACRS recovery period of seven years but with proper maintenance and reconditioning every four years have an average service life over three times as long. See Tech. Adv. Mem. 96-18-004 (Jan. 23, 1996). On the other hand, to account for inflation and the tendency to obsolescence some argue that front-loaded rates are necessary. The 1954 Code provided accelerated rates of depreciation for real estate (from 175% to 200% declining balance), but after the Tax Reform Act of 1986 only straight-line or ratable recovery may be used. Thus, arguably, the pre-1981 accelerated rates and 35 year aggregate life under the component depreciation method was closer to economic depreciation than is the current straight-line 27.5 or 39 year life for residential and non-residential real estate. On the other hand, most taxpayers currently leverage real estate and deduct the full amount of interest unreduced for the inflation penalty in interest. 1 U.S. DEP'T TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH—OVERVIEW 98 (1984) [hereinafter TREASURY I]. The varying treatment of real estate from 1981 to 1993 as reflected in the different periods for depreciation depending upon the year placed in service is a consequence of (a) the historical experience of the 1981 preference (15 year life coupled with a declining rate method) coupled with deregulation of S&L's produced "see-through" office buildings, i.e., speculative vacant office buildings with no interior partitions, contributing to the collapse of S&L's as the real estate bubble burst as bubbles have for the past three centuries), and (b) application of pay-go principles to real estate with real estate revenue losers being paid for with real estate revenue raisers.

\textit{Radio Address to the Nation on Tax Reform, I. PUB. PAPERS RONALD REAGAN 419, 420 (Apr. 13, 1985).}

Have you ever heard of a see-through building? Well, it's one that has no interior walls because it has no tenants. Between 1983 and 1984, only about half of the increase in available commercial office space was reflected in rentals. The other half resulted in vacancies. You see, the tax benefits for investment in some kinds of real estate deals are so generous that being able to rent space may be secondary. The result is overbuilding and high vacancy rates in many American cities.


5. Section 165(a) provides a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." I.R.C. § 165(a) (1994). In the case of individuals, however, such deductible losses are limited to losses incurred in a trade or business or in any (non-trade or -business) transaction entered into for profit. These limitations do not apply to losses arising from casualty or theft, however. See I.R.C. § 165(g) (1994). For losses (not from casualty or theft) to be ordinary, either from a capital asset or an expenditure, they must not arise from a sale or exchange. See
depreciation of tangible property under Section 167 (prior to accelerated depreciation and especially MACRS under Section 168) and amortization of intangible property conceptually consists 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, underatement) 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." Parallel to Sections 162, 167, 168 and 212, the "clear-reflection-of-income" requirement of Section 446 generally leads to capitalization of costs providing a benefit lasting substantially beyond the close of the tax year.

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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 1.167(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.

7. Treas. Reg. § 1.461-1(a)(1) (as amended in 1994) ("If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible or may be deductible, only on part, for the taxable year in which made."); accord Gen. Couns. Mem. 36,961, at 44-45 (Dec. 21, 1976) (footnote omitted):

The film producer/taxpayer's) practice of currently deducting its production expenditures does not clearly reflect income. 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. Gen. Couns. Mem. 36,824 (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. 36824, supra, at 2; see also, O.M. 18282, *** I-341-75 (Sept. 30, 1975), at 7-8; O.M. 17736, *** I-4333 (July 26, 1972), at 10-11. 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.

Id. In Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971), Justice Blackmun determined that in order to qualify for deduction under Section 162(a), "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." Id. at 352. The Court held that certain premiums paid by a savings and loan association, pursuant to federal statutory requirement, for deposit insurance were not
For generally, where an expenditure provides substantial future benefits, current deduction understates the taxpayer's current income and overstates future income. Under judicially adopted financial accounting concepts, capitalization — when coupled with depreciation or amortization — serves to match (albeit usually roughly) an expenditure generating future income with such income. Similarly under an economic model of determining net income, a capital expenditure is not spent in the year it is made; rather, the expenditure is converted into a different type of property. The cost of this property then reduces gross income in each tax period according to the change in its value between the beginning and the end of the period in question. The fact that the property actually appreciates is not relevant to tax depreciation under Section 168 so long as there is some wear and tear or obsolescence. This leads to the delightful tax tales of Mr. Liddle’s Fiddle and Mr. Selig’s Ferrari Testarossa marvelously recounted by Lee

“ordinary and necessary” expenses under Section 162(a) but were instead capital expenditures. Id. at 354. The premiums created a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations. Id. at 355. Although the premiums were paid during the taxable year, were made for carrying on a trade or business and were “necessary,” Justice Blackmun found that the premiums were not “ordinary expenses” because they “served to create or enhance for [the institution] what is essentially a separate and distinct additional asset.” Id.

8. NCNB Corp. v. United States, 651 F.2d 942, 961 (4th Cir. 1981) [hereinafter NCNB I], rev’d and remanded, 684 F.2d 285 (4th Cir. 1982) (en banc) [hereinafter NCNB II]. NCNB II was overruled by INDOPCO. Whether this overruling of NCNB II resurrects NCNB I may be a determinative factor in the future evolution of case law and administrative guidelines on expense/capital expenditure and amortization.

9. Matching costs with revenues produced in a particular period is a basic financial accounting concept under Generally Accepted Accounting Principles (GAAP). See Harold Dubroff et al., Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles, 47 ALA. L. REV. 354, 358-59 (1983). Judicial acceptance of the basic financial accounting concept of deferring deductions through capitalization until related income is recognized should not involve the adoption, as well, of the GAAP hierarchy of expense principles. See Commissioner of Internal Revenue v. Idaho Power Co., 418 U.S. 1, 16 (1973); Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979). But see NCNB I, 651 F.2d at 948-49.

10. The match is usually rough since often neither the recovery period nor the rate correspond with anticipated, much less actual experience. A significant exception is the income forecast method of depreciation with a three and ten year look-back under new Section 167(g).


12. See Kahn, supra note 12, at 3.

13. Liddle, 65 F.3d at 332-33 (allowing seven year capital recovery under 1954 Code Section 168 of a 300-year old appreciating bass violin). “[T]he phrase ‘of a character subject to the allowance for depreciation’ refers only to that portion of section 167(a) which allows a depreciation deduction for assets which are subject to exhaustion and wear and tear. Clearly, property that is not subject to such exhaustion does not depreciate.” Id. at 334; accord Selig v. Commissioner, 70 T.C.M. (CCH) 1125 (holding that a show car that was not driven was subject to ACRS because it became obsolete). The opposite rule applied under Section 167 depreciation of tangible property. See authorities cited in Liddle, 65 F.3d at 335.
Sheppard and Ira Shepard.\textsuperscript{15}

The immediate genesis of the present uncertainty as to capitalization rules began over three decades ago with the litigation as to the proper tax treatment of business expansion/start up costs. At the time, the "black hole" of capitalization of start up costs without amortization being available lead many courts to permit a current deduction particularly of recurring costs in expanding a business (often with a broad definition of business) as less income distorting than capitalization without amortization.\textsuperscript{16} The courts in the 1970s\textsuperscript{17} and the National Office in the 1980s\textsuperscript{18} (just as the judicial tide

\begin{footnotesize}
\begin{enumerate}
\item See judicial authorities collected in John Lee, Start Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics, 6 VA. TAX REV. 1, 26 (1986) [hereinafter Lee, Clear Reflection of Income]; see also Brett M. Alexander, Note, An Analysis of INDOPCO, Inc. v. Commissioner, 54 OHIO ST. L.J. 1505, 1513 (1993). A major cause for lack of administrative or judicial amortization was association of the expenditure, even if recurring, with the wrong asset, generally the business itself, thought like purchased goodwill, generally to have an indefinite life. Capitalized start-up costs traditionally were added to one of three items: (a) the nonamortizable basis of the business created in part by them; (b) (prior to Section 197) to a nonamortizable permit required to operate as a business; or (c) to amortizable business assets used in the created business. Lee, Clear Reflection of Income, supra, at 4 n.3.
\item See, e.g., Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 782-85 (2d Cir. 1973); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974):
The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable. 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 the taxpayer's financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged. Id. at 1192. See generally Lee, Clear Reflection of Income, supra note 16, at 25, 52-57.
\item Gen. Couns. Mem. 38,410 (June 18, 1980) (in addition to whether a cost creates a separate and distinct asset, "the recurrent (or nonrecurrent) nature of the expenditure is an appropriate basis on which to distinguish capital from ordinary expenses"); Tech. Adv. Mem. 86-11-005 (Nov. 26, 1985) (costs of a new product package design [unique cardboard base in which a container sits and that extends up from the base for marketing women's hose, which enjoys wide customer recognition] must be capitalized since they create "intangible assets with useful lives in excess of the taxable year in which such costs were incurred"), considered in Gen. Couns. Mem. 39,483 (Mar. 5, 1986); Tech. Adv. Mem. 81-41-033 (June 30, 1981) (costs incurred by a mutual savings bank in securing regulatory approval to operate branch facilities, created a separate and distinct capital asset, while other recurring promotional costs were deductible expenses under Section 162); Tech. Adv. Mem. 82-02-010 (Sept. 28, 1981) (cancellation of debt to facilitate an agreement for continuation of the distribution of the taxpayer's product does not create a separate and distinct asset); Tech. Adv. Mem. 82-04-061 (Oct. 28, 1981) (cost of training employees and testing new equipment in newly constructed manufacturing facility does not result in the creation or acquisition of an asset that is separate and distinct from the constructed facility); Tech. Adv. Mem. 84-23-005 (Feb. 8, 1984) (expenditures incurred for hiring, relocating and training employees in connection with the establishment of a new restaurant by a taxpayer with existing restaurants in other locations, do not result in the creation or enhancement of a separate and distinct asset); Tech. Adv. Mem. 90-24-003 (Mar. 2, 1990) (savings bank must capitalize costs to create or acquire home equity line-of-credit loans since such loans are separate assets with lives extending beyond
\end{enumerate}
\end{footnotesize}
was turning) adopted a no "separate saleable asset" doctrine or rule permitting current deduction of various business costs including business expansion costs. We believe that the pragmatic reason for such adoption was to accomplish the "rough justice" of current deduction where no amortization deduction was available.19 Some tribunals20 and now,

the current taxable year). In order to discredit the above earlier General Counsel Memoranda (GCM) adopting the separate asset test for expensing, the Government argued in its Brief in INDOPOCO that "Petitioner also cites various technical advice memoranda and general counsel's memoranda prepared by the IRS .... Such internal IRS memoranda, which do not undergo the intensive review process accorded to formal IRS rulings and procedures intended for guidance to the public, have no precedential force, and are thus irrelevant here." The Brief's conclusion as to policy review may be accurate as to TAMs but not as to GCMs. Comparison of GCMs of yesteryear and the best TAMs of today and the published revenue rulings that they consider or that are redacted from them, respectively, reveals that the published rulings too often delete the very legal, policy and strategic analysis developed in the GCM or TAM in the "intensive review process" to determine whether to issue a published ruling. A most extreme case is exposed by Gen. Couns. Mem. 36,993 (Feb. 3, 1977), which notes that Rev. Rut. 59-129, 1959-2 C.B. 58, was published in "digest form," merely concluding that the entity was a church without setting forth the 14 characteristics of a church that the accompanying GCM relied upon. Of course, the Service continued to use the 14 factors. Sadly, compare excellent Tech. Adv. Mem. 96-45-002 (June 21, 1996) (allowing current deduction of pre-opening costs of new stores in same business with discussion of recurring and predominantly short-term benefits and analysis of Encyclopedia Britannica and Sun Microsystems among other precedents as support; and then noting "that the cost of training employees is generally deductible under section 162") with disappointing Rev. Rut. 96-62, 1996-53 I.R.B. 1 ("the costs of trainers and routine updates of training materials, are generally deductible as business expenses under that section [162] even though they may have some future benefit."). Careful deconstructing of the published ruling in light of submitted comments, particularly politically influential interest groups, provides considerable guidance to the illuminati if not the cognoscente as well of income tax capitalization. See notes 208-211 infra and accompanying text. That's not what we call general guidance. While by law GCMs and TAMs are not legal precedent, their reasoning should be taken into consideration. E.g., Doubleday & Co., Inc. v. United States, 721 F. Supp. 436, 442 (E.D. N.Y. 1989) ("Though the court is well aware that letter rulings such as the one above has no precedent value, the court feels that the reasoning employed is nevertheless sound."); accord Rev. Rut. 57-562, 1957-2 C.B. 159; Gen. Couns. Mem. 39,822 (July 17, 1990); Priv. Ltr. Rut. 7308109360A (Aug. 10, 1973). Law professors and their students can learn a lot by studying them. Such rulings do constitute "substantial authority," see note 198 infra, which today means more than precedent to many.


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' ... A 'rough guess' as to useful life produces less distortion of income than the 'rough justice' of a current deduction. ... The most important common factor [in Briarcliff Candy and its progeny], 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.' ... To avoid inequity some courts, rather than functionally challenging these definitional rules, created their own definitional separate, saleable property test. These courts, and some commentators, thought that the "rough justice" of currently deducting an expenditure, regardless of whether its benefits were short- or long-lived, produced less distortion of income than no deduction at all.

Id. at 25. See also John Lee, Doping Out the Capitalization Rules After INDOPOCO, 57 TAX NOTES 669, 670 (1992) [hereinafter Lee, Capitalization Rules].

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
seemingly, the Office of Chief Counsel\textsuperscript{21} believes that a current deduction 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. 

Id. at 670; see also Alexander, supra note 16, at 1513. For a very intriguing law-and-economics flavored argument that capitalization (without amortization) is in order where monitoring performance of assets with unascertainable useful lives see Note, INDOPCO v. Commissioner: Form over Substance in the Judicial Regulation of the Market for Corporate Control, 12 VA. TAX REV. 121, 131-33 (1992).

20. See, e.g., Southland Royalty Co. v. United States, 582 F.2d 604, 618 (Ct. Cl. 1978): [T]he 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: 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. 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. Colorado Springs Nat'l Bank, 505 F.2d at 1192; Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283-84 (1967)

[S]ections 283 and 446 are inextricably intertwined. A contrary view would encase the general provisions of section 263 with an inflexibility and sterility neither mandated to carry out the intent of Congress nor required for the effective discharge of respondent's revenue-collecting responsibilities. Accordingly, we turn to a determination as to whether petitioner's method of accounting 'clearly reflects income' pursuant to the provisions of section 446. . . Income must be reflected with as much accuracy as recognized methods of accounting permit. . . . [The Commissioner] is given broad discretion in determining whether a particular method of accounting clearly reflects income and a heavy burden is imposed upon the taxpayer to overcome a determination by respondent in this area.

Id. at 283-84. See also Lee, Capitalization Rules, 20 supra note 19, at 674-77. The notion of capitalization being inextricably intertwined with clear reflection of income was convincingly stated by Professor Gunn over two decades ago, and was long advocated by Professor Lee and reflected in Professors Bittker and Lokken's conclusion. This position was in turn adopted by the Government on Brief in INDOPCO, that "the analysis properly focuses 'on whether income will be better reflected by deducting or by capitalizing the amount in question.'" Respondent's Brief at 29, INDOPCO (No. 90-1278). Such a clear reflection of income focus has on many other occasions convinced the Chief Counsel's Office in its policy review of proposed private and published letter rulings and technical advices. See notes 291-97 infra and accompanying text.

21. See Rev. Rul. 94-38, 1994-1 C.B. 35 allowed a current deduction of expenditures to remediate soil contaminated by the taxpayer's manufacturing operations. The ruling first considered the potential improvement to the land. Id. at 6-7. Adopting the test promulgated by Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), the ruling compared the value of the land immediately before the contamination with its value after remediation. Id. at 7. The ruling concluded that by returning the property to its original state, the treatment failed to improve the land. Id. Cf. Tech. Adv. Mem. 94-11-002 (Nov. 19, 1993) (costs of removing asbestos-containing materials from taxpayer's boiler house were held capital expenditures since they "increased the value, use and capacity of the taxpayer's facility as compared to its original asbestos-containing condition"). Nor did the "expenditures . . . prolong the useful life of the land, nor . . . adapt the land to a new or different use." Rev. Rul. 94-38 at 7. During
in such circumstances more clearly reflects income than capitalization without amortization and so do we. The Joint Committee on Taxation Staff identified ease of administration as another policy basis for allowing a current deduction for the costs of self-created intangibles:

Under present law, many expenditures by a business that may contribute to the creation of intangible assets are currently deductible as expenses of doing business. Thus, for example, salaries of employees, advertising, and other operating expenses generally are currently deductible, even though these expenditures may create or enhance the goodwill, going concern value, reputation, or customer base of the business. *Expensing generally is allowed under present law because of the administrative difficulty of ascertaining the extent to which these expenditures contribute to the value of the intangible asset.*

Professor Lee has long agreed with Professor Alan Gunn that current deduction is less income distorting than capitalization without amortization when those are the only two options. This article argues that we can do better, elaborating on Professor Gunn’s thought and the following thought of Professor Boris Bittker:

In many . . . situations, however, the usual criteria of a capital
expenditure are either over-inclusive or under-inclusive. The “separate and distinct additional asset” and “useful life beyond the current year” criteria, if applied rigorously, would classify numerous purchases of minor items as capital expenditures—an accountant’s fountain pen, a carpenter’s screwdriver, a welder’s goggles. The regulations explicitly permit farmers to deduct the cost of “ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc.”; and professional taxpayers are allowed to deduct the cost of “books, furniture, and professional instruments and equipment, the useful life of which is short.” In a similar vein, the Court of Claims, recognizing that the fundamental issue in this area is whether the taxpayer’s income is clearly reflected, has held that a railroad may deduct the cost of items costing less than $500, regardless of the asset’s expected useful life, if this practice is consistently followed and is used by the interstate Commerce Commission for rate-making purposes.

This emphasis on the long-run consequences of the taxpayer’s accounting practice acknowledges that a rule of reason is essential. If every cost contributing to the profits of future years were to be disallowed, it would be necessary to divide almost every salary and advertising expense between its immediate impact on the customer and its contribution to the company’s long-lived goodwill. Recognizing this, the Supreme Court [in *Lincoln Savings*] has said that “the presence of an ensuing benefit is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.” . . . [E]ven the most routine repairs often have a long-term impact but are, nevertheless, classified as deductible expenses rather than as nondeductible capital expenditures.

In addition to being over-inclusive with respect to minor items, the conventional criteria of a capital expenditure are sometimes—although less frequently—under-inclusive. Thus, a vocational course qualifying the taxpayer to embark on a new career does not create a "separate and distinct additional asset" in the ordinary sense. The cost of the educational program is nevertheless a non-deductible capital expenditure rather than a currently deductible business expense. . . . . As with the danger of over-inclusion, the best remedy against an under-inclusive application of the capital expenditure concept is to focus on whether income will be better reflected by deducting or by capitalizing the amount in question. This is obviously not an easy standard to apply, but it has the virtue of emphasizing the basic objective of the relevant statutory provisions rather than secondary guideposts.25

The issue of the proper standard (and rules) for capitalization has become acute if not critical. The Supreme Court’s recent decision in *INDOPCO*26 overruled the separate asset doctrine,27 which Professor Lee,

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25. BITKER & LOKKEN, supra note 5, at ¶ 20.4.1. (footnotes omitted).
26. *INDOPCO*, 503 U.S. at 86-87. Justice Blackmun stated the issue as “whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible
still following in the footsteps of Professor Alan Gunn, had criticized long ago. 28 INDOPCO also reinforced the presumption that expenditures producing substantial future benefits must be capitalized (and, if that capitalized cost qualifies as depreciable property, amortized or depreciated over the years benefited or some usually shorter statutory period). 29 At the same time Justice Blackmun left the door open in INDOPCO for current deduction of some expenditures with incidental future benefits just as he had earlier in Lincoln Savings and Loan. The result has been great controversy with little guidance from the Court. 30 We believe that the greatest light can be shown on the controversy by focusing on the basic standard for resolving capitalization versus expensing controversies set forth by Tax Court Judge Theodore Tannenwald three decades ago in Fort Howard Paper Co. v. Commissioner: whether the taxpayer’s method of tax accounting (for the item) clearly reflects her income under Section 446. 31 This analysis convinced Professors Alan Gunn, John Lee and Boris Bittker.

Widespread federal income tax audits of capitalization and related issues, including amortization of self-created intangibles, 32 are anecdotally
reported in the tax and general press, and factually reflected in the large number of technical advice memoranda and audit guidelines touching on these issues. Empirical studies by other agencies reveal that at the large public corporation level (accounting for over 80% of corporate taxable income and over 50% of all business sector profits), capitalization/depreciation/expense is the largest category of contested Section 162 items. Section 162 in turn generates more tax controversies than any other Code section. The Service repeatedly asked for help from practitioners and industry, but had scant response until it issued controversial TAM’s denying current deductions for substantial and non-recurring expenses. In Notice 96-7 the Internal Revenue Service

[as to capitalization] is to keep cases involving these issues out of litigation, which is expensive both to taxpayers and the government, the Treasury official [Robert Kilinskis] noted."

33. See note 71 infra.

34. See note 80 infra.


36. GENERAL ACCOUNTING OFFICE, REP. NO. GAO/GGD-93-93-100, RECURRING TAX ISSUES TRACKED BY IRS’ OFFICE OF APPEALS (1996), available in LEXIS, Fedtax Library, TNT File, 93 TAX NOTES TODAY 98-24 (May 6, 1993) (1993 GAO Recurring Tax Issues). Only at the large public corporation level is capitalization a real issue in audits tracked as of the early 1990s. Burgess J. W. Raby & William L. Raby, Tax Forum 20: Practitioner Reaction to INDOPCO, 73 TAX NOTES 1581 (Dec. 30, 1996) (80% of regional and local accounting firm tax partners across the country in survey by authors did not encounter INDOPCO in deficiencies arising out of tax audits). 1995 GAO Recurring Business Tax Disputes, supra note 35, confirms this. We suspect that the biggest Section 162 issue for the business clients of the regional CPA firms the Raby’s surveyed is reasonable compensation. This is surely the case as to the approximately 750,000 C corporations reporting annual taxable income, but less than $350,000.

See GENERAL ACCOUNTING OFFICE, supra note 35.


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." 39

This article is largely derived from our joint Submission of comments pursuant to Notice 96-7.40 It maintains that guidance as to capitalization is needed, if for no other reason, due to the substantial amount of transaction costs (noted above) it generates. After reviewing the alternatives of judicial and legislative resolution of the capitalization morass, this article recommends instead several alternative IRS/Treasury regulatory approaches. The primary proposal is promulgation of interpretative (at this time) regulations setting forth (a) capitalization principles or standards and (b) rules establishing a presumption of capitalization where the expenditure is expected to yield substantial future benefits and, most importantly setting forth "rough justice" exceptions to such presumption. These exceptions would apply under a balancing test effecting "structured discretionary justice" as insightfully conceived by Administrative Law Professor Kenneth Davis in *Discretionary Justice, A Preliminary Inquiry.*41 We agree that such an approach best channels the discretion of agency fact finders, in this case revenue agents considering tax accounting practices after INDOPCO. The best restriction is not to take away all of the agent’s discretion, even

39. 1996-97 I.R.B. 22 (Feb. 5, 1996). Chief Counsel Stuart Brown recently stated that the IRS recognizing that there was unhappiness with the manner in which capitalization issues are being addressed or resolved in the field, issued this notice to solicit views on whether a global response, rather than a case-by-case or expense-by-expense response was possible. TEI Minutes of Tax Executives Institute-Internal Revenue Service Liaison Meeting, Nov. 19, 1996, available in LEXIS, Fedtax Library, TNT File 97 TAX NOTES TODAY 20-46 (Jan. 30, 1997) (TEI-IRS Liaison Minutes). "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." Id.

40. Available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 101-20 (May 22, 1996). As Professor Lee was working on converting our Submission into this article and had almost reached part III (which then followed current Part IV), he learned of a proposed disallowance of prepublication costs of non-academic books of a professor at the College of William & Mary (and established author), resulting in the work in progress, "Still Chewing on That Old Rag?": Writer's Prepublication Expenses Revisited after INDOPCO and New Section 167(g) (Writer's Prepublication Costs Revisited). As he was completing that piece, the cyclical safety aircraft engine maintenance (overhaul every four years) cauldron boiled over. That resulted in John Lee, Glenn Walberg & Darryl Whitesell, Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More Trouble Than It's Worth?, 17 VA. TAX REV. 1 (forthcoming Summer 1997) (hereinafter Lee, Walberg, & Whitesell, Cyclical Aircraft Maintenance Costs). When Lee returned to this piece, he drew upon the further thought and research in those pieces. In all real sense all three are a joint work exploring differing aspects of this area.

41. KENNETH CULP DAVIS, DISCRETIONARY JUSTICE, A PRELIMINARY INQUIRY 103 (1969) [hereinafter DISCRETIONARY JUSTICE].
case by case, as limitation riders triggered by an incremental approach would. Rather, the agent’s discretion should be directed through regulations to factors relevant to distortion of income; and the agent should be told how to apply these factors in a balancing formula. Additionally, such a global approach is strongly recommended over the incrementalism evidenced in private rulings and even more so in published revenue rulings. A global approach is politically more viable and thus more apt to effect horizontal equity.

Political science Professor Charles Lindblom in *The Science of ‘Muddling Through’* has called for an incremental ruling approach

where policymakers within an agency can not agree.\textsuperscript{43} Such lack of agreement is all too evident in conflicts between field or National Office of Chief Counsel on post-\textit{INDOPCO} capitalization/expensing issues.\textsuperscript{44} The disagreement goes back for at least three decades and appears to reflect as much as anything else a greater appreciation of judicial pragmatism by the Chief Counsel’s Office.\textsuperscript{45} Lindblom\textsuperscript{46} maintains that more can be accomplished by a series of little steps than in one big reform.\textsuperscript{47} This article asserts to the contrary that muddling through as the administrative answer to capitalization/expensing issues is more likely than a global approach to flounder on the shoals of interest group pressure. The story of post-\textit{INDOPCO} capitalization rulings shows that interest groups fare better countering politically adverse rulings one at a time separately than in a more global reform.\textsuperscript{48} This is so even though global legislative reform tends to preserve a few tax preferences for selected interest groups.\textsuperscript{49} With incrementalism all interest groups tend to prevail. This divided we conquer approach was implicit in those narrow issue-specific comments made in response to Notice 96-7.\textsuperscript{50} In contrast, more global tax reform provisions, such as the uniform capitalization rules of Section 263A in the Tax Reform Act of 1986 and the amortization of purchased intangibles under Section 197 enacted in the first Clinton Administration's tax act, OBRA 1993, were better able to achieve rough justice despite some exceptions.\textsuperscript{51} Indeed, some define rough justice as trading off interest groups with some winners and some losers (and in taxes by reducing administrative costs to Treasury’s
satisfaction, notwithstanding a few tax preference exceptions). Only a global approach can satisfy the strong horizontal equity prerequisite for fundamental tax reform, identified by then Senate Finance Committee Chair Bob Packwood, as "all share the pain." This article argues that only such a global approach is likely to prevail politically, incrementalism will lose hot issue after hot issue. This is particularly true in light of House Ways and Means Committee Chair Bill Archer's steadfast opposition to new taxes. This article urges the Packwood principle of horizontal equity or all-share-the-pain (with a few too inevitable political exceptions or pain balms) over the Archer approach of viewing each industry-adverse post-INDOPCO ruling as exacting a new tax. House Ways and Means Chair Bill Archer really means no new taxes.

The proposed standard for regulatory capitalization is minimum distortion of income both as to timing and character. The proposed rough justice timing exceptions allowing current deduction of costs with current and future benefits should encompass small, short-lived, or regularly recurring costs, and the presumably rare occasions in which depreciation or amortization poses extreme administrative difficulties. These guiding principles and rules should be illustrated with numerous examples derived


53. Sen. Packwood is reported to have agreed to the elimination of a capital gains preference in the 1986 Code (in exchange for lower rates) so long as "there is 'equal treatment' for all industries." Jeffrey H. Birnbaum & Alan S. Murray, Showdown at Gucci Gulch 83 (1987). This was an admirable and principled significant concession given that timber interests (in the Northwest and Southeast) are the most vocal supporters of a capital gains preference (although accounting for only a minute percentage of annual capital gains realizations). See John W. Lee, Critique of Current Congressional Capital Gains Contentions, 15 VA. TAX REV. 1, 27-28 (1995) [hereinafter Lee, Capital Gains Contentions].

54. See TEI-IRS Liaison Minutes, supra note 39 ("Mr. Wheeler [General Motors Corporation, TEI Executive Committee] said that the more the capitalization issue festers, the more Congress may be tempted (or urged) to micromanage the area through legislation."); notes 57-59 infra and accompanying text.

from judicial and agency ruling experience. Ideally these regulations would go beyond stating the standard and the rules (with illustrations) to fashioning a balancing test along the lines of Discretionary Justice. Such balancing test would weigh (a) the accounting and recordkeeping burdens to the taxpayer (and in some circumstances the administrative costs to the Service) of capitalizing and depreciating the future benefit costs, against (b) the increased revenues to Treasury from such capitalizing and depreciating. (Where public perceptions of inequity are strong, increased horizontal equity could be taken into account on the benefit side of the scales). The balancing test structuring the factfinder’s discretion also would direct the weight to be given to, and the parameters of, such “rough justice” factors of smallness, short-lives, and recurring, as well as revenue increase. This “second best” global solution is politically more viable than the global ideal of capitalization of all multi-period costs, with economic depreciation over economic lives with other complete adjustments for inflation. It is also more politically and administratively viable than the illusory practical incrementalism of case-by-case resolution of individual taxpayer’s capitalization issues on audit. The administrative record to date gives every appearance of “muddling through” a political minefield with IRS reversals on SAIF fees, soil remediation, and sooner-or-later cyclical aircraft

56. DISCRETIONARY JUSTICE, supra note 41, at 103. See James W. Colliton, Standards, Rules and the Decline of the Courts in the Law of Taxation, 99 DICK. L. REV. 265, 266 (1995) (most of tax law follows evolution of (1) Congress enacts broad general tax provision, (2) controversies generate judicial and administrative interpretations or rules causing “Congress to amend the statute by providing more detailed rules [; (3) [a]s I.R.S. and the courts interpret these new rules, controversies again develop which inspire Congress to provide yet more detailed rules.”). For a similar evolution from general statute through case law confusion (although hardly loophole opening) to overly detailed, generally restrictive statutory rules in areas of mixed business personal elements such as the costs of employer ordered travel, moves, meals and lodging, conventions, and education; see John W. Lee, Command Performance: The Tax Treatment of Employer Mandated Expenses, 7 U. RICH. L. REV. 1, 2, 28-9, 37, 59-61, 74-76, 93-96 (1972). Professor Bittker asked for a reprint of this article in which Professor Lee first considered some of the issues discussed here. Moreover, a Judge Tannenwald opinion was the source of the “command performance” symbolism. McDonell v. Commissioner, T.C.M. (CCH) 115 (1967). Professor Lee finds the connections between Bittker, Tannenwald and himself in several doctrinal areas pleasing, but not mere coincidence.

57. In 1992, deduction of (or amortization of capitalized) SAIF fees was a “significant issue” for the savings and loan industry under the IRS Industry Specialization Program. John J. Monaco, Executive Director Coordinated Examination Programs, Industry Specialization (ISP): Opportunities to Relieve Corporate Tax Burden (Dec. 22, 1992), available in LEXIS, Fedtax Library, TNT File, 92 TAX NOTES TODAY 256-17 (Dec. 24, 1992). Monaco claimed that significant issues differed from “coordinated issues” in that only the latter were governed by precise mandatory guidelines; the former might develop into coordinated issues, but they might not. Id. The 125 “significant issues” were organized by 20 industries. Id. By 1996, the Service and Treasury had abandoned attempts to capitalize such fees. See 142 CONG. REC. S 11899-90 (daily ed. Sept. 30, 1996) (reproducing Letter dated Sept. 27, 1996 from House Ways and Means Committee Chair Archer to House Appropriation Committee Chair Livingston).

58. One of the “significant issues” for the forest products industry was the cost of toxic waste clean-up, but it did not appear to be a industries-wide significant issue. It did arise, however, in a 1992
maintenance costs. The proposed structured discretionary rough justice regulations would effect the horizontal equity policy of all suffering equally.

The uncertainty and political opposition to IRS capitalization rulings can only be increased by a side effect of incrementalism as implemented through published revenue rulings through the end of 1996. Published rulings permitting expensing of present and future benefit expenses have followed the "digest" format under which sparse facts and little legal analysis is disclosed. Professor Davis calls for this drafting approach when the agency is unsure of the underlying principles. Professor Lindblom calls for it when the agency experiences internal conflicts. The higher level of analysis in the TAMs and once GCMs suggests that Chief Counsel's Office is more sure of the underlying principles or better rules than the published rulings would indicate. Conflict with the field and National appeals as to the capitalization ramifications of INDOPCO is another story. The Service and Treasury should rethink the transaction

soil remediation TAM. Chief Counsel's Office capitalized the costs of soil remediation but allowed amortization over a period equal to the remaining useful life of the taxpayer's natural gas pipeline. Since the taxpayer was in the business of pumping natural gas, this theoretically was equal to the useful life of the taxpayer's business or at least principal asset. The Service had previously used similar approaches as to the training costs of workers in a new nuclear power plant. Contemporaneously with the resulting political firestorm, Treasury and the Service reversed course. Rev. Rul. 94-38, supra note 21 (allowing a current deduction, in part because were the soil remediation costs capitalized and added to the cost of the land, no depreciation would be available. That too would result in distortion of income, so a current deduction was allowed.).

59. The cyclical aircraft engine overhaul issue also arose from the 1992 "Significant issues list," this time as to the airlines industry. The hint to agents gave rise to an audit issue resulting in Tech. Adv. Mem. 96-180-04 (Jan. 23, 1996), released May 3, 1996. That TAM capitalized the costs of major engine overhauls occurring every 4 years and allowed capital recovery as if the capitalized costs were a new aircraft or 7 years spread out over 8 years. "I must repeat that the Internal Revenue Service position represents a new tax burden on critical airline safety inspections and repairs." Letter dated Oct. 8, 1996 to Commissioner Margaret Richardson from House Ways and Means Committee Chair Archer, available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 198-5 (1996). IRS Chief Counsel Stuart Brown replied that the TAM was not binding on other taxpayers. Letter dated Oct. 1, 1996 to Chair Archer from Chief Counsel Brown, available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 198-2 (Oct. 9, 1996). This, of course, did not satisfy Chair Archer since the industry was being audited on this issue [as Archer had planned we might add]. Letter dated Oct. 8, 1996 to Commissioner Richardson from House Ways and Means Chair Archer ("I must repeat that the Internal Revenue Service position represents a new tax burden on critical airline safety inspections and repairs.") available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 198-2 (Oct. 9, 1996).

60. See notes 51 supra and 334 infra and accompanying text for horizontal equity at work politically. Horizontal equity is defined as similarly situated taxpayers paying similar amounts of taxes. See Lee, Entity Classification, infra note 80, at 121 n. 271.

61. See notes 18 supra and 244 infra.

62. DISCRETIONARY JUSTICE, supra note 41.

63. See note 43 supra and accompanying text.

64. See notes 87 and 90 infra.
costs and potential political consequences of incrementalism, namely, triggering limitation riders.

Other proposed regulatory capitalization rules would require capitalization while providing depreciation where the cost (a) recurs less frequently, (b) still provides substantial future benefits when repeated, or (c) is quite substantial (even if providing minor increase in value). Safe harbor uniform lives amortization, another proposed "rough justice" remedy, should be provided based on the tax policy of simplification, and by "approximation" through uniform useful lives producing minimum distortion of income, thus serving the policy of administerability. Minimum distortion of income as to character should be addressed at this time primarily through examples in the regulations applying the "origin of the claim" doctrine, particularly as to merger issues.

Works in progress on other specific capitalization/expensing issues (Cyclical Aircraft Maintenance Costs and Writer's Prepublication Costs Revisited) explore the notion of "negotiated rule making" and its application to fashioning such regulations. Under that scenario representatives from at least Treasury, the Service, the Joint Committee on Taxation and the professional groups (e.g., ABA and AICPA) would, through the process of "collegial tax reform," agree upon the framework of such regulations. The model is the number of such successful projects in the late 1970s and early 1980s often headed up by Professor Martin Ginsburg.65 Other major players with experience with this issue include, on the administrative side, Jerry Cohen, Harry Guttman and Ken Gideon. Peter Faber has been active on the capitalizing versus expensing issue from the ABA Tax Section side. This time the group of colleagues might include, in addition to representatives from Treasury and the professional groups (ABA and AICPA in particular), representatives from (1) the Service (both Chief Counsel and Field or audit); (2) academics (including some with administrative experience in


in order to further facilitate a dialogue with respect to such general guidance by the Service and comments by taxpayers, we recommend that the Service establish a committee for input from taxpayers and tax practitioners with regard to the general guidance and with respect to the specific approaches, principles or issues such general guidance should address.

_id._ Professor Lee had added that Submission to his file without fully appreciating. The second, implementing proposal is essentially what this article proposes. Professor Lee came up with the idea thinking about the cyclical airlines problem, not then recalling the Illinois CPA proposal. He has always had a fond spot for Illinois, besides the accident of his birth in Chicago (at three months he moved to Bellefontaine, Ohio). On his maternal grandmother's side (who was born in Madison County, Illinois) an ancestor was born in Illinois in 1800, the grandson of a Swiss mercenary who emigrated to Virginia in 1777 to fight in the Revolution.
this area, such as Professor Thomas Evans); (3) industry representatives (perhaps as self-identified by the submitters of comments pursuant to Notice 96-7 — former Service officials with great experience in the tax accounting areas, including Glenn Carrington and Carol Conjuga so submitted); and (4) due to the interest by the Ways and Means Committee in some capitalization issues and the work by various other agencies on capitalization issues, representatives of the tax writing Committees and of GAO and CRS. This article does not discuss the topic of negotiated regulation any further. To emphasize that the heart of proper taxpayer treatment of current deduction versus capitalization-cum-amortization is the standard of clear reflection of income effected through "rough justice" minimum distortion, not future benefit per se, these regulations could be issued under Section 446 with cross references under Sections 162 and 263.

II. PROMULGATION OF CAPITALIZATION GENERAL PRINCIPLES (OR STANDARDS) AND RULES

A. The Case for Further Guidance as to Tax Treatment of Future Benefit Expenditures

More for the record than in expectation of immediate enactment, Professor Lee urged Chair Rangel's House Ways and Means Subcommittee on Select Revenue Measures in its second 1993 Hearing on Miscellaneous Revenue Issues "not to stop with cleanup costs, but address as well the looming question of tax accounting for self-created intangibles in general." (It was clear at the Hearing that no legislation on clean-up costs or any of the other numerous issues would be forthcoming, much less the

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66. The principal, possibly insurmountable, disadvantage to this approach is the rule that the Commissioner cannot impose an accounting method (which includes the taxpayer's expensing versus capitalizing practice) just because it more clearly reflects income. Gen. Couns. Mem. 34,959 (July 25, 1972); Gen. Couns. Mem. 35,259 (Mar. 6, 1973)

We recognize that the mandate of Code § 263 has been questioned in several recent decisions. These courts framed the issue in terms of whether the taxpayer's method of accounting clearly reflected income. In our opinion, however, income is not clearly reflected if an expenditure resulting in the acquisition of an asset having a useful life greater than one year is currently expensed. Id. (citations omitted). Gen. Couns. Mem. 35,116 (Nov. 14, 1972) (expenditures in the nature of repairs and maintenance resulting in the acquisition of assets with a useful life exceeding one year were still currently deductible; "useful life" test was not affected; de minimis rule allowing current expensing of minor capital expenditures, was merely a rule of accounting and administrative reason, reflecting only on the fact that Code Section 263 is not absolutely inflexible.). See generally, Peter Faber, INDOPCO: The Still Unsolved Riddle, 47 TAX LAW. 607, 612-13 (1994).

67. 1993 Hearings, supra note 24 at 1699; see David G. Coolidge, Note, A Square Hole for a Square Peg: Section 165 and Environmental Cleanup Costs, 14 VA. TAX REV. 779, 785 (1995).
general subject of capitalization. Professor Lee mostly wanted to give staff something to think about.) He described in his Prepared Statement the substantial administrative costs that had arisen and would continue to arise out of capitalization tax issues. And so it happened.

This article elaborates that further guidance is needed regarding the ordinary deduction versus capitalization with amortization of the costs of self-created intangibles. The primary reason is the attention being given these issues by revenue agents in the Field as shown in Government Accounting Office studies and Congressional Hearings as well as the professional, popular and academic journals. The resulting transaction

68. 1993 Hearings, supra note 24, at 1699.
69. GENERAL ACCOUNTING OFFICE REP., supra note 35.
70. In the 117 Office of Appeals cases . . ., large corporate taxpayers disagreed with IRS most frequently over the issue of capital expenditures, which accounted for about 42% of the issues they contested. It was also the issue with the most dollars at stake in the 117 cases, accounting for $1.1 billion of the total $1.9 billion in proposed tax adjustments. In these cases, the corporations argued for immediate deduction of large expenses related to events such as corporate mergers, reorganizations, or environmental cleanups. IRS contended that such expenditures had future benefits and should therefore be treated as capital expenditures under Section 263, not immediately deductible in the current tax year.
costs of this unfettered revenue agent's discretion are unacceptable to the taxpayers, Service/Treasury and the courts as well as Congress. This should be self-evident from the recent enactment of Section 197, and before that of Section 195, to end similar transaction costs as to amortization of purchased intangibles and of intangibles created before a business commences, respectively. Yet each time, as well as in the case of Section 263A providing "uniform capitalization rules," Congress carved

out an exception from the new provision for self-created intangibles of existing businesses,\textsuperscript{77} leaving them subject to the existing case law. Congress specifically had in mind the separate asset prerequisite for capitalization (mis)reading of \textit{Lincoln Savings and Loan}\textsuperscript{78}—thought to provide a current deduction.\textsuperscript{79}

The current capitalization morass at the public corporation level (which reports over 80\% of the corporate sector income and over 56\% of the combined corporate and sole proprietor sector gross receipts combined)\textsuperscript{80}

\begin{flushright}
\textbf{Id.}
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benefit to future years in not alone sufficient, otherwise all ordinary and necessary business expenditures resulting in greater profit or future benefit would have to be capitalized, which is not the law.” John Lee, \textit{A Blend of Old Wines in a New Wineskin: Section 183 and Beyond}, 29 TAX L. REV. 347, 462 (1974) [Lee, Section 183 and Beyond]. The Conference Report attempted to “clarify” the above legislative history with the following poorly-proofread statement: “that, in addition to the costs specifically excepted from capitalization under the conference agreement (e.g., research and experimental costs, selling, marketing, advertising, and distribution expenses) are not subject to capitalization under the uniform capitalization rules.” H.R. REP. No. 99-881, at II-305 (1986). The Bluebook shifted to a new rationale and proves that the parenthetical was meant to close with “experimental costs”: “[C]onsistent with the long-term contract regulations under section 471, selling, marketing, advertising, and distribution expenses were not intended to be subject to capitalization under these rules.” \textit{STAFF OF THE JOINT COMMITTEE ON TAXATION}, 99th Cong. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 510 (Comm. Print 1986) (1986 Bluebook). But even more directly, the Conference Bill modified the Senate bill by adding “tangible” as a limitation on \textit{produced} personal property.

77. The 1980 legislative history to Section 195 stated that in the case of an existing business, eligible start-up expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business, but as under prior law, such expenditures would continue to be currently deductible. S. REP. NO. 96-1036, at 12 (1980). The determination of whether there is an expansion of an existing trade or business, or a creation or acquisition of a new trade or business, is based on the facts and circumstances of each case as under prior law. This position, which only obliquely can be gleaned from the statute, see original Section 195(b)(2) and current Section 195(c)(1)(B), probably is intended to preserve the victories of the banking industry in the bank credit card start-up cases. The result, however, with subsequent conflicts as to bank expansion costs, is complete confusion as to the scope of capitalization under Section 195. Congress had been so warned by a witness in the Hearings. Lee, \textit{Clear Reflection of Income}, supra note 16, at 102-03. The OGRA 1993 legislative history to Section 197 simply states that “[i]t is also believed that there is no need at this time to change the Federal income tax treatment of self-created intangible assets, such as goodwill that is created through advertising and other similar expenditures.” H.R. REP. NO. 103-111, at 760 (1993). This immediately follows the statement that:

It is believed that much of the controversy that arises under the present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets and by treating acquired goodwill and going concern value as amortizable intangible assets.


\textsuperscript{78}. Commissioner v. Lincoln Sav. & Loan, 403 U.S. 345 (1971). See note 76 \textit{supra}.


\textsuperscript{80}. The 1993 corporate income tax distribution shows the same concentration: the 7,000 corporations with assets from \$100,000,000 to \$250,000,000 reported 6.2\% of corporate earnings; the 3,000 with assets from \$250,000,000 to \$500,000,000, 5.3\%; and the 4,000 with more than \$500,000,000, 71.2\%. Joint Committee on Taxation Staff, \textit{Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems} (JCS-1-96 Mar. 14, 1996), available
is the largest category of Section 162 deduction/Section 263 capitalization issues, which in turn are the largest group of audit controversies at this level. Commissioner Goldberg stated that capitalization issues were the most common Industry Specialization Program (ISP) (Co-ordinated Audit) issue. They have greatly contributed to the confusion. These ISPs are

in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 53-8 (Mar. 15, 1996). Thus the largest 14,000 corporations (out of 4,000,000 or so corporations) reported 83.7% of corporate income. This pattern is long-standing. John Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations and the Tax Legislative Process*, 8 VA. TAX REV. 57, 100-01 n. 169 (1988) (1984 data) (hereinafter Lee, *Entity Classification*). These corporations make up almost all of the publicly traded corporations and vice versa. Sole proprietors while greatly outnumbering C and S corporations, (15,800,000 to 4,000,000 C and S corporations (roughly 50/50)) in 1993 accounted for only 29% of the combined sole proprietor and corporate sector gross receipts. We expect that corporate sector profit margins exceed the sole proprietor sector and that the corporate sector and in particular the largest 14,000 C corporations captured an even greater percentage of the business sector income in the booms of 1994 and particularly 1995. 1992 pre-tax corporate profits increased 16.6% with the


81. See note 69 supra and accompanying text.

82. 1991 Hearings on Intangibles, supra note 32, at 49 (Prepared Statement of Commissioner Goldberg) ("We also know that intangibles are among the most prevalent issues in the Large Case (ISP & CEP) Program today. The administration of these issues demands a significant proportion of the Service's resources. For example, 20% of the staff time of the Exam function's engineers is occupied with evaluating intangibles.") (Footnote omitted). *List of Significant Issues in the Internal Revenue Service Industry Specialization Program, Accompanied by Explanation by John Monaco, Executive Director, IRS Coordinated Examination Programs, 1992 DAILY TAX REPORT 247 d32* (Dec. 23, 1992); Monaco, *supra* note 57 (listing "Significant Issues"); John J. Monaco, *CEP Program: Changes in the Industry Specialization Program, 44 TAX EXEC. 163-170* (May-June 1992), available in LEXIS, Fedtax Library, TNT File, 92 TAX NOTES TODAY 116-72 (June 4, 1992); *Tax Analyst has Obtained CEP-QIP Proposal for Changes to Coordinated Examination Programs with Comments by Counsel and Appeals, 90 TAX NOTES TODAY 151-15 (July 20, 1990) (core initial targets, debt-equity and purchased intangibles (viz., fall-out from LBOs)); *Service Briefs CAG on Coordinated Examination Program, 90 TAX NOTES TODAY 89-30* (Apr. 27, 1990) (same); Dan Baucom & Peter Scott, *How to Survive a Large-Case Audit Under Revised IRS Guidelines*, 79 J. TAX'N 82 (Aug. 1993); Carrington, *supra* note 21, at 25-22 through 25-41 and 25-43. Roughly 1/4 of the 125 "significant issues" in the IRS Industry Specialization Program then released involved capitalization/amortization versus expense issues. And capitalization issues account for one Code Section (Section 263) and a subissue under another (Section 162 of course) out of the 14 Code Sections identified by GAO as accounting for almost half of the 12,000 appealed issues awaiting resolution in court. 1993 GAO Recurring *Tax Issues, supra* note 36. Fourteen tax code sections account for almost half of the 12,000 appealed issues awaiting resolution in court. *Id.* GAO also identified the 53 subsections within the 14 code sections that were most frequently appealed or had the highest dollar amount of proposed adjustments. *Id.*

Data also show that issues related to these 14 code sections accounted for an average of 44 percent of all issues resolved or closed by Appeals during fiscal years 1991 and 1992, 52 percent of the proposed adjustment amounts, and 59 percent of the proposed adjustment amounts sustained by Appeals. Capitalization accounted for between $3,047,000 and $3,122,000 of the $56,029,000 in proposed adjustments under the 14 Code sections (and $99,034,000 in total proposed adjustments as of September 30, 1992 or .054% to .056% of
The GCMs and now TAMs reveal that Chief Counsel on the other hand is keenly aware of judicial trends in the capitalization area. Indeed, National Office Chief Counsel officials probably disagree with many of these ISPs. Glenn Carrington (former Assistant Chief Counsel Income Taxation and Accounting Issues) has suggested that many conflict with rules underlying some published Revenue Rulings and TAMs progeny of INDOPCO. He also points, as do many industry voices, to these

83. The first step is identifying a significant issue as widespread and complex. If a significant issue remains significant and becomes more widespread, the industry specialist is involved in the development of the significant issue into a coordinated issue paper. If the issue is coordinated, a coordinated issue paper is written becoming the method by which the IRS examines the cases, procedures, processes and techniques used to audit the particular issues. Deposition of IRS National Director of Corporate Examinations Addresses FSA and ISP Programs, available in LEXIS, Fedtax Library, TNT file, 95 TAX NOTES TODAY 67-84 (Apr. 6, 1995).

84. Draft Internal Revenue Service Coordinated Issue Paper Regarding Shelf Space or Slotting Allowance, Dated Sept. 10, 1992, obtained by BHA: 1993 DAILY TAX REPORT 33 d58 (Feb. 22, 1993), was not approved by the Chief Counsel's Office. Glenn Carrington criticizes this ISP as inconsistent with INDOPCO. Carrington, supra note 21 at 25-23 through 25-24. "With respect to a draft IRS significant issues paper on the capitalization of slotting allowances, Carrington said the position drafted at the field level has not been approved by the IRS national office." Official Gives Update on Series of Guidance on Tax Accounting Issues, 1993 DAILY TAX REPORT 46 d6 (Mar. 11, 1993) (33 DTR G-10, L-3, 2/22/93). Some ISPs are approved, however, by National Office audit.

85. See note 18 supra.

ISPs as evidencing a broader interpretation of *INDOPCO* in the field.\textsuperscript{89} The same split between the field and National Office as to the post-*INDOPCO* world may be seen in the large number of National Office TAMs in this area reversing the Field's call for capitalization.\textsuperscript{90} The transactional...

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87. Carrington, *supra* note 21, at 25-41; cf. *Controversies Over Cost Capitalization Seen Increasing Following "INDOPCO,"* 1993 *DAILY TAX REPORT* 25 d22 (Feb. 9, 1993) (electronically reproduced) (observing that revenue agents began challenging historically deductible expenditures contrary to statements by the IRS National Office that capitalization principles have not changed after *INDOPCO*); Brian McConville, *ABA Tax Section Panel Wrestles with Impact of INDOPCO,* 93 *TAX NOTES TODAY* 101-8 (May 11, 1993) (electronic reproduction) (noting that *INDOPCO* never changed capitalization standards even though "some agents apparently view *INDOPCO* as the 'kitchen sink'"); *Comments of TEI on Notice 96-7, supra* note 69 ("despite frequent public assurances from the IRS National Office that *INDOPCO* did not change the law regarding capitalization, agents have seized upon that decision's reference to 'future' benefits' to support novel capitalization theories.").

88. *Official Gives Update on Series of Guidance on Tax Accounting Issues,* 1993 *DAILY TAX REPORT* 46 d6 (Mar. 11, 1993) (electronically reproduced) ("The brooding omnipresence in the sky may not have changed, but the battle in the trenches sure has."). (Statement of Kenneth Kempson, General Electric Co.); Letter dated December 22, 1992 from Paul R. Huard to IRS Chief Counsel Abraham N.M. Shashy, Jr. ("Revenue agents are routinely relying on *INDOPCO* in tax[...ervention, remediation, and similar environmental] context[s] and others should not lead to a different result than would have occurred before it was decided."); in *NAM Voices Concern About IRS Guidance on Environmental Remediation Expenses,* 93 *TAX NOTES TODAY* 187-23 (Sept. 9, 1993) (electronically reproduced); see Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992)(requesting further factual development by the examining agent to determine whether costs of environmental assessments and audits, alternative technology research and development, and a PCB compliance manual are deductible).

89. Carrington, *supra* note 21, at 25-22-4. "Mr. Shrewbridge [Bell South Corporation, TEI Treasurer] said that field agents seemed to be effecting policy changes through the examination process . . . ." *TEJ-IRS Liaison Minutes,* *supra* note 39. *INDOPCO* itself is cited by only a few of these ISPs, e.g., *Securities & Financial Services Industry Coordinated Issue Capitalization of Costs to Obtain Management Contracts, available in,* LEXIS, Fedtax Library, TNT File, 94 *TAX NOTES TODAY* 75-13 (Apr. 19, 1994); Settlement Guidelines Capitalization of Lease Related Expenses (Jan. 21, 1993), available in, LEXIS, Fedtax Library, TNT File, 93 *TAX NOTES Today* 179-31 (Aug. 27, 1993). Peter K. Scott, *Capitalization Requirements after INDOPCO,* 1 1993 So. FED. TAX INST. 1-21 (1993), points out that the large number of 1992 IRS Coordinated Examination Program list of "significant issues" involving capitalization, without citing *INDOPCO,* shows the importance of the issue. Additional proof lies in the large numbers of TAM's and Revenue Rulings citing *INDOPCO.* See note 90 infra.

90. Tech. Adv. Mem. 96-45-002 (June 21, 1996) (business expansion costs, i.e., start-up costs in the same existing business currently deductible); Tech. Adv. Mem. 96-38-002 (June 3, 1996); Tech. Adv. Mem. 95-40-003 (June 30, 1995) (overruling examining agent's disallowance of a deduction for amounts paid for cancellation of the stock options that were above the amounts that the option holders would have received for the cancellation of their options if the taxpayer's stock price had not been affected by the takeover); Tech. Adv. Mem. 95-27-005 (Mar. 15, 1995) (holding that taxpayer's special bonus payments to its management investors, pursuant to leveraged buyout, were deductible because of their compensatory nature, despite the field's contention that the origin of the payments was the leveraged buyout); Tech. Adv. Mem. 95-35-011 (May 15, 1995) (professional fees incurred by the taxpayer from a prudency audit during utility plant construction had the requisite "trade or business origin" and were deductible expenses); Tech. Adv. Mem. 95-13-002 (Nov. 28, 1994) (allowing a deduction for public utility taxpayer's conservation and load management expenditures contrary to District Director's position that expenditures' future benefits warranted capitalization); Tech. Adv. Mem. 94-27-002 (Mar. 30, 1994) (payments to settle antitrust litigation against taxpayer for allegedly conspiring to "unlawfully monopolize the interstate transportation of coal" held to be deductible since the potential liability was related to misconduct in taxpayer's day-to-day business); Tech. Adv. Mem. 93-33-005 (May 7, 1993) (concluding that capitalization should not be required for taxpayer's purchase...
costs to taxpayers and the IRS in contesting the tax treatment of self-created intangibles arising from these ISPs might not equal the transactional costs of determining the proper tax treatment of purchased intangibles, but they are still intolerable. The existence of this situation proves beyond a doubt that neither the courts nor the Congress (at least initially) has been an effective actor here. At the same time following an incremental approach here runs, as discussed below, the grave political risk of limitation riders, at least as to specific capitalization hot spots. Horizontal equity and reducing transaction costs is more likely to be achieved, or at least in larger part, by a global rule. And structured discretionary rough justice is the second best global solution here for properly channeling agent discretion. Otherwise curbing by Congress without resolving the problem is a likely consequence.

Many of the existing ISP capitalization issues arose out of the 1980's LBO craze. Mergers exploded again commencing in 1994, reaching record-breaking peaks in 1995 and 1996, and still continuing at a fair pace, if not result, with the percentage of hostile takeovers increasing...

95. For critical views of whether the benefits of the 1990's acquisitions will turn out any better than the 1980's merger mania see Bauder, supra note 94; Daniel Kadlec, '90s Mergers Begin to Mirror '80s Froth, USA TODAY, Nov. 14, 1995, at B3; Kirsten Downey Grimsley, The Axe That Cuts Both Ways; Downsizing's Human Cost Outweigh Economic Gains, Many Experts Now Say, WASH. POST, Nov. 5, 1995, at H1; accord Louis Uchitelle, Not Making It: We're Leaner, Meaner and Going Nowhere Faster, N.Y. TIMES, May 12, 1996, at E1 (productivity did increase in manufacturing, 3% versus 1% for economy as a whole; rub is that laid off workers tended to shift to less productive and lower pay jobs; downsizing may hurt productivity by destroying "loyalty, job stability and continuity, increasingly recognized as ingredients of productivity. The American Management Association, in its surveys, finds that a majority of companies that cut staff have failed to increase productivity a year or two later."). See also Clay Chandler, Ambivalent About Business, WASH. POST, May 12, 1996, at H1 and H5. Cf. Marjorie E. Kornhauser, The Morality of Money: American Attitudes Towards Wealth and the Income Tax, 70 IND. L.J. 119 (1994) (analyzes similar American "ambivalence about earned and unearned income, savings and spending, and wealth in general"). Most tellingly, leading business, financial and economic/news journals have recently criticized downsizing. E.g., Philip Zweig, The Case against Mergers, BUS. WK., Oct. 30, 1995, at 122; Fire and forget?, THE ECONOMIST, Apr. 20, 1996, at 51 (fewer than half of American companies that downsized in the 1990s subsequently had higher profits and even fewer improved productivity; 90% of companies outperforming their industry had "stable" structures; downsizing disrupts a firm's informal networks); Alex Markels and Matt Murray, Axing for Trouble: Call It Dumbsizing: Why Some Companies Regret Cost-Cutting, WALL ST. J., May 14, 1996, A1 ("They find profits are hurt, customers and suppliers lost, employees miffed."). Moreover, about 20% of "contract workers" employed by temporary help agencies have returned to their old companies sans benefits in "another move toward a system in which companies and employees feel less obligated to each other." Louis Uchitelle, More Downsized Employees are Returning as Rentals, N.Y. TIMES, Dec. 8, 1996, at 1-1). Downsizing strikes a particularly hostile chord in the public's ears since it coincides with stagnant wages coupled with rich stock appreciation rewards to top management as the market approved of downsizing. Louis Uchitelle, 1995 Was Good for Companies, and Better for a Lot of C.E.O's, N.Y. TIMES, Mar. 29, 1996, at A1. Actually

[ ]there is no agreement as to why inequality is rising faster in the United States than elsewhere. Explanations include falling wages for unskilled workers as automation spreads, low tax rates on the rich during the 1980's, relatively low minimum wages, the decline of trade unions and the rapid rise in the 1980's of the stock and bond markets in which rich people are heavily invested. . . . While incomes rose for the most affluent two-fifths of the nation's households as the economy expanded in 1993, the rest of the country suffered from falling incomes, after adjusting for inflation.

Keith Bradsher, Gap in Wealth in U.S. Called Widest in West, N.Y. TIMES, Apr. 17, 1995, at A1 and D4. The pre-tax changes in income appear due in part to increased pay for skills (particularly those attained through education) and decreased pay for lack of skills, which in turn may reflect to some degree the globalization of the economy with the economic principle of "factor price equalization" coming into play according to MIT Professor Lester Thurow. LESTER THUROW, HEAD TO HEAD: THE COMING ECONOMIC BATTLE AMONG JAPAN, EUROPE AND AMERICA, 52-3 (William Murrow & Co. 1992); Economic Report of the President, H. R. DOC. NO. 102-177 (1992). See G. Paschal Zachary, High Tech explains Widening Wage Gaps, WALL ST. J., Apr. 22, 1996, at A1. The argument of capital gains proponents "that wages have stagnated in large part because we have a Tax Code that penalizes people who invest, people who save, people who take risks to create new jobs . . .", 141 CONG. REC. H4216
from the 1980s' pattern. Already the deductibility of costs of defending against hostile mergers is a hot issue with conflicting judicial precedents.


Mergers accentuated the winner-take-all and growing income disparity trends in our society as a whole. Yates, supra note 94 ("Although mergers and acquisitions can leave employees uneasy— or worse— that is usually not the case when it comes to those at the top. CEOs and other senior executives often walk away from a merger or takeover with prodigious golden parachutes designed to guarantee them soft landings."); L.M. Sixel, Surviving the merger squeeze, HOUS. CHRON., May 10, 1996, at 1 (merger is often a euphemism for downsizing with 1 in 6 job losses in 1995 attributable to mergers; 1 in 4 in 1996). For a critique of the winner-take-all philosophy of pay “awards,” see Robert H. Frank & Philip J. Cook, The Superstar Economy: Why a Flat Tax Would Make America Less — Not More— Eficient, N.Y. TIMES, Nov. 12, 1995, at C2; Steven Pearlstein, Reshaped Economy Exacts Tough Toll: Competition, Efficiency Grow — as Does America's Income Disparity: Improved Competitiveness Exacts Social Price, WASH. POST, Nov. 12, 1995, at A1); Steven Pearlstein, New Economy Gives Work a Hard Edge, WASH. POST, at Nov. 14, 1995, A1; Peter Passell, Lonely, and Rich, at the Top, N.Y. TIMES, Aug. 27, 1995, at 4-6; R.C. Longworth & Sharman Stein, Battered Middle Class Turning Anxious, Angry, CHI. TRIB., Aug. 20, 1995, at 1C.

96. The 1980s acquisitions often consisted of leveraged buyouts or cash purchases of control of Target’s stock (“LBOS”) financed by junk bonds, often aimed at selling off unrelated T product lines (often acquired in the third wave 1960’s diversification stock and convertible debt acquisitions) to firms in related fields, with the remaining core business being again taken public by the key management group and financiers. Strom, supra note 94. In contrast many of these 1990s acquisitions capitalize on the recent rally of the stock market, which sent the Standard & Poor’s index of 500 stocks up about 30 percent in 1995, by financing the takeovers with steadily appreciating shares. Id. Alternatively booming big corporation profits finance cash purchases or bank funding at low rates is available to large corporate Purchasers. Id. Today’s method of financing acquisitions (and the percentage that are “hostile”) has changed since the 1980’s but the overall trend in both groups of acquisitions is 1 by large public corporations is away from diversification and towards consolidation or “corporate clarity.” Id.; Late Nights, supra note 94 (58% by volume stock deals up from 51% in 1994 and 12% in 1988). Other factors contributing to the deal-making boom include a perception of a looser regulatory environment and a sense that in a period of a slow-growth economy, business expansion can best be achieved by acquiring competitors. Deals also can be a way to satisfy pushy investors who want the reduced costs and better earnings that can be achieved in some mergers.

Strom, supra note 94; see Late Nights, supra note 94 (low interest rates and bank liquidity have lower cost of financing and booming share prices boosting net worth have made it easier to issue new shares to pay for deals; pattern of push towards "corporate clarity" rather than diversification of earlier decades); Charles Stein, The Year of the Deal, BOSTON GLOBE, Nov. 7, 1995, at 39 (favorable financial markets, modest economic growth, intensified competition and globalization contribute to deals).

97. Compare In re Federated Dep't Stores, Inc., 135 B.R. 950 (Bankr. S.D.O.H. 1992) (no future benefit found in hostile takeover) with A.E. Stanley Mfg. Co. v. Commissioner, 105 T.C. 166 (1995) (future benefit found in hostile takeover). A recurring opinion in Staley Mfg., relying on Delaware corporate law, correctly pointed out that while management defending against a hostile takeover may start with the posture of defending the company, once the bid price reaches fair market value, management's duties to the shareholders overrides with management's duty to be auctioneers for value of company. Id. at 205. This is corroborated by the pattern of once the sale of a company is in play it usually is sold
and the Service’s most clear change of position in light of INDOPCO. A major comparable exception was Tenneco’s spin off of long-held Newport News Shipbuilding and Tenneco oil and gas interests (which were acquired by El Paso Energy Corp.), ending one of the last big industrial conglomerates of diversified enterprises. 

98. See Note, INDOPCO v. Commissioner: Form over Substance in the Judicial Regulation of the Market for Corporate Control, supra note 19, at 121 n.2; Davis, supra note 72, at 1472; Melissa D. Ingalls, Note, INDOPCO, Inc. v. Commissioner, 43 DEPAUL L. REV. 1165, 1166-67 (1994).

99. A major comparable exception was Tenneco’s spin off of long-held Newport News Shipbuilding and Tenneco oil and gas interests (which were acquired by El Paso Energy Corp.), ending one of the last big industrial conglomerates of diversified enterprises. See James Sterngold, INVESTING IT: Tenneco’s Big Shipyard May Soon Sail Off Solo, N.Y.TIMES, Feb. 18, 1996, at 3-3 (one of last big industrial conglomerates); Barbara A. Nagy, Tenneco spins off EB rival; Newport News may face takeover, HARTFORD COURANT, Dec. 1, 1996, at F1 (massive 5-year transformation leaving parent only in the automotive parts and packaging businesses), joining “growing ranks of U.S. corporations that are redefining what they do. . . . Since 1991, Tenneco has spun off or sold its gas and mineral holdings, farm machinery division and Newport News Shipbuilding. Its products are also shifting — from farm machinery and nuclear submarines to Hefty bags and Munro shock absorbers.”; John N. Maclean, Building Value, Creating Options; Tenneco Strategy: ‘Sell ‘Em, Spin ‘Em Out or Operate ‘Em’, Chi. TRIB., Jan. 29, 1995, at C1 (strong Midwest core).

100. Floyd Norris, Market Place: Latest Mergers Driven by Cost Cuts, N.Y.TIMES, Nov. 7, 1995, at D1 (consolidation and cost cutting, not diversification, driving current mergers). Even in LBOs, similar cost cutting features (in addition to bust-up sales) were present. Other possible sources for the typical premium of 35% above the trading value before the tender offer in the LBO’s were wealth transfers— from employees through layoff or givebacks, senior debt holders, and shareholders themselves in a management LBO using insider information as to inside asset values. Possible additional reasons for the typical premium of 35% above the trading value before the tender offer in the LBO’s were wealth transfers— from employees through layoff or givebacks, senior debt holders, and shareholders themselves in a management LBO using insider information as to inside asset values in a management (bust-up) LBO. Joint Committee Staff, Federal Income Tax Aspects of Corporate Financial Structures, 100th Cong. S. 420, S. 476, and S. 632 (Feb. 6, 1989); Corporate Financial Structures, supra at 58-63. As to the last objection, a concern of then Finance Committee Chair Bentsen, Treasury Secretary Brady and SEC Chairman David Ruder claimed that in the late 1980s LBOs, the “auction” of competing (LBO) bids against management
judicial authority demonstrates that the potential reduction of the Taxpayer's operating costs is not in 636242 (Nov. 12, 1991) [hereinafter Capital Corp. after the Government's Big Win in U.S. Sup. Ct. note 21, at 492-95; Lee Response to the Capitalization versus Deduction Question: Federation Comments Regarding Further Capitalization Guidance dated May (corporate division); Denver & Salt Lake Ry. Co. v. Commissioner, 206 F.2d 244 (2d Cir. 1953) (recapitalization and reorganization expenditures); General Bancshares Corp. v. Commissioner, 326 F.2d 663 (friendly takeover); Bilar Tool & Die Corp. v. Commissioner, 530 F.2d 708, 710 (6th Cir. 1976) (corporate division); Vulcan Materials Co. v. United States, 446 F.2d 690 (5th Cir. 1971) (recapitalization and reorganization expenditures); General Banchsares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (stock dividends effecting change in the capital structure) (Blackmun, J.); Mills Estate v. Commissioner, 206 F.2d 244 (2d Cir. 1953) (recapitalization attaining altered corporate structure); Denver & Salt Lake Ry. Co. v. Commissioner, 24 T.C. 709 (1955), appeal dismissed, 234 F. 2d 663 (10th Cir. 1956) (merger with parent company); Skenandoa Rayon Corp. v. Commissioner, 122 F.2d 268 (2d Cir. 1941) (recapitalization); Motion Picture Capital Corp. v. United States, 80 F.2d 872 (2d Cir. 1936) (merger). The Service has ruled to the same effect. Rev. Rul. 67-125, 1967-1 C.B. 31 (alteration of the capital structure); Rev. Rul. 73-580, 1973-2 C.B. 86 (corporate mergers and acquisitions); Gen. Couns. Mem. 39,097 (Dec. 21, 1983); Gen. Couns. Mem. 35,881 (June 28, 1974).

103. Courts have consistently held that costs incurred as an incident to a corporate reorganization, recapitalization or acquisition by another entity should be capitalized. See, e.g., INDOPCO, 503 U.S. at 79 (friendly takeover); Bilar Tool & Die Corp. v. Commissioner, 530 F.2d 708, 710 (6th Cir. 1976) (corporate division); Vulcan Materials Co. v. United States, 446 F.2d 690 (5th Cir. 1971) (recapitalization and reorganization expenditures); General Banchsares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (stock dividends effecting change in the capital structure) (Blackmun, J.); Mills Estate v. Commissioner, 206 F.2d 244 (2d Cir. 1953) (recapitalization attaining altered corporate structure); Denver & Salt Lake Ry. Co. v. Commissioner, 24 T.C. 709 (1955), appeal dismissed, 234 F. 2d 663 (10th Cir. 1956) (merger with parent company); Skenandoa Rayon Corp. v. Commissioner, 122 F.2d 268 (2d Cir. 1941) (recapitalization); Motion Picture Capital Corp. v. United States, 80 F.2d 872 (2d Cir. 1936) (merger). The Service has ruled to the same effect. Rev. Rul. 67-125, 1967-1 C.B. 31 (alteration of the capital structure); Rev. Rul. 73-580, 1973-2 C.B. 86 (corporate mergers and acquisitions); Gen. Couns. Mem. 39,097 (Dec. 21, 1983); Gen. Couns. Mem. 35,881 (June 28, 1974).

104. Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296, 308-11 (Cl. Ct. 1984); Gunn, supra note 21, at 492-95; Lee & Murphy, supra note 28, at 521-26, 545; Calvin H. Johnson, Capitalization after the Government's Big Win in INDOPCO, 63 TAX NOTES 1323 (1994); Paul J. Green, The Second Circuit Review—1986-1987 Term: Commentary: Authors Prepublication Expenses: The Second Circuit's Response to the Capitalization versus Deduction Question: Hadley v. Commissioner, 54 BROOK. L. REV. 673, 703 (1988). Assistant Solicitor General Kent Jones in arguing INDOPCO relied upon Motion Picture Capital Corp. v. Commissioner, 80 F.2d 872 (2d Cir. 1936), for the proposition that where the court—the Second Circuit emphasized that reorganization expenses don't provide any current benefit to the corporation. They do not assist in the production of current income, they do not — they are not incurred in the ordinary course of producing income, certainly none of the expenses incurred by Indopco have anything to do with generating income for the corporation in 1978, the year they were incurred.

including *INDOPCO* have done.  

Professor Lee's Prepared Statement identified the ultimate source of the capitalization versus expensing problem as arising from Congress' pattern for the last decade and a half or so of carving out self-created intangibles from its capitalization/amortization reforms, viz., §§ 195, 263A and 197. I understand that at least initially a reason for such carve out was preservation of court victories permitting current deduction of expenditures producing intangibles with future benefit won by special interest taxpayers (e.g., banks) under the "separate asset" rubric (recently and fatefully overruled by the Supreme Court in *INDOPCO*).  

For some time the tax-writing Committees have known that the Service lacks the resources to examine each current deduction/capitalization/amortization issue taxpayer-by-taxpayer. Thus horizontal, and perhaps as well vertical, equity and sound administration call for a more uniform treatment of self-created intangibles along the lines of the one-size fits [most] all taxpayers approach of Sections 195 and 197. Politically horizontal equity at least in the version of all-share-the-pain appears a necessary political ingredient for regulatory reform of the unadministerable capitalization rules.

This article proposes more of a "rough justice" general principle of minimum distortion of income with several simple implementing rules (current deduction for small, short-lived or recurring costs creating intangibles, capitalization and amortization over standard lives for most other self-created intangibles) rather than just one-size-fits-all. Such adjustments are "Second Best." But they are more attainable at least

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105.  Lee & Murphy, *supra* note 28. As Professor Lee recalls, Professor Gunn's illustration of his thesis of capitalization to prevent character distortion with reorganizations and the costs of raising capital convinced Lee of the strength of Gunn's distortion of income model. Bittker is now generally cited for clear reflection of income as the principle underlying capitalization versus expensing. See Faber, *supra* note 66, at 635. (It ultimately traces back through Alan Gunn to Judge Tannenwald's insightful *Fort Howard* decision. See note 18 *supra.* The literature and the arguments of the Solicitor General's office in *INDOPCO* are further testimonials.


108.  *See NCNB II, 684 F.2d at 296* (Murnaghan, J., dissenting):

The legislative history [of Section 195], properly read, in no way compels the erection of a large, unreasonable and inherently unfair tax preference. Other taxpayers must capitalize and not deduct all at once expenditures having extended lives or applications. The taxpayer here, and others, preeminently banks, who will benefit from the decision of the en banc majority, can by no means merit description as "economically deprived." The benefit heaped upon them further contributes to the deserved description of our income tax system as a disgrace.

109.  The original idea of Second Best is that where there are multiple market failures, the best solution to one market failure alone may not be the best overall solution. R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-57). Indeed government inaction may be the best solution since the various market failures may cancel each other out—balance
politically than the elegant ideal of capitalization for all multi-period costs with economic lives, depreciation rates and proper accounting for inflation throughout the tax system. They are also more attainable politically and infinitely more administrable than the case-by-case audit and litigation of a muddling through incremental rulings approach.

Ideally, after public hearings and debate Congress would authorize legislative regulations with suggested factors along the line of the proposals in this article and our earlier Submission. In 1993 a House Ways and Means Subcommittee declined to address taxation of clean up costs, much less capitalization in general through legislative regulations. Moreover, the pattern of Congressionally-drawn "special interest" exceptions from capitalization under Sections 195, 197, and 263A for self-created intangibles of existing businesses suggests that Congress would not be the best initial actor here anyway. Indeed, it is with INDOPCO's overturning of the "separate asset" doctrine, which Congress had implicitly or explicitly thought would provide a current deduction to existing businesses incurring such costs, that the very self-created intangibles Congress had excepted in 1986 and 1993 ironically become the bone of contention in audit (driven in part by the capitalization ISPs).

This article recommends that at the least the Service and Treasury issue "interpretative" regulations, providing substantive guidance as to capitalization along the above "rough justice" lines, with numerous examples drawn from the judicial and Service rulings, many of which are discussed or cited. Professor Lawrence Lokken describes this approach as "rough cut" or common-law regulations. Such drafting approach (a) states more

of imperfections or two wrongs may make a right. Christopher R. Leslie, Achieving Efficiency Through Collusion: A Market Failure Defense to Horizontal Price-Fixing, 81 CAL. L. REV. 243, 267-68 (1993) This article uses the term in the later developed meaning of a solution that is not the ideal solution, but does not carry with it disadvantages that the ideal solution would.

110. 1993 Hearings, supra note 24, at 1699-1700 (Prepared statement of Professor Lee).
111. Id. at 1641 (Statement of Subcommittee Chairman Rangel) (After an aide directed Chairman Rangel's attention to the passage in the Joint Committee Staff Hearing pamphlet passage discussing capitalization theories as to soil remediation costs, Rangel asked the witnesses whether they didn't need any help from Congress or was existing law good enough for them. Chairman Rangel's irony, for which he is famous, was delicious. Lay industry representatives were happy with existing law. The attorney wanted clarification.).
112. Notes 76 and 77 supra.
113. See note 76 supra.
114. Lawrence Lokken, New Rules Bifurcating Contingent Debt—A Good Start, 51 TAX NOTES 495, 504 (1991). This is comparable to revenue rulings published in "digest" form. See note 18 supra. For further discussion of such process, known as "incrementalism", see notes notes 42-45 supra and accompanying text. See generally Michael Asimow, Nonlegislative Rulemaking and Regulatory Reform, 1985 DUKE L.J. 381.

Often, as an agency gains experience in exercising a particular power, it may formulate that experience in more or less precise rules that would guide the staff. At the outset, the guidance might take the form of answers to hypothetical questions about what the staff might do in
sparsely the suggested principle and rules, supported in the Preamble by the judicial and ruling precedents, and (b) provides number of examples with facts and conclusions but little reasoning. The original 1956 version of the Section 355 regulations fits this description. (The published expensing of current and future benefits revenue rulings to date have followed this digest approach.) The case-law experience literally was distilled into rules with facts from life in the Section 183 regulations. A pure judicial precedent/general principle approach probably would eschew safe harbors for amortization (other than the average period between recurrences) thus leading to pressure for a current deduction when amortization as a practical matter is unavailable. Such a rule of either depreciation or current deduction should be explicitly stated.

Another even less bold alternative is to release the results of Notice 96-7 as a discussion draft rather than proposed and/or temporary regulations. But, again, the political tax history of two decades ago highlights the risk of wasted resources of this approach where there is substantial business taxpayer opposition to a change in a perceived favorable status quo. This clearly has been the case to date as to post-INDOPCO capitalization private rulings.

This article recommends that the Service and the Treasury boldly issue regulations going beyond case-by-case ruling to structured discretionary justice regulations. Such regulations would channel the agent’s discretion through a burdens and benefits test for determining whether expensing would distort the taxpayer’s income. Such balancing test would take into account factors such as (a) the relative smallness, regularity and shortness of the recurrence cycle, and shortness of term benefitted; and (b) the difficulties or impracticalities of depreciation. Additionally where the recurrence cycle was longer, say four years or more, but shorter than the useful life of the asset benefitted; regulations should provide that the various circumstances. Alternatively, it might simply provide a checklist or itemize the factors to be taken into account without explaining how to weight them. Later, an agency may state tentative standards in the form of a nonlegislative rule. Ultimately, an agency may be willing to commit itself to a legislative rule that definitively and rigidly prescribes how the power will be exercised.

Id. at 386 (footnotes omitted).

115. See note 224 infra.
116. Note 18 supra.
117. See Lee, Section 183 and Beyond, supra note 76, at 395-444.
118. For instance, in 1975 the Service issued a discussion draft of proposed regulations as to the taxation of fringe benefits under Section 61. 40 Fed. Reg. 41,118 (1975). This proposal was withdrawn and when issuance of new guidelines was in the air, Congress prohibited issuance of regulations or revenue rulings, etc., for a specified period which was then extended. Archie Parnell, Congressional Interference in Agency Enforcement: The IRS Experience, 89 YALE L.J. 1360, 1372 & n.85 (1980). Ultimately, Congress enacted Section 132 in 1984.
recurring cost would be treated as a freestanding intangible, depreciated over the cycle. Truly bold regulations would provide, for example, five year safe harbor amortization where there was no cyclical aspect and no definite life. Analogous administrative precedent has allowed similar safe harbors as a matter of “administrative convenience.” This balancing of burdens and benefits would result in Second Best Rough Justice. It also better serves the tax policy of horizontal equity or all share the pain. This article also considers perhaps somewhat politically risky scenarios under which the Notice 96-7 project could evolve into a legislative regulation authorization, which would provide the most certainty.

B. Who is the Better Actor? The Case for IRS/Treasury Guidance

The question is who is the best actor to clarify capitalization principles and rules. The choices are judicial, legislative, or administrative regulation, presumably with interpretive regulations, or under a possible scenario, legislative regulations. This article concludes that IRS/Treasury is the best choice for cleaning the Augean Stables of expensing/capitalizing and amortizing self-created intangibles before the mass of building capitalization litigation hits the courts, resulting in uncertainty for some time with unacceptable transaction costs to all of the players—shades of purchased intangibles prior to Section 197. (The more likely quietus is a


At issue, according to 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, for with no recovery, or capitalize it with some sort of recovery. . . . Attorney Robert Liles of Miller & Chevalier, Washington, said taxpayers likely would be hesitant to seek such a [legislative] resolution because the revenue estimate for the measure probably would be prohibitively large.

Liles was alluding to “paygo” rules under which a revenue loser (comparing the revenue results of the new legislative tax rule with the results under the prior rule [not necessarily the same as prior practice] must be “paid for” by new tax rules increasing revenue or, less commonly, spending cuts. See Lee, *Capital Gains Contentions, supra* note 53, at 57.

120. Whenever I try to describe the task we face every day in this area, I can’t decide whether the appropriate metaphor is Sisyphus pushing the stone up the hill or Hercules cleaning out the stables. Even though I favor the latter because it similarly assaults my senses, Hercules ultimately succeeded in his task. I have doubts about whether we can without legislation. It is wishful thinking to suppose that litigation will achieve uniform results. The courts are as frustrated as we are with the status quo.


121. *Id.* at 49 (Prepared Statement of Commissioner Goldberg):

[W]e conducted a detailed analysis on three recent cases, each of which we counted on to set precedent with respect to a particular intangible. We determined that we spent an average of about 6,000 staff hours and at least $160,000 in out-of-pocket expenses per case. The numbers obviously can’t be universalized, but with at least 159 identified intangibles, you draw your own conclusions.
limitation rider.) The case against guidance through private letter rulings and technical advice memoranda has been made in *Comments of Tax Executives Institute, Inc. on Notice 96-7*, submitted to the Internal Revenue Service on March 20, 1996. Additionally, the political danger in such

*Id.* Additionally, a substantial portion of the 1990's ISP's are devoted to this area and the costs of that program are substantial as well. "The cost of additional staffing and support items to carry out the recommendations is projected to be approximately $4.6 million for Examination." *CEP-QIP, Proposal for Changes to Coordinated Examination Programs* (Apr. 9, 1990), *available in LEXIS*, Fedtax Library, TNT File, 90 *TAX NOTES TODAY* 151-15 (July 20, 1990) (this appears to be for one year—48 positions were added in the National and Regional Offices). Commissioner Goldberg pointed out that transaction costs to taxpayers of such controversies were correspondingly substantial:

> We don't have good data on the burden to taxpayers, but we know that it must be heavy.
> In order to avail themselves of the benefits of amortization of intangibles — unlike tangible assets where it might be a matter of picking up the Code and turning to section 168 — taxpayers must expend enormous amounts of money in obtaining expert advice. Anecdotally, staff members of the Office of Appraisal Services informally have been told that, in a typical one billion dollar acquisition involving intangibles, a taxpayer will expend 10 staff years of expert appraisal analysis, at a cost which may reach one million dollars.
> And many taxpayers face these costs. Of CEP taxpayers currently under examination — the largest corporate taxpayers in the system — at least 10% have potential disputes over the amortization of intangibles. In General Program cases — the remaining corporate taxpayers — at least 10% of corporations under examination have claimed amortization for acquired intangibles. These smaller cases often do not have expert appraisal reports, thus the Service and the taxpayer must "start from scratch" long after the fact to reconstruct whether the intangible meets the tests for amortization. And again, if a controversy is litigated, it is reasonable to assume that many of the taxpayers on the other side of these controversies incur litigation costs and attorneys fees commensurate with or far greater than ours."


an approach is discussed more thoroughly in this article than in our Submission.

1. Judiciary

Public choice literature posits that the judiciary is a more efficient actor than an agency under the theory that the former is less subject to capture by the regulated pressure groups. But the IRS appears less


123. See note 54 supra.

124. "Public Choice is the economic study of nonmarket decisionmaking or simply the application of economics to political science." DENNIS C. MUELLER, PUBLIC CHOICE 1, (1979) cited in Daniel A. Farber & Philip P. Frickey, The Jurisprudence of Public Choice, 65 TEX. L. REV. 873, 878 (1987). See generally notes 373-75 infra and accompanying text. "Public Choice literature suggests that interest groups with concentrated interests in legislation may wield asymmetrical influence in the political marketplace, and that they may exert that influence at the cost of the more diffuse interests of the public." John F. Manning, Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules, 96 COLUM. L. REV. 612, 677 & n.307 (1996) (rests on two premises: (1) market for legislation (favorable outcomes rewarded with campaign contributions, votes, future jobs, honoria, etc.) and (2) concentrated interest groups have (a) lower organization costs, (b) readier means of policing free riders, and (c) higher per capita benefits from favorable regulatory outcomes). Professor Manning lists scholarship arguing that interest group theory overly simplifies political behavior. Id. at 678 n.314. Professor Lee agrees, however, with Professor Manning that interest group influence is important and disproportionate in shaping public policy and that the interest group model is useful in identifying tendencies in our political system. Id. at 678 n.315.

125. For a summary of the literature that independent agencies with less clear lines of accountability are more susceptible than other governmental institutions to capture see MICHAEL D. REGAN, REGULATION: THE POLITICS OF POLICY 52-66 (1987). For the view that the judiciary is less susceptible to capture see Richard A. Posner, Theories of Economic Regulation, 5 BELL J. ECON. & MGMT. SCI. 335, 350-51 (1974). Diffuse policy making centers (as in IRS/Treasury) tend more to resist capture. Mark Seidenfeld, A Civic Republican Justification for the Bureaucratic State, 105 HARV. L. REV. 1511, 1565-66 (1992). This is to a degree exemplified by the split between Audit and Chief Counsel.

subject to capture than more narrow and smaller agencies. IRS and Treasury have long histories of hard fought for independence. "Traditionally the Treasury has been seen as less susceptible to interest group capture than other administrative branches." This article does not view the IRS/Treasury drive for "rough justice" as evidencing agency capture. The much more real danger is of Treasury and the Service yielding to the current intense political pressure from House of Representatives Committee on Ways and Means Chair Archer, to preserve the status quo of current deduction practice issue by issue as sometimes appears to be the case. Nevertheless other factors militate in favor of the Service/Treasury over the judiciary in this field.

A primary disadvantage to case-law development of rules (less so standards) is the tendency for courts not to evenly reach a consensus. Instead, particularly in this multi-fora tax world they tend to apply conflicting rules. This increases uncertainty and transaction costs as discussed in the next topic. Often tribunals mechanically applying rules conflict with those seeking to reach equitable results more consonant with
the underlying standard.\footnote{132} The stories of the no separate asset and the future benefit doctrines\footnote{133} and amortization of purchased intangibles\footnote{134} too richly illustrate these tendencies.

Many authorities base capitalization on future benefit\footnote{135}—otherwise there is an "economically inefficient" incentive to cast such a transaction in a deduction posture, as Judge Posner pointed out in\textit{Fishman v. Commissioner}.\footnote{136} But well-reasoned decisions have permitted current deductions under a clear reflection of income analysis along the lines of the proposed de minimis, short lived, and steady-state recurring exceptions model or its corollary, impracticality of amortization,\footnote{137} notwithstanding a future benefit capitalization presumption.\footnote{138} Such authorities often conclude that current deduction would not distort the taxpayer's income (e.g., small, short-term benefits or recurring in relation to revenue increase from capitalization) as much as capitalization (particularly if without amortization) would.\footnote{139} Some in the IRS National Office\footnote{140} and some commentators\footnote{141} have favored these judicial precedents from time to time.

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\footnote{132}{See Lee, \textit{Clear Reflection of Income}, supra note 16, at 5.}
\footnote{133}{Id. at 51-71.}
\footnote{134}{\textit{GENERAL ACCOUNTING OFFICE}, supra note 93 (judicial inconsistencies as to customer lists and core [bank] deposits).}
\footnote{135}{Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984) (advertising costs contributing to acquisition of a capital asset were capital expenditures); Darlington Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494 (4th Cir. 1968) (costs of eliminating unproductive middleman capitalized because intended to produce a positive business benefit for future years); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir. 1937) (commissions paid to solicitors in campaign to retain old and obtain new customers capitalized); Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), \textit{acq.}, 1975-1 C.B. 2 (payment for cancellation of a territorial agreement capitalized because acquisition of right to conduct business and earn profits over future years).}
\footnote{136}{837 F.2d 309 (7th Cir. 1988).}
\footnote{137}{Income and expense must be matched temporally in order to minimize the inevitable misallocations of resources that a taxing system creates. ... Because of the time value of money—real riskless interest rates are positive—a deduction taken today is worth more than one taken a year from now. Hence if an expense incurred to produce future income can be deducted from current income rather than postponed until it has borne its fruits, taxpayers will have an incentive to incur such expenses earlier than they would if there were no income tax; and tax law seeks, to the extent compatible with revenue and distributive objectives, to interfere as little as possible with the pattern of expenditures that would exist in the absence of taxation.}
\footnote{Id. at 312.}
\footnote{138}{"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." \textit{INDOPCO}, 503 U.S. at 87. For an excellent analysis of the Service's possible interpretations of this passage see Carrington, \textit{supra} note 21, § 25.02[4][d] at 25-8 through 25-9.}
\footnote{139}{See note 20 supra.}
\footnote{140}{See note 21 supra.}
The resultant uncertainty as to when the exceptions apply argues strongly against judicial resolution alone of the ordinary versus capital dichotomy (or perhaps better spectrum). In the sixty years since Justice Cardozo in Welch v. Helvering told us to look to "[l]ife in all its fullness . . . [to] supply the answer to the riddle" of what is ordinary, the demarcation between ordinary and capital expenditures has been the most difficult to draw in the tax field. As a practical matter, the dueling capitalization versus expensing precedents mean that taxpayers often have substantial authority for deducting future benefit costs not fitting the rules proposed in this article. This poses an administrative nightmare. More fundamentally, a case-law approach to capitalization too often has to turn in theory on a case-by-case determination of useful life for amortization of any capitalized expenditure. (The too-often easier analysis is to conclude that when amortization is not available, current deduction more clearly reflects income, i.e., under the analysis of this article, produces less distortion of income than the "black hole" of capitalization without amortization.) Case-by-case

note 148 (recurring and burden outweighs benefits); see note 249 infra for submissions pursuant to Notice 96-7 also advocating similar factors.

142. Commissioner Goldberg pointed out that the courts were unable to resolve the purchased intangibles morass. See note 32 supra. Astute tax writing committee members such as Rep. Rangel hold similar beliefs as to judicial inefficiency. 1993 Hearings, supra note 24, at 1708. Professor Lee has long thought about whether the ideal evolution of rules implementing standards as judges and commentators collaborating, which is then administratively codified by the Service and Treasury in administrable rulings (and ultimately codified by Congress). Section 355 well illustrates part of this process. Earlier, perhaps more primitive, examples would be the Clifford or grantor trust provisions of Subchapter J of the Code (and the family partnership provisions of Subchapter K). See Colliton, supra note 56 (evolution of grantor trust provisions). Professor Boris Bittker's role in the tax issues of (a) capitalization versus expensing of future benefit costs and (b) year one-year two balancing entry doctrines (tax benefit, claim of right, cancellation of indebtedness, and Crane/Tufts doctrines, and perhaps less obviously open and closed transaction doctrines and myriad piecemeal statutory partial codifications, including depreciation recapture and the no double deduction notion of Arrowsmith and Skelly Oil, well-illustrates the collaborative judicial/commentary mode of tax law reform. Cf. William D. Popkin, The Collaborative Model of Statutory Interpretation, 61 S. CAL. L. REV. 541 (1988) (advocating Congressional and judicial collaboration, which started Professor Lee thinking along the lines of analogous collaboration with the Bittker "balancing entry" story in mind).

144. Id. at 115.
146. There is enough stuff out there on a one out of three, any of us can find authority on any side, and therefore people will take any side, and so what we need is more direction and then let the service do what it does best, but with authority.
1993 Hearings, supra note 24, at 1708 (Statement of Professor Lee).
147. General Accounting Office, supra note 93.
148. This approach has judicial and some Treasury support. See note 21 supra. [W]hile capitalizing and amortizing periodic customer development expenditures may have some theoretical appeal, as a practical administrative matter it is not feasible. More
useful lives is contrary to the evolution over six decades of more and more standardized lives for tangible assets as under Section 168.\footnote{GENERAL ACCOUNTING OFFICE, supra note 93.} It similarly importantly, this treatment is not even necessary to achieve a proper accounting of periodic net income. For an on-going business entity with a steady level of customers, the annual expense deductions related to periodic customers development expenditures should be roughly the same as amortization deductions. This also should be the case even for companies with a growing number of customers, since amortization periods for capitalized new customer development expenditures typically would be much shorter than amortization periods for purchased customers. For example, it is well-known in the newspaper publishing industry that only a small percentage of new subscribers actually renew their subscriptions enough times to become 'seasoned' subscribers with expected lives of approximately 15 to 25 years, as are at issue in \textit{Newark Morning Ledger}. Furthermore, it would be impracticable to identify and capitalize the proper portions of those periodic expenditures that contribute to customer development.

Tax authorities and financial accounting authorities have long recognized these circumstances and, accordingly, have permitted the expensing of periodic customer development expenditures as incurred. This administratively simple treatment provides 'rough justice' as it applies evenly to all taxpayers who develop customers, and typically does not result in a material distortion of net income.

Steven Gerard, \textit{The Continuing Controversy over Newark Morning Ledger and the Mass Asset Rule}, 58 \textit{TAX NOTES} 99, 100 (1993). This article argues that often the "platinum mean" of standardized safe harbor amortization periods is better than current deduction or no deduction from a policy and equity as well as economic efficiency standpoint.

149. In GAO's opinion, conflict between taxpayers and IRS regarding which purchased intangible assets are amortizable is likely to continue. The fact and circumstance based nature of the controversy leads to costly disagreements between taxpayers and IRS and inconsistent treatment for similarly situated taxpayers. A legislative change similar to the changes made to the tangible asset rules to address these same problems is needed. Keeping the current tax rules would mean accepting frequent and costly disagreements between taxpayers and IRS, with the courts acting as the final arbiter.

When these conflicts arise, they are caused by the disparity between the tax treatment of (1) goodwill and other nonamortizable intangible assets without determinable useful lives and (2) amortizable intangible assets with taxpayer-determined useful lives. This disparity gives taxpayers an incentive to establish values and useful lives for purchased intangible assets other than goodwill. The current tax treatment of goodwill and similar intangible assets fails to recognize the economic benefits that wasting intangible assets contribute over time. These assets are consumed over time even if a precise period cannot be determined. Denying amortization deductions does not result in an accurate determination of taxable income since expenses are not properly matched to income generated. Recognition of these economic benefits over time for tax purposes can be accomplished by establishing specific statutory cost recovery periods for purchased intangible assets similar to those now used for tangible assets. Providing specific cost recovery periods could, therefore, result in a more accurate measurement of income. It could also eliminate conflicts resulting from the nondeductibility of purchased goodwill and disagreements over the estimated length of useful lives.

Administrative concerns, such as the appropriate identification of the categories to which particular intangible assets belong and the calculation of asset values, should be considered when choosing the lengths of cost recovery periods and category definitions. These conflicts were not significant when compared to conflicts over goodwill but could increase as the number of categories eligible for amortization and the span of cost recovery periods increase. \textit{Id}; Gen. Couns. Mem. 34,102 (Apr. 17, 1969):

[W]e fully realize that characterization of expenditures incurred in a silting removal
conflicts with the almost one-size-fits-all more recently enacted the fifteen-year amortization period for purchased intangibles under Section 197. The GAO believed the disagreements between IRS and taxpayers over which intangible assets may be amortized will continue unless changes are made in the current rules. Recognition of all intangible assets that waste away over time and the development of guidelines for their amortization would help to prevent such disputes and provide uniform treatment for all taxpayers.

An interesting question which arises and remains unanswered — were indirect costs included in the computations in arriving at the percentage repair allowance?

There is no indication in the administrative file whether in setting these [repair ratio] percentages [for railroads] any indirect costs were taken into account. Inquiry was made of the Engineering and Valuation Branch as to whether they have this information, and they did not, but they made a request of the Office of Industrial Economics for the information. They also referred us to Mr. Seymour Fiekowsky, an economist in the Treasury Department who worked on the original repair allowances adopted under CLADR. Mr. Fiekowsky said that in preparing the data on which the original allowances were based the personnel working on the matter were limited by the information shown on the books of account of the industry members surveyed. He said that conceptually indirect costs are a part of the expenditures for repair, etc., but that his group did not have the means to go beyond the accounts in which the companies surveyed recorded repair, etc., expenditures. Accordingly, he did not know to what extent, if any, indirect costs were taken into account in setting the repair allowance percentages. [The individual draftsperson of a 1979 increase in the repair allowance percentage] said that neither he nor, as far as he could ascertain, any one else in his office knew whether indirect costs were taken into account in setting the original repair allowance percentages. He stated that in assembling the information on which the 1979 increase was based he did not have access to the methodology used in determining the original repair allowance percentages, and so did not try to follow the same or a modified procedure in developing the 1979 percentage. The aforementioned individual said that the major
The paradigm there was based in part on precisely this idea of one-size-fits-
(almost, but not quite due to special interest exceptions)-all.

In addition to the conflicting precedents, tax audit and litigation and
requests for interpretation generate inflated transaction costs due to
confusion, misunderstanding and lack of expertise of advisers of small
taxpayers. While such costs may as a matter of tax policy be tolerable
as to sophisticated, i.e., high income taxpayers, and even intended as to tax
shelter devices, they are intolerable and unadministerable as to most
other taxpayers, in particular small businesses. This was the message
of IRS/Treasury in 1992 that “rough justice” in the form of simple rules
right on the average and general principles were preferable to detailed rules.
Professor Lee argued in the 1993 Rangel Miscellaneous Revenue Hearings
that the real concern in the post-INDOPCO capitalization world should be
“avoiding litigation costs on both sides.” Taxpayer representatives
made the same arguments as to pollution clean up costs; and avoidance

problems with which OIE was concerned in developing the 1979 Class 40.1 percentage were
inflation and excluded additions. There was discussion as to whether overhead should be
included, but little or no attention was given to indirect costs. There was a significant
difference between the figures reported by the ten railroads for ADR purposes.

Note that Boris Bittker had a hand in this also. See note 226 infra. Congress (or Treasury) probably
shared these concerns, in that the CLADR regulations were in effect codified in 1971. Nevertheless,
Professor Lee believes that such rule making is within the clear reflection of income prerogative of the
Commissioner.

151. See note 32 supra.
152. Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms before
the House Comm. on Ways & Means, 99th Cong. 32-33 (1984) (Statement of Assistant Secretary of
Treasury Chapoton.)

MR. PEASE. Will these [time value of money] proposals that you have, if they are
enacted in total, tend to complicate or simplify the Tax Code?

MR. CHAPOTON. Unquestionably, where they apply, they will tend to complicate, in most
cases would have some complicating effect. That is why every attempt has been made
particularly in the time value of money changes to provide exceptions so they do not apply
to the everyday taxpayers in normal transactions and apply principally to large tax
transactions, tax shelters, and otherwise, where very sophisticated planning is involved.

MR. PEASE. So in an effort to close off abuse tax shelters, we are going to further
complicate a tax code that many people feel is already too complicated.

MR. CHAPOTON. I do not think we need to apologize when we complicate the Tax Code
for very complicated transactions, and that is the intent here.

Id.

153. John Lee, The Art of Regulation Drafting: Structured Discretionary Justice under Section 355,
44 TAX NOTES 1029, 1031 n.17 (1989) [hereinafter Lee, Structured Discretionary Justice].
154. 1993 Hearings, supra note 24, at 1687 (Testimony of Professor Lee).
155. Letter dated July 8, 1993 from Donal E. Flannery and Carol Conjura of KPMG Peat Marwick
to Samuel Y. Sessions, Deputy Assistant Secretary for Tax Policy Re: Proposals for the Tax Treatment
of Environmental Cleanup Costs, available in LEXIS, Fedtax Library, TNT File, 93 TAX NOTES TODAY
148-25 (July 15, 1993):

The magnitude of the issue and its tax policy repercussions are too great to allow any
resolution other than one in which the weight of authorities and sound tax policies are
considered. Rather than providing taxpayers with useful guidelines for taking a correct tax
of such transaction costs on both sides had been a major factor in Commissioner Fred Goldberg's stumping for "rough justice" regulations.\textsuperscript{156} Indeed, Treasury's support of statutory simplification as to depreciation of intangibles has been long and consistently bottomed on reduction of administrative costs.

2. Congress

a. Historical Experience with Detailed Statutes versus General Statute with Detailed Regulations

Our Submission outlined at this point some of historical experience with general and particular statutes and regulations particularly in the tax-free reorganization area. This topic is not considered in this article.

b. Does Treasury favor legislative resolution?

Probably with Section 197 in mind, Treasury officials have suggested that legislation was the best answer to the deductibility of pollution clean-up expenses imbroglio.\textsuperscript{157} Presumably some in Treasury would believe that the same is true for capitalization in general. This article takes a contrary position for the reasons discussed below.

c. The Case Against Initial Legislative Resolution

This article argues that at least initially\textsuperscript{158} Congress is not the best actor in resolving the capitalization versus expensing morass for four reasons. The first two are structural policy reasons outlined in our

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\footnotesize
return position the first time, unending litigation would result from a failure to reconsider these TAMs. We believe such failure would be counterproductive for both taxpayers and the government, and would only provide taxpayers with the assurance that the Service will challenge most of their deductions on audit. Taxpayers should not have to resolve their cases in court if it is possible for the Service and Treasury to interpret the law and existing authorities in a reasoned, practical manner.

\emph{Id.} 156. Bennet Minton, \textit{Goldberg Urges Compromise on Simplification}, 53 TAX NOTES 148 (1991) ("Goldberg urged businesses to accept that simplification would produce only 'rough justice.' 'Tax law is not a work of art; it is a crude, ugly means of financing government. Don't chase an imperfection,' he advised."). See notes 307-15 \textit{infra} and accompanying text.
158. Congress can perform a valuable role in reforming this area by codifying in the future the then existing structured discretionary rough justice expensing/capitalizing regulations. See notes 232-36 \textit{infra} and accompanying text.
Submission: (1) a quicker tendency to overregulation through too many rules and (2) a tendency, with sometimes good and sometimes bad effects, to carve out exceptions for various classes of taxpayers. Such exceptions seriously violate horizontal equity and too often, not always, vertical equity. The latter was the motivating factor at the time of our Submission. It alluded, however, to the first of the following two political reasons for Congress not being the best actor here. Professor Lee now finds these more determinative in supporting that conclusion. Reason (3) is the proclivity of Rep. Archer, to resort to strong-arming administrative regulation of capitalization-expensing issues without supplying a substantive resolution, “limitation riders” in the literature. Former high Treasury or Service and Joint Committee Staff officials with whom Professor Lee has enjoyed the good fortune to discuss this issue agree that such approach would be a very bad thing. We believe that an incremental approach as exemplified in the published rulings as of the end of 1996 are more subject to the risk of “limitation riders.” (4) Chair Archer may feel compelled
to go the "limitation rider" route due to counterintuitive and factually incorrect paygo assumptions. After our Submission Professor Lee further researched and thought more about these two issues in connection with research and thought on cyclical aircraft engine "inspections", i.e., replacement, where in the heat of the moment he ignored them. They will be covered more extensively in Cyclical Aircraft Maintenance Costs. This article will only sketch the direction that thought is now taking.

Hyperlexis and Pressure Group and Other Exceptions

Two sources of hyperlexis spring to mind. One, most clearly identified by Commissioner Fred Goldberg in the Bush Administration, is the tendency to spin out ideal rules striving for theoretical purity. The most extreme recent example is surely that of time value of money rules. This pattern is usually coupled with exceptions based upon the populist tax policy of simplicity for small taxpayers. The other source, more commented on by public choice theorists, is the spawning of exception after exception for special interest or pressure groups which may coincide with simplicity or be dressed in its rhetoric. Theories here fortunately can be tested against closely comparable real tax world realities. Section 195, 197 and 263A all deal with aspects of capitalization versus expensing and serve as laboratories for testing approaches.

The pattern of recently enacted or proposed tax legislation as to capitalization (Section 263A) and to a lesser extent amortization of

164. See note 40 supra.
166. A former chief counsel under President Carter not involved in the 1984 legislation described it as the extreme of rules elevating theoretical purity over administrability.
167. See, e.g., I.R.C. §§ 263A(b)(2)(B) and (f)(1)(B)(ii); 447(d)(1); 448(b)(3); 453A(b)(1); 460(e)(1)(B)(ii); 469(i)(3)(A); 483(d)(2); and §§ 1274(c)(3) and 1274A. For a description of certain income tax provisions that apply to small businesses see Staff of the Joint Committee on Taxation, House Committee on Ways and Means on April 24, 1996 (JCS-3-96 Apr. 23, 1996), available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 81-16 (Apr. 24, 1996).
168. Frank Easterbrook, Court and the Economic System, 98 HARV. L. REV. 4, 16 (1984). He posits that the "more detailed the law, the more evidence of interest-group compromise and therefore the less liberty judges possess." Id. Ironically, essentially this scenario of construction was followed by the Board of Tax Appeals in upholding the device (spin-off of newly-incorporated subsidiary holding stock in third corporation X followed by liquidation of subsidiary and sale of X stock) in Gregory, reversed by the Second Circuit and the Supreme Court in the classic expansive judicial doctrine, business purpose. See Lee, Structured Discretionary Justice, supra note 153, at 1033. Easterbrook continues that general-interest statutes are designed to vest discretion in the courts, as in anti-trust common law. Easterbrook, supra, at 16. In those instances, "decisions of courts are the things for which the parties bargained, and so judicial power to extemporize is at its greatest." Id.
169. Section 263A generally applies a single set of capitalization rules (implemented through awesome complexity in regulations) to all costs incurred in (1) manufacturing or constructing real or tangible property and (2) acquiring property (real or tangible or intangible) for resale. See 1986
intangibles (Section 197)\textsuperscript{170} and the Clinton Administration's proposed "Brownfields" provision,\textsuperscript{171} all display a pattern of hyperlexis, or detailed rule with detailed exceptions and exceptions to the exceptions piled upon detailed rules. It may be that Congressional staff are more prone to hyperlexis than IRS or Treasury staff, but the more likely cause is the far greater desire on Congress' part to infinitely more narrowly define beneficiaries and targets of tax legislation\textsuperscript{172} than on the part of IRS/Treasury. This compounds in tax legislation the tendency of both Congress and Treasury to hedge with safeguards broader policy rules.\textsuperscript{173} Too much complexity poses administrative problems as well, confusing IRS field agents\textsuperscript{174} as well as taxpayers.

Complex tax legislation often manifests a two track pattern of more complex (usually anti-abuse) rules for larger taxpayer or tax shelters and

\textit{Bluebook, supra} note 76, at 509. Representative Downey, member of the House Ways and Means Committee and important player in the Tax Reform Act of 1986, read the legislative history of Section 263A as:

suggest ...[ing] that the thrust of the provision was to require various producers of tangible property already capitalizing direct and some indirect costs to more comprehensively capitalize other indirect costs. Congress meant to exempt from the new uniform capitalization rules those taxpayers, or expenditures, that were already exempted under prior law from the general capitalization rules. For instance, farmers and ranchers were exempted. The exemption from uniform capitalization rules in the timber industry and the ornamental tree industry was continued.


170. Section 197 provides 15-year amortization (depreciation) for a laundry list of intangibles mostly acquired in connection with an acquisition of assets constituting a trade or business. I.R.C. §§ 197(a), (d) (1994). A large number of exceptions are included in Section 197(e). Some consist of assets already covered by more favorable specific provisions or rules, e.g., computer software, sports contracts and mortgage servicing contracts. Conversely other exceptions consist of assets that were traditionally not depreciable because not a wasting asset, e.g. an ownership interest in a corporation, partnership or land, or because the acquisition was in a non-recognition transaction, e.g., transaction costs in a tax-free corporate organization or reorganization.

171. The Clinton Administration proposal would allow an election to treat certain environmental remediation expenditures otherwise chargeable to capital account to be currently deducted if the contaminated site (1) is used in trade or business, (2) located in a targeted area (empowerment zone, enterprise community or site included in Environmental Protection Agency brownfields pilot project), and (3) contains a hazardous substance ("brownfields"). Staff of Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (Released on Mar. 19, 1997) 49 (JCS-2-96 Mar. 27, 1996), available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 62-6 (Mar. 28, 1996).

172. In this context at least Congress is more subject to capture than Treasury or the IRS.

173. Section 263A and its amendments display all of these elements. That story was researched after our Submission for Writer's Prepublication Costs Revisited, supra note 40. Therefore this article only sketches the conclusions reached there.

174. "It is also worth noting the obvious: If IRS employees cannot understand those laws, regulations, and administrative rules, we will have a hard time administering and enforcing them." \textit{Hearings on Impact, Effectiveness, and Fairness of the Tax Reform Act of 1986 before the House Ways and Means Committee}, 101st Cong. 53-56 (1990) (Statement of Commissioner Goldberg) [hereinafter \textit{Hearings on Impact of TRA 1986}].
more simple rules for smaller taxpayers or those who materially participate in the activity being regulated. 175 This was especially the case in the Tax Reform Act of 1986's tax accounting and tax shelter provisions, 176 but appears a general populist pattern as well across the Code over the past two decades. 177

As far as uncertainty goes, we suspect that even more chaos is created when Congress carves out from already complicated tax statutes special interest exceptions allowing existing businesses to garner the fruits of their then favorable existing case law victories. The story of the separate asset test best illustrates this. 178 For these victories have generally proven pyrrhic, as if the Service then attacked the thus highlighted current law "flaw." Professor Lee so testified in 1993. 179

Further case-law development in the tax treatment of self-created intangibles carved-out from Section 263A might have been anticipated by staff. Section 195 already provided the example of Congress carving out a case law exception (based upon the separate asset doctrine) with cases culminating in INDOPCO subsequently rearranging the underlying case-law guideposts. 180 The GAO pointed out that pre-Section 197 case law permitting the expensing of the costs of creating intangibles arose against a

175. For small taxpayer exceptions see note 167 supra. Material participation exceptions or prerequisites as the case may be are contained in sections 42(h)(5)(B), 147(c)(2)(B)(ii) and (C)(i), and 469(c)(1)(B) and (h).
176. See note 167 supra.
178. See notes 76 and 77 supra.
179. See 1993 Hearings, note 24 supra:

The special interests' victories proved ephemeral, just as one witness warned in the § 195 hearings of the possible expansion of capitalization doctrines in the business expansion area. And so it happened, first with business expansion costs at the circuit court level and then with INDOPCO at the Supreme Court level as to self-created intangibles in general. Enlightened by Professor Gunn's The Requirement that a Capital Expenditure Create or Enhance an Asset discovered in researching for the Bittker Treatise and the case law business expansion cases of the late 1970s and early 1980s and especially Wolfsen Land & Cattle and NCNB I, I then described in 1986 in the VIRGINIA TAX REVIEW (1) the conceptual and policy weaknesses of the "separate asset" doctrine in business expansion and elsewhere; (2) developed the minimum distortion of income model for distinguishing ordinary deductions from capital expenditures, set forth above, along with its case law and policy support; and (3) in particular noted the judicial tendency to reject an income distorting "nothing" under capitalization without adequate capitalization and to choose instead an also income distorting immediate deduction. (I also criticized on a technical basis section 195 far more than with hindsight I would today.)

1993 Hearings, supra note 24, at 1702 (footnotes omitted). Compared with what was to come, section 195 was a success story. Start up issues now appear rarely in the cases. Cabintaxi Corp. v. Commissioner, 63 F.3rd 614, 620-21 (7th Cir. 1995), is a rare exception. They do still appear in rulings. See notes 76 and 77 supra.
backdrop of amortization not being available, due in perhaps large part to the difficulty of establishing useful lives.\textsuperscript{181} That backdrop shifted after enactment of Section 197's amortization of (purchased) intangibles.\textsuperscript{182} Then Chair Dan Rostenkowski averred in 1991 that the proposal which became Section 197 in OBRA 1993 would not affect advertising costs.\textsuperscript{183} Some members of the Ways and Means Committee presciently warned that

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\textsuperscript{181} GENERAL ACCOUNTING OFFICE, supra note 93.
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An analysis of purchased intangible asset taxation also requires a familiarity with the treatment of costs incurred in creating such assets. Generally, costs of creating long-lasting assets are included, or capitalized, in the cost basis of the asset and deducted over the asset's life. Because some intangible assets, such as goodwill, are not normally considered distinct or traceable assets by taxpayers, most costs of creating them, like advertising expenses, are usually deducted in the year incurred rather than capitalized and amortized over the life of the asset. The result of these tax rules is that purchased goodwill is treated less favorably than other purchased assets, while the costs of creating goodwill are treated more favorably than creation costs of other assets. This unusual result must be kept in mind in devising solutions to the problems of intangible asset tax rules.

Providing specific cost recovery periods for intangible assets may lead to another possible benefit. Taxpayers may be prevented from deducting as current expense certain purchased intangible asset costs that should be amortized for tax purposes following a business acquisition. We have been told that taxpayers may expense certain intangible asset costs after an acquisition for financial accounting purposes because this procedure can improve operating results. At the same time, this practice may cause taxpayers to inappropriately accelerate tax deductions, which could be prevented if amortization of these costs were required over specific cost recovery periods.

A capital expenditure is one that is expected to produce returns for future years, while a current expense is devoted to income production in the current year or other immediate needs. For tax purposes, capital expenditures are recoverable over the life (or capital cost recovery period) of the assets they create, while current expenses are generally deducted when incurred. However, many capital expenditures that create or enhance long-lasting goodwill (or assets that are functionally equivalent to goodwill) are treated as business expenses and deducted in the current tax year. For example, IRS allows a current deduction for most advertising expenses even though the benefit may extend beyond the year in which the cost is incurred. Taxpayers may expense costs associated with some intangible assets, such as advertising that creates goodwill, because, in accordance with judicial interpretations, these intangible assets are not usually considered to be distinct or traceable. An additional reason for this treatment for certain assets may be that it is difficult to determine how much of an expense contributes to the intangible asset and when the asset is created.

A change that would allow recovery of the cost of all purchased intangible assets, including goodwill, would alter the treatment of goodwill for the first time since 1927 and would create uncertainty about the future treatment of expenditures that create goodwill and similar assets. The 1927 regulations disallowing amortization of goodwill have influenced the treatment of intangible asset creation costs by taxpayers, IRS, and the courts. Clarification of the future treatment of such expenditures, even if no change is desired, may be necessary to avoid confusion.

\textit{Id.}

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\textsuperscript{182} \textit{Id.}
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\textsuperscript{183} 1991 Hearings on Intangibles, supra note 32, at 21 (Statement of Chairman Rostenkowski.) ("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.").
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self-created intangibles should not be swept under the rug. Assistant Secretary of Treasury for Tax Policy Ken Gideon refused to be drawn into the issue.

**Political Stories**

"Appropriation Riders" and "Limitation Riders"

The current political climate regarding any tax increases even by regulations, at least as regards the House Republican majority, displays characteristics of the tax political climate of two decades ago. Then the conservative coalition overturned several IRS/Treasury projects through "appropriation riders," which forbade staff from being paid to work on the projects, or "limitation riders," which directed the IRS or Treasury to apply the law without regard to a particular ruling or regulation. Today's
Republican majority in the House reflects in large part the white Southern male voter's replacement of conservative Democrats with Republicans for the first time this century, making the South the most solidly Republican region in the nation. The Conservative Coalition has become the Conservative Partisan Southern-flavored Majority. The lesson to be drawn from those events of two decades ago is the wisdom of building coalitions with professional groups supporting reform effort (often modified to that end) as was done in the "collegial" tax reform achievements of the 1980's.

In addition to the adverse political climate, regulatory reform will be structurally more difficult here than in the closely analogous reform of the tax treatment of purchased intangibles in Section 197. There the very same large taxpayers that were "losers" under the new legislation (for instance, as to intangibles like customer lists), were "winners" as to goodwill or going concern value, which now could be amortized over 15 years whereas case law had allowed no amortization. Moreover, in the aggregate winners and losers tended to balance out. Again there would losers under the model as contrasted with current practice, but there would be few winners who could now currently deduct that which they had previously capitalized and depreciated. This will make revision of the tax treatment of self-created intangibles very difficult politically. The winner here is certainty and reduction of transaction costs.

Pay As You Go or Paygo Strictures

The "pay-as-you-go" or "paygo" procedures governing current tax legislation require any revenue decreases to be offset by (1) increases in revenue from other new tax provisions or (2) decreases in spending, so that there is no net increase in the Federal deficit. In performing estimates for this purpose, the Joint Committee on Taxation establishes a base line...
which assumes that the "present law" being changed yields a certain amount of revenue. A decision such as INDOPOCO overruling the separate asset test (under which most taxpayers currently deducted costs with future benefits) would be taken as establishing the baseline. Thus a legislative reinstatement of the separate asset test would be counted as a revenue loser despite its codifying actual taxpayer practice. This renders near term legislative resolution of current deduction versus capitalization highly unlikely.

3. The Case For IRS/Treasury Regulation

This article argues that guidance should be through promulgation of interpretative capitalization regulations rather than issuance of published revenue rulings because only with final regulations are both taxpayers and the Service bound. Most of the comments submitted to the Service to date argued to the contrary for rulings, but typically they were very specific industry- or issue-oriented and probably assumed (correctly) that narrow relief was easier to obtain. Administratively and politically a global resolution is needed.

a. The Case for (Interpretative) Regulations over other Rulings

The Tax Executives Institute (TEI) makes the case that such guidance should be through regulations and not through the private or even public

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196. Id. (story of Newark Morning Ledger as changing radically the revenue estimates of the enactment of Section 197).
197. See note 119 supra.
198. Taxpayers can use rulings and proposed regulations as a shield. In certain circumstances they constitute substantial authority for purposes of Section 6662. Treas. Reg. § 1.6662-4(d)(3)(ii) (as amended in 1995). But as an IRS sword they are no stronger in the Tax Court than any other Service argument on brief, i.e., they prevail only if convincing as an interpretation of the Code with no presumption attached. Linda Galler, Judicial Deference to Revenue Rulings: Reconciling Divergent Standards, 56 OHIO ST. L.J. 1037 (1995). See generally Ellen P. Aprill, Muffled Chevron Judicial Review of Tax Regulations, 3 FLA. TAX REV. 54 (1996). In the 1990s many circuit courts have come to give more—some even controlling—weight to IRS rulings. Galler, supra, but see Paul Caron, Tax Myopia Meets Tax Hyperopia: the Unproven Case of Increased Judicial Deference to Revenue Rulings, 57 OHIO ST. L.J. 637 (1996). The divergent approaches and resultant uncertainty render the rulings approach as contrasted with regulations even more inadvisable. Moreover, the advantage of the input of public comments in the regulations process is very important. Published rulings would probably end the split between Chief Counsel and field as to the scope of INDOPOCO. Regulations as proposed by this article would be more certain.
199. See note 122 supra.
rulings process.\textsuperscript{200} (1) Private letter rulings have no precedential value although they may constitute substantial authority until they become stale.\textsuperscript{201} (2) The transaction costs are too high taxpayer by taxpayer, particularly where the issues arise only in audit.\textsuperscript{202} The small number of Private Letter Rulings citing \textit{INDOPCO} as contrasted with the large number of Technical Advice Memoranda doing so corroborate this point.\textsuperscript{203} Additionally, private letter rulings and most published rulings have historically been conclusionary with sparse analysis—digest rulings. The fact specific nature of such rulings does not lend itself to development of broader principles. A thesis of this article is that the wealth of ruling experience as to capitalization revealed in pre-\textit{INDOPCO} General Counsel Memoranda and post-\textit{INDOPCO} Technical Advice Memoranda and published Revenue Rulings have set the stage at least for articulating general principles illustrated by examples and perhaps for structured discretionary justice as well.\textsuperscript{204} Following the current incremental path with digest rulings is likely to result sooner or later in various "limitation riders" restricting the Service's application of future benefit capitalization to mixed benefit costs traditionally currently deducted by the taxpayer.

TEI generally urged the Service and Treasury to "promulgate general guidance" (note that regulations are promulgated, revenue rulings are published), but in its more detailed discussion it

urges the IRS and Treasury to publish general guidance clarifying the tests for capitalization or deduction of particular types of expenditures. Specifically, we urge the government to continue to define the boundaries of the capitalization guideline articulated in the \textit{INDOPCO} decision, including its application to the issues identified in parts V and VI below. The greatest benefit to the greatest number of taxpayers — and to the government — will be achieved through the issuance of general guidance. Where ruling guidelines or principles are extant within the Chief Counsel's office (but unpublished), we suggest that such guidelines or principles be publicized in order that taxpayers may have more certainty in properly preparing their tax returns.\textsuperscript{205}

In the nine months following TEI's submission, the Service did release some outstanding TAMs with sound, extensive analysis with sufficient overlap to

\textsuperscript{200} \textsuperscript{200} Comments of TEI on Notice 96-7, \textit{supra} note 69. TEI has been one of the leading critics of revenue agents' widespread proposed capitalization of traditionally deductible expenses in reliance on \textit{INDOPCO}.

\textsuperscript{201} \textsuperscript{201} \textit{Id.}

\textsuperscript{202} \textsuperscript{202} \textit{Id.}

\textsuperscript{203} \textsuperscript{203} \textit{See} note 7 \textit{supra}.

\textsuperscript{204} \textsuperscript{204} \textit{DISSERTATION JUSTICE, supra} note 41, at 103.

\textsuperscript{205} \textsuperscript{205} Comments of TEI on Notice 96-7, \textit{supra} note 69.
indicate that “unpublished” guidelines (small, regularly recurring, and short-term future income) were indeed extant in the Chief Counsel’s Office. At least one National accounting firm publicized these guidelines to its clients by sending them copies of TAM 9645002 which applied such analysis to preoperating costs, including employee training costs. The Service appears to be ignoring TEI’s advice as to publicizing such guidelines. Revenue Ruling 96-62 is more than just another conclusionary digest ruling, merely holding that training costs, “including the costs of trainers and routine updates of training materials, are generally deductible as business expenses . . . even though they may have some future benefit.” It announced that “[t]raining costs must be capitalized only in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer’s trade or business.”

Ordinary course overlaps recurring and short-term future benefits. Primarily for significant future benefits beyond ordinary course expenditures similarly overlaps small. Probably most significant was the traditional ordinary course factor. The National Retail Federation’s Comments urged the Service to issue a number of public rulings on specific questions including employee training costs to clarify that “most expenses incurred by taxpayers in their normal course of business are deductible.” Similarly, the Financial Executives Institute argued that common operating expenses made for the purpose of running a business on a day-to-day basis are currently deductible. The American Bankers Association explicitly requested the capitalization of expenses that have been historically deducted as ordinary and necessary business expenses. But overall, such subtle reasoning is not to be expected in many revenue agents and especially not small business people and any of their non-specialist advisers. This is precisely what TEI and our Submission advised against.

b. **Ideal: Legislative Regulations**

211. Much more soundly the American Bankers Association urged that the standard should be whether expensing clearly reflects the taxpayer’s income. Letter dated May 3, 1996 from Donna J. Fisher, representing the American Bankers Association to John Moriarty, re: Notice 96-7, available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 98-28 (May 17, 1996).
Professor Lee proposed to Subcommittee Chair Rangel’s 1993 House Ways and Means Subcommittee’s second Hearing on Miscellaneous Revenue Matters that Congress authorize legislative regulations to be formulated by the experience the IRS gains from “rulings” applying capitalization factors which either a code section or the legislative history would supply.\textsuperscript{212} (Professor Lee has since discovered that the Service’s ruling experience before and after \textit{INDOPCO} supplies sufficient factual background to act now. Moreover, the recent TAMs display a good grasp of case law doctrine,\textsuperscript{213} unlike the digest published rulings which reveal only conclusions.). The Subcommittee did not act on this suggestion nor on the suggestions for taxation of clean up costs. Nor, for that matter, did it act then on any of the items covered in three days of hearings. So if IRS/Treasury is merely interpreting existing law, a basic question may arise as to their authority to promulgate “rough justice” solutions arguably going beyond the case law.

Similar issues as to Treasury’s authority to promulgate regulations have arisen before, e.g., the original Asset Depreciation Range (“ADR”) regulations,\textsuperscript{214} indexing basis of capital assets for inflation,\textsuperscript{215} and more recently the check-the-box notion for elective treatment as a pass-through or separate entity by most unincorporated entities.\textsuperscript{216} On the other hand, the Chief Counsel’s Office has over the years extensively considered the authority to create safe harbor rules pursuant to its clear reflection of income mandate under Section 446 and the doctrine of administrative convenience.\textsuperscript{217} This article advocates that Treasury/IRS should act globally, providing more detailed and substantive rough justice rules in regulations, including amortization safe harbors. If such regulations are challenged, retroactive congressional codification may be available as discussed below. If the Service instead holds to incrementalism with digest published rulings, well-reasoned TAMs, and in the end unfettered revenue agents, the end result is more likely to be “limitation riders” than judicial resolution. The

\textsuperscript{212} \textit{1993 Hearings}, supra note 24, at 1688, 1699, 1705-06; Coolidge, \textit{supra} note 67.
\textsuperscript{213} See notes 18, 206 \textit{supra} and accompanying text.
\textsuperscript{214} See note 232 \textit{infra}.
\textsuperscript{216} See Treas. Reg. § 301.7701-1 through -3 (as amended in 1996). Joint Committee Chief of Staff Kenneth Kies has questioned whether Treasury has the authority to issue these regulations. Heidi Glenn, \textit{JCT to Go Public about Private Meetings}, 73 \textit{TAX NOTES} 1007 (1996) (Kies recommends legislation to codify new regulation). See generally Fleischer, \textit{supra} note 129.
\textsuperscript{217} See notes 278-301 \textit{infra} and accompanying text.
Administration's strategy is not really apparent. Stonewalling the audit activities of agents has no likelihood of success, but often seems a sign of coming capitulation.

c. "Interpretative" Regulations: Distilling/Codifying Case Law

Looking back no further than the 1954 Code, three historical patterns of drafting regulations which codify case-law rules, and more rarely principles, come to mind. They mirror Professor Davis' paradigm of evolution of administrative rule making.218 Such evolution is more fully discussed below. The first stage is just announcing the conclusion on stated facts. The Service has aptly referred to comparably laconic published rulings as "digest" rulings. This in effect was the pattern of the IRS/Treasury 1993-96 capitalization/expensing rulings, sadly including at first blush Revenue Ruling 96-62.219 IRS considers only ordinary course of business training costs with extremely conclusionary reasoning instead of the full range of start up costs in business expansion and excellent reasoning provided in Technical Advice Memorandum 9645002,220 from which Revenue Ruling 96-62 appears to be digested. The next rung up the evolutionary ladder of agency rule making, but still in the first stage, is promulgating temporary regulations in question and answer form, which still mostly state the question and conclusion but may offer some explanation.221 In the second stage the Service develops from its ruling or audit experience general principles or more often rules implementing the general principles. The Section 183 regulations' nine profit motive factors, derived primarily from the case law, well illustrate this stage.222 In a sense the original 1955 version of the Section 355 regulations with numerous examples illustrating

218. See DISCRETIONARY JUSTICE, supra note 41. See generally Daniel J. Gifford, Discretionary Decisionmaking in the Regulatory Agencies, 57 S. CAL. L. REV. 101, 103, 117 (1983) ("Davis envisions a process through which initially wide discretion is narrowed—first by standards, then by principles, and finally by rules."). For the classic description of incremental decisionmaking by administrative agencies see Lindblom, supra note 42, at 80-88.


221. See, e.g., Temp. Treas. Reg. §§ 1.401(a)-20, 53 FED. REG. 31837 (1988); 1.1(i)-1T, 52 FED. REG. 33579 (Sept. 4, 1987); 54.4976-1T, 51 FED. REG. 31837 (1986); 1.267(a)-2T, 49 FED. REG. 46995 (Nov. 30, 1984); 1.1041-1T, 49 FED. REG. 34452 (Aug. 31, 1984).

a few rules or hidden principles and rules without disclosing the standards, also serves as an exemplum. In any event, the preamble to any proposed capitalization/expensing regulations along these lines should identify sources of the examples much as the earliest Section 385 proposed regulations’ preamble did. The third level in the evolution of administrative rulings is “structured discretionary justice” where regulations set forth specific factors to be used in balancing tests or rules implementing the general principles or standard of the statutory provision. Professor Lee has long thought that the best example is the revised Section 355 regulations, with the new Revenue Procedure on business purposes. These regulations provide (a) the factors to be used in implementing the standards, (b) balancing tests for applying the factors with directions for striking the balance, and (c) numerous examples applying all of this.

Two unacceptable regulation drafting patterns are (1) the hyperlexis as in the Section 385 regulations purportedly mechanizing the debt-equity factors, but really just shifting to the more manageable (i.e., compromisable


224. Almost three decades ago Georgetown Law Center Professor Peter Weidenbruch ably and memorably taught Professor Lee that lesson with those regulations and its commentators (cited in John Lee, Functional Divisions and Other Corporate Separations under Section 355 after Rafferty, 27 TAX L. REV. 453-98 (1972) [hereinafter Lee, Functional Divisions]. He then thanked Professor Weidenbruch for his influence on the Rafferty piece and Tax Court Judge C. Moxely Featherston for patiently teaching him the first skills of legal writing. He recalls their help frequently and ever will be thankful.


226. DISCRETIONARY JUSTICE, supra note 41.


229. Study of these regulations was the laboratory for Professor Lee’s first thinking about these things.
in audit) bifurcation arena;" and (2) arguably the misstatement of general case-law principles as under the temporary Section 338 regulations addressing year 2 contingent income of target corporation as a cost-basis acquisition with earn-out contingent consideration.

The administrative costs of creating and then applying mature capitalization versus expensing factors regulations might be large. But the likely revenue costs of not applying them also is apt to be large since the most likely consequence will be a current deduction sooner or later through litigation or legislation. But the administrative and revenue costs might not be as great for the mid-1990’s transactions as GAO findings and CEP audits as the 1980’s acquisitions might indicate. That data probably reflects more the leveraged buyouts of the 1980s than the more frequent stock merger of the 1990’s, with carryover basis and thus no cost basis of “purchased” intangibles to dispute. Moreover ISP’s and reportedly IRS agents in audits are already examining post-INDOPCO issues, thus administrative costs saved by not applying a multifactor regulatory approach with uniform amortization periods are apt to be spent in audit and litigation.

d. **Bold, Ahead of the Curve Regulations Subsequently Codified by Congress**

A bold, politically risky strategy is to promulgate regulations going beyond the case law as to uniform amortization periods based on the clear reflection of income override as to tax accounting method (which includes

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230. The drafters of the proposed Section 385 regulations reasoned that the reasonable interest or “bifurcation” rule (bifurcating payment for the single instrument into part debt and part equity) does not inquire into the nature of the debenture—is it stock or indebtedness? Instead, it inquires into the nature of the . . . advance—is it payment for the debenture or part payment for the debenture and part contribution of capital? . . . By posing the question in this way, [this provision] attains three goals. First, it replaces the subjective analysis of the case law with a definite question—what is the fair market value of the debenture? Second, it remains responsive to the relevant factors identified by the case law. Many of these factors—e.g., maturity date, right to enforce payment, capitalization, ability of the corporation to obtain loans elsewhere—have a direct bearing on fair market value. [The pertinent provision of the regulations] weighs these factors according to their effect on the fair market value of the debentures. Third, [this provision] makes it easier for the Government and the taxpayer to reach a compromise. Under the case law, debenture is one or the other—stock or indebtedness. There is not much room for compromise. On the other hand, if the taxpayer believes that a debenture is worth $400 and the Government believes that it is worth $300, there may well be a possibility of compromise. The Government does not have to choose between abandoning its position and driving the taxpayer to litigation. *Preamble*, 45 Fed. Reg. 18,956 (March 24, 1980).

capitalization/current deduction practices). Then if commentators criticize their validity as an interpretation of existing law, Congress can come behind and codify the principles and most if not all of the rules into legislation. Historical examples that come to mind of such codification are the *Clifford* Regulations[^232], codified by Subpart I of Subchapter J of the 1954 Code[^232]; the 1968 revision of the Section 305 regulations, codified by the Tax Reform Act of 1969[^234] and close historical analogy of the 1971 proposed Asset Depreciation Range depreciation regulations which were partially codified by the Revenue Act of 1971[^235]. Significantly in the latter instance Congress specifically approved of the simplification approaches taken in the proposed ADR regulations:

The committee recognizes that many of [the] elements contained in the ADR system (including repeal of the reserve ratio test) are designed to achieve significant simplifications in the administration of the depreciation rules by substantially limiting the number of situations in which disputes are likely to arise based on the particular facts and circumstances of the individual taxpayer’s situation. It is contemplated that these elements of the ADR system will be incorporated by the Treasury into the class life

[^232]: Colliton, *supra* note 56, at 289-305, lucidly traces the evolution from Helvering v. Clifford, 309 U.S. 331 (1940) (short duration of trust, beneficiary was taxpayer’s spouse, and retention of control over corpus results in grantor continuing to be owner of corpus), to Clifford regulations (T.D. 54,488, 1946-1 C.B. 19), which supplied rules aimed at duration of trust, power to control beneficial enjoyment and retained administrative controls. *Commissioner v. Clark*, 202 F.2d 94 (7th Cir. 1953), held these regulations invalid. Congress in effect codified the approach of these regulations in the 1954 Code.


[^235]: Pub. L. No. 92-178 § 109 (former 1954 Code § 167(m)). Professor Boris Bittker argued that Treasury did not have the authority [prior to such statutory authorization] to make such “extraordinary departures [ranges of class lives and “repair deduction allowance” as to rehabilitation and improvement expenditures] from widely accepted principles regarding the division between current expenditures and capital items....” Boris I. Bittker, *Treasury Authority to Issue the Proposed “Asset Depreciation Range System” Regulations*, 49 TAXES 265, 266-67 (1971). Possibly prompted by Professor Bittker’s point on repair allowance and capital expenditures, the legislative history states:

It is not intended, however, that expenditures which are clearly of a capital nature, such as, those which substantially increase the productivity or capacity of an existing identifiable unit of property or those which modify an existing identifiable piece of property to make it usable for a substantially different use are to be treated as deductible expenditures under this [repair allowance] provision rather than as capital expenditures.

system provided by your committee's bill.\textsuperscript{236}

At the time of our Submission pursuant to Notice 96-7 we caveated that it was a risky tactic to invite Congressional attention. We warned of the danger of a repeat of the 1970's limitation riders prohibiting the Service's regulation of tax issues without providing a substantive legislative resolution. This we believed was all the more reason to exclude small businesses from more theoretically pure capitalization rules. However, further research and thought on this aspect in connection with \textit{Cyclical Aircraft Maintenance Costs} led to the conclusion that Congress' attention has already been attracted as witness SAIF, soil remediation, and cyclical aircraft maintenance costs.\textsuperscript{237} We believe that this makes the case for an overall regulatory approach rather than piecemeal rulings which threaten to follow a pattern of abandoning the Treasury/Service position, unpopular ruling by ruling.\textsuperscript{238}

\section*{III. \textsc{Capitalization Standards and Rules After \textit{Indopco}}}

\subsection*{A. Overview}

Why should the doctrinal (and tax policy) analysis not stop with future benefit in order to more nearly match expenses and income by deferring deduction of the former until the latter is recognized? The Treasury I approach to multi-period costs which yielded substantial future benefit was to capitalize the cost and depreciate it over the period benefitted (with adjustments throughout the income tax system for inflation).\textsuperscript{239} A number of academics\textsuperscript{240} and the Treasury staff advocate this approach, generally

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\textsuperscript{236} H.R. REP. No. 92-533, supra note 235, at 32.
\textsuperscript{237} See notes 57-59 supra and accompanying text.
\textsuperscript{238} Id.
\textsuperscript{239} 2 TREASURY I, supra note 4, at 202-11.
\end{flushright}

Under current law, certain indirect costs, such as fringe benefits and the cost of borrowing to carry multiperiod production to completion, generally are not capitalized. In addition, the capitalization rules do not apply uniformly to all activities, and they vary depending on whether the output is sold or used in the producer's own business. Long-term contracts, self-constructed assets, inventories, minerals, and timber all have different cost capitalization rules. The Treasury Department proposals will make the cost capitalization rules more comprehensive and apply a uniform rule to all multiperiod production activities.

Making cost capitalization rules more uniform would ensure neutrality across types of
on the grounds of efficiency or perhaps more soundly on neutrality.\footnote{241} The short doctrinal answer is that the courts, Congress and the Service have always tempered the otherwise absolute rule of future benefit results in capitalization with a host of exceptions. The rationale by-and-large explaining these exceptions (often unstated) rests on the premise that in certain circumstances, current deduction of expenditures benefiting future tax years does not distort a taxpayer’s income. The presence or absence of such distortion should be determined under a sort of “second best,”\footnote{242} rough justice balancing of tax accounting and administrative burdens of capitalizing (and depreciating) future benefit costs with the revenue benefits to the Fisc of such capitalization. A current deduction would be permitted where such burdens to the taxpayer, or on more rare circumstances to the Service alone, outweigh the benefits. In such circumstances current deduction clearly reflects the taxpayer’s income. A better formulation of the rule is that such deduction does not distort the taxpayer’s income more than minimally.

B. Timing Distortion of Income

The following proposed rules are derived from the better case and administrative law “straws in the wind,”\footnote{243} implementing this notion of businesses, reduce tax shelters, and improve equity. Uniform rules would eliminate the current tax incentive for businesses to construct their own plant and equipment, even when they are not the most efficient producers. In addition, due to the incomplete capitalization rules, industries with long production processes—the so-called “natural deferral” industries, such as timber and minerals—are dominated by tax shelter investors. Thus, current law results in serious dislocations and inequities. Among the many consequences, shelter investors bid up land prices and drive down product prices in these tax-favored industries; as a result, low-bracket individuals and businesses with little taxable income to shelter can no longer earn a sufficient after-tax rate of return from investments in these activities.

\footnote{241} George Mundstock, Taxation of Business Intangible Capital, 135 U. Pa. L. Rev. 1179, 1183 n.14 (1987), convincingly argues that the case for neutrality, i.e., a tax provision should not modify behavior unless such modified behavior is preferable to the unmodified behavior, is much easier made as to a particular tax provision than the case for efficiency, i.e., “behavior that would occur in the absence of governmental modification probably represents the economy operating as efficiently as possible, so that any tax-induced modification of this behavior reduces economic efficiency.” Id.

\footnote{242} David S. Davenport, Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy, 42 Case W. Res. L. Rev. 793, 797, 869-70 (1992) (“mistakes offset each other and produce a reasonable balance or equilibrium, a kind of ‘rough justice’”); Hamish F.M. Hume, Note, The Business of Learning: When and How the Cost of Education Should be Recognized, 81 Va. L. Rev. 887, 911-13 (1995). We view second best more as easier attainable politically or applied than the ideal solution. See also Hearings on Impact of TRA 1986, supra note 174 (Statement of Commissioner Goldberg) (“While the laws we have enacted are part of the problem, our regulations and administrative practices are equally culpable. We must settle for rough justice, we must recognize that the best is the enemy of the good.”).

\footnote{243} In note 142 supra we outlined Professor Bittker’s balancing entry conception undergirding the Crane doctrine, the tax benefit doctrine, the claim of right doctrine, and the Arrow Smith and Skelly
minimum distortion of income. Expenditures with future benefit are currently deductible under Section 162 where (1) on the average the "asset" created by the expenditure provides a "short term" benefit (generally but not exclusively of one year or less); (2) the expense is "de minimis"; (3) on average expenditure recurs in a "steady state" or increasing level on a "roughly" annual basis (say at least every three years \(^{244}\)), or (4) where depreciation is impractical. \(^{245}\) As a corollary of these rules, if at the time the expenditure at issue recurs, the prior similar expenditures still will yield substantial future benefits, then such future benefits are not incidental. Generally such recurring expenditures should be capitalized and amortized over the longer period benefitted. Where a substantial expenditure on the average recurs in a cycle longer than say three years, it generally should be capitalized as a freestanding amortizable asset (a deferred charge in financial accounting terms). The amortization period could be determined in a common law fashion, by regulation drafting based on how often the expenditure recurs. Uniform amortization periods would save the most transaction costs.

C. Character Distortion of Income

The rules as to character distortion are not as well developed as the timing distortion rules. Essentially the current rule is that more than minimum distortion of income occurs where an expenditure arising out of a capital or non-tax transaction is currently deducted in full against ordinary income. Therefore, at this stage the regulation should be limited to the

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Oil doctrines. The most audacious of these articles, Boris Bittker, Tax Shelters, Nonrecourse Debt, and the Crane Case, 33 TAX L. REV. 277 (1978), spoke of "straws in the wind." In Tufts it shaped the path the wind blew.

244. Tech. Adv. Mem. 96-45-002 had 1-3, which is standard interim drafting. Rev. Rul. 96-62 is more of a digest ruling obfuscating its reasoning. Rather it states that INDOPCO's clarification that creation of a separate asset was not a prerequisite to capitalization did not change the fundamental legal principles for determining whether a particular expenditure can be deducted or must be capitalized. . . . The INDOPCO decision does not affect the treatment of training costs under section 162. Amounts paid or incurred for training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses under that section even though they may have some future benefit.

245. An example is a writer's prepublication costs due to the impossibility of estimating future income (for new writers at least) under the income forecast method of depreciation and the impossibility of determining useful life in such circumstances. Similarly current deduction of soil remediation costs has been allowed at least in part due to the absence of amortization. See note 21 supra.
standard of avoiding character distortion, traditionally expressed as the rule
or doctrine of "origin of the claim," which should be expressed more
through examples than definitions for the reasons stated below. The bold
step here, which has the backing of a few commentators and even fewer,
more obscure judicial straws in the wind supporting it than the other rough
justice rules, but still strongly recommended, is to base denial of deduction
of merger costs on the grounds of character distortion. Current deduction
causes character distortion when the corresponding income in the merger
exchange is not recognized by the target corporation either because Section
361 applies or control of target is acquired and no Section 338 election is
made. This would end the growing brouhaha about hostile mergers yielding
no future benefit.

Although beyond the scope of this article, the following tentative ideal
model for "integration" of the corporate/shareholder tax systems supports the
non-deductibility of most merger costs. The model is a populist adaptation
of Professor Joseph Dodge's two-tier integration model and of Professor
Glen Coven's mandatory carryover of basis model for tax-treatment of
 corporate acquisitions. Professor Dodge would couple (a) annual accrual or
realization of gain or loss as to public stock and (b) annual pass-through of
profit (and perhaps losses) as to non-publicly traded stock, with elimination
of the current corporate level tax in both instances. Professor Coven
proposes to treat all transfers of a going corporate business (whether by a
stock or asset transfer, and whether the consideration is stock or other
property) as mandatory carryover basis (and implicitly non-recognition) at

247. Glen E. Coven, Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules,
248. Dodge, supra note 246, at 266-67 (the rest of the article is rigorous and elegant application
of these ideas). Professor Lee fully agrees with this two tier model. See John Lee, President Clinton's
Capital Gains Proposals, 59 TAX NOTES 1399, 1414, and 1418 (1993) (same proposals in barebones
form). Their reasons are quite different, however, with Professor Lee's being ultimately based on populist
notions of (a) the critical difference between public and closely held corporations being separation of
ownership and control, and (b) and thus the current graduated inside corporate rates where most of the
owners materially participate violating horizontal and vertical equity. See Lee, Entity Classification,
supra note 80, at 67-68, 86-88 and n.118, 96, 100-01, 107-08; see also Joseph A. Snoe, Entity
Classification under the Internal Revenue Code: A Proposal to Replace the Resemblance Model, 15 J.
CORP. L. 647, 649 (1990) (more clear and more elegant articulation of similar model). Professor Lee's
shift from calling for a schedular large business sector tax (or pass-through integration as to public
companies) to annual accrual as to public stock was strongly influenced by David J. Shakow, Taxation
Shalkow's suggestion that closely held companies should be encouraged to go public ignores the real
world of amount of assets (and corollary of amount of income) and absence of outside investors as to
the almost 2,000,000 close C corporations (with very few shareholders on the average) as contrasted with
6,000 or so large public corporations. Instead we should be mandating, or at least encouraging, pass-
through treatment as to C corporations where the owners are active in the business.
Professor Lee’s favoring of a passthrough approach where ownership and management are not separated results in an “aggregate” approach to an entity where more than one owner/manager is involved. The essence of the aggregate approach is to treat the owner as near as possible as if she owned the business directly. Under this conceptualization two entrepreneurs joining their owner-managed businesses together would not be taxed because neither has yet disposed of her business. This is particularly clear in the case of entities actually subject to Subchapter K of the Code, where built-in gain or loss at the time of the merger usually must be specially allocated after formation/merger of the businesses to the owner of the business prior to the merger/formation. In short, mergers of publicly traded and closely held corporations with like corporations ideally should be treated as non-recognition transactions. Consequently, to allow a current (or any) deduction for the costs of such income would result in a distortion of income on a character basis rather than timing basis, as Alan Gunn pointed out over two decades ago. But for Professor Lee’s collaboration with Bittker on his Treatise, Lee would not have discovered in the late 1970’s Gunn’s prescient, seminal scholarship here.

D. Rough Justice Exceptions to the Future Benefit Capitalization Presumption

Professor Lee has long advocated the following “rough justice” rules, now the apparent consensus of practitioner commentators and taxpayer representatives including many of the submitters (as least as to
steady state recurring and de minimis amounts and the balancing process)\textsuperscript{254} and of student commentators.\textsuperscript{255} Moreover, the Solicitor

\textsuperscript{254} Comments of Tax Executives Institute, INC. on Notice 96-7 dated March 20, 1996, \textit{available in LEXIS, Fedtax Library, TNT File, 96 TAX NOTES TODAY 60-19} (March 26, 1996)

General's office raised similar arguments in INDOPCO as to the recurring component of the model (which is the acid test for the minimum distortion of income approach).

While capitalization is conceptually necessary for all expenses that create a material future benefit, the goal of achieving an accurate measure of net income is a pragmatic one. Expenses of advertising and maintenance create both present and future benefits, but capitalization is not required as a practical matter even though some future benefit results, because the current benefit predominates and the expense is a regularly recurring one, so you achieve essentially the same statement of income whether you deduct the entire expense in the current year or whether you amortize a portion that relates to the future benefit each year. Since the current deduction for those kinds of recurring expenses would not materially misstate income, they are allowed.256
The Chief Counsel's Office in TAM 96-45-002 recently reasoned correctly that:

Capitalization is not required for every expenditure that produces a future benefit. This proposition was explicitly stated by the Supreme Court in *INDOPCO* when it noted that the mere presence of an incidental future benefit may not warrant capitalization. 503 U.S. at 87. Further, the logical extension of requiring capitalization of all costs that produce future income is that almost every business expenditure is capitalizable. That this position proves too much was acknowledged by the court in *Encyclopedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982)(cost of editorial services in developing a new book held to be capital), rev'd T.C. Memo. 81-255 (1981). In that case, the court started with the proposition that where income is generated over a period of years, the expenditures should be classified as capital. 685 F.2d at 214. But the court went on to note the practical difficulties in using this approach which would result in practically every expenditure being capitalized. 685 F.2d at 217. The court reasoned that the distinctions between recurring expenditures and nonrecurring expenditures provides a crude demarcation in determining whether an expenditure should be capitalized or deducted currently. *Id.* Based on these distinctions, the court held that the royalties at issue were capital. *See also* Mountain Paper 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). Although a capitalization result was ultimately reached, *Encyclopedia Britannica* is important because the court acknowledged that not every cost producing future income must be capitalized and that the recurring nature of expenditures helps distinguish between items that are deductible under section 162 and those that must be capitalized under section 263. 257

adopted the separate and distinct asset test as a panacea for all capitalization questions. In a literal sense, the fact that an expense creates an asset that is separate and distinct is neither necessary nor sufficient for capitalization. Prepaid rent expense for 6 months is a distinct capital asset, but it's fully deductible if it's fully consumed in the current year. A ballpoint pen is an asset, and it may well provide benefits beyond a single year, but it's fully deductible as a regularly recurring ordinary business expense. *Id.* (emphasis added). These points, of course, were presented on brief. *Brief for Respondent at 13-14, INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1983) (No. 90-1278).


The recurring nature of the costs at issue supports allowing Taxpayer a current deduction for the pre-opening costs. As noted above, "the distinctions between recurring expenditures and nonrecurring expenditures provides a crude demarcation in determining whether an expenditure should be capitalized or deducted currently." *Encyclopedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 214 (7th Cir. 1982); *see also* Rev. Rul. 89-23, *supra.* In this case, the pre-opening costs are recurring costs that Taxpayer incurs in operating all its stores. These costs include the cost of stocking the stores with inventory and supplies, staff
Unfortunately some of the strength of this reasoning is dissipated with the publication of Revenue Ruling 96-62 in superficially digest form granting a current deduction for worker training costs. No explicit reasoning is provided beyond platitudes that INDOPCO did not change the capitalization doctrine. The implicit reasoning such as this Article reads into the sparse statements of facts should satisfy the craft bias of tax academics and professionals as to complexity. Professor Lee is beginning, however, to think that if Appeals begins to apply its audit stances as to post-INDOPCO capitalization of traditionally deductible costs of business operation, legislative suspension until regulations ideally “negotiated” and employing “structured discretion” as “rough justice” factors are promulgated might not be a Second or Third Best or so strategy. It wouldn’t be the first nor even the second time Professor Lee’s understanding has evolved here.

The minimum distortion of income/rough justice analysis in TAM 96-45-002 is consistent with the leading judicial authorities and administrative reasoning. Justice Harry Blackmun in Lincoln Savings and Loan, now properly read for the proposition that an expenditure incurred to enhance or create an asset producing substantial future benefit generally should be capitalized, caveated that “the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.” Justice Blackmun two decades later in INDOPCO reiterated that the mere presence of an incidental future benefit may not warrant capitalization. He left to others the cataloging and explaining of the exceptions.

Judge Richard Posner in Encyclopaedia Britannica cautioned that capitalization of all costs producing future income would result in almost every business expense being capitalized, an unadministrable result.

If one really takes seriously the concept of a capital expenditure as

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training, store promotional costs, utilities, rent and other related miscellaneous expenses for goods and services already provided to Taxpayer. The recurring nature of these costs suggests that they should not be capitalized under section 263.

Id. 258. See notes 207-210 supra and accompanying text.


260. Lincoln Savings, 403 U.S. 345, 354. This was the peg for the separate asset doctrine. Gunn, supra note 23 and Lee & Murphy, supra note 28, showed that the separate asset doctrine was unsound and not mandated by Lincoln Savings. The doctrine was by and large a reaction to IRS overreaching in requiring capitalization without allowing any (or only inadequate) depreciation. NCNB I, 651 F.2d at 959; Lee, Start-Up Costs and Clear Reflection of Income, supra note 16, at 51-6.

261. INDOPCO, 503 U.S. at 87.
anything that yields income, actual or imputed, beyond the period . . . 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. . . . 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. 262

Professor Boris Bittker had earlier used the same reasoning and example as *Encyclopaedia Britannica*:

[I]f the IRS seriously endeavored to disallow every cost contributing to the profits of future periods, it would be necessary to divide almost every salary and advertising expense between its immediate impact on the customer and its contribution to the company's long-lived goodwill. Recognizing this fact of business life, the Supreme Court has said that "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year." 263

The Fourth Circuit panel in *NCNB I* similarly described these exceptions as "situations involving considerations of pragmatism and uncertainty in which, with the blessing of the Commissioner, taxpayers may deduct currently certain expenditures, notwithstanding the presence of

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263. 1 BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶20.4.1, at 20-67 (1st ed. 1981) (quoting Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971)). Professor Lee had long found both statements compelling. Upon rereading Lee, *Section 183 and Beyond*, *supra* note 76, at 462, for this project, he can see why: "increase in earning power or benefit to future years is not alone sufficient [for capitalization], otherwise all ordinary and necessary business expenditures resulting in greater profit would have to be capitalized, which is not the law." *Id.* (criticizing increase in earning power rationale for capitalizing start-up costs). The "law" Lee had in mind was above all Judge Tannenwald's concurring opinion in *Primuth*. (Note that Judge Samuel Sterrett wrote the majority opinion in *Primuth* and decided the sleeper *Wolfsen Land and Cattle*.) He had been a clerk at the Tax Court when it was decided in court review and recalls the excitement we all felt at the new development. Then Lee might know the rule, but not likely the reason therefor. In any event, once Lee mapped out the minimum distortion of income/rough justice exception to future benefit capitalization model, if start-up costs and clear reflection of income isn't attention grabbing enough, he'll keep on sorting out the rough justice rules and restating them and the minimum distortion of income standard. Lee keeps on chewing that old rag, because he keeps finding proof in the case law, Service or staff policies and commentary that his trouble or better care is worth it. Lee is grateful to all who have encouraged that care over the years, not the least of which has been repeated scholarship support from the College of William and Mary and the Law School used on aspects of this subject over the years. And he thanks all who have listened and given him feedback in the halls, lounges and classrooms or wherever, and to the critics who helped sharpen the focus. And always Lee thought of Bittker's pragmatism as he worked on this task.
probable future benefit." The panel majority dubbed this a "not-worth-the-trouble exception." Judge Tannenwald in Sun Microsystems employed the more neutral term of "incidental future benefits" used in INDOPCO. In Sun Microsystems the taxpayer, a beginning high-tech company, argued that issuance of stock warrants to a new, major customer based upon volume of future purchases constituted sales discounts; while the Government argued that under the "new look" that was given to the issue of business expense versus capital expenditure by INDOPCO, the stock warrants represented the capitalizable cost of an investment opportunity to develop a long-term relationship with the customer. Judge Tannenwald responded:

We find it unnecessary to refine this claimed "new look" for the purpose of our decision herein. In the first place, INDOPCO stands primarily for the proposition that a separate asset is not necessary in order to characterize a payment as a capital expenditure. In the second place, INDOPCO articulated this proposition in the context of a situation which clearly involved a capital transaction. Finally, the Supreme Court recognized that, while realization of future benefits is important in determining existence of a capital expenditure, "the mere presence of an incidental future benefit — 'some future aspect' — may not warrant capitalization". INDOPCO . . . "[T]he anticipated long-term benefits to SMS [the taxpayer] from the relationship with CV [the customer] were 'softer' and were speculative, compared to the immediate benefits to SMS of the anticipated sales of computer workstations to CV under the Purchase Agreement."

We conclude that the instant situation falls within the "incidental future benefit" category reflected in INDOPCO. Cf. Snyder v. United States, 674 F.2d 1359, 1365 (10th Cir. 1982) (author's expenses in connection with a book to be published in future held deductible); Primuth v. Commissioner, 54 T.C. 374 (1970) (fee in order to secure employment held deductible); Rev. Rul. 92-80, 1992-2 C.B. 57 (INDOPCO does not

264. The Commissioner allows current deductions for some repair and educational expenditures which will benefit a taxpayer during subsequent tax years. In addition, Congress has made many exceptions to the general rule, for instance, by providing for the current deductibility of research and experimental expenditures. See I.R.C. § 174 (1997). Finally, there is a residuum of current expenditures which will have some future benefit but which "cannot, as a practical matter, be associated with any other period" and allocation of which "either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose. These 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.

265. Id. at 953.

266. 66 T.C.M. (CCH) 997 (1993).

267. INDOPCO, 503 U.S. at 87 ("although the mere presence of an incidental future benefit— 'some future aspect [is not controlling, from Lincoln Savings]— may not warrant capitalization . . .").
preclude deduction of advertising expenses having a future benefit); see Lee, "Doping out the Capitalization Rules after INDOPCO", 57 TAX NOTES 669 (Nov. 2, 1992); Note, "Deductibility of Takeover and Non-Takeover Expenses in the Wake of Indopco", 45 TAX LAW 815 (1992).

Indeed, the long-term benefits herein appear to be no different than those present in stock options given to employees which were held not to impair their compensatory character even before the enactment of the statutory framework that now exists. See Commissioner v. LoBue . . . . 268

1. Balancing Test

While the author of the majority opinion in NCNB I probably intended a disparaging import to the "more trouble" description, he in fact succinctly described the proper approach to expensing versus capitalization/depreciation. It is a balancing test as shown by the Court of Claims in its landmark opinion in Cincinnati N.O. & Tex Pac. RR:

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. 269

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268. The Chief Counsel's Office casts further light on the "incidental benefit" notion in Tech. Adv. Mem. 96-45-002 (business expansion costs in the same geographic area generating predominantly short-term benefits currently deductible notwithstanding incidental future benefits citing Iowa-Des Moines Nat'l Bank, Sun Microsystems [importance of immediate sales], and advertising authorities). Judge Tannenwald, for decades highly regarded for his command of and influence on tax doctrine, played a major role in developing the doctrine as to capitalization. He was the author of Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283 (1967), the seminal reading of Sections 263 (capitalization of amounts paid for permanent improvements or new buildings) and 446 (taxpayer's tax accounting method must "clearly reflect income") are "inextricably intertwined. A contrary view would encase the general provisions of section 263 with an inflexibility and sterility neither mandated to carry out the intent of Congress nor required for the effective discharge of respondent's revenue-collecting responsibilities."). Fort Howard in turn provided the conceptual underpinning for Cincinnati N.O. & Tex Pac. RR v. United States, 424 F.2d 563, 569 (Cl. Ct. 1970), for its adoption of a minimum capitalization rule under the clear reflection of income standard. (Both cases appeared to have inspired Professor Lee's friend Alan Gunn.) Moreover, Judge Tannenwald's concurring opinion in Primuth, 54 T.C. at 381, 382, is among the first to note that educational and advertising expenses are currently deductible despite future benefits. Judge Tannenwald's opinions 25 to 30 years ago looking across narrow doctrinal lines to underlying concepts in the business expense and capitalization area inspired Lee back then to try to think that way. An early attempt along those lines caught Boris Bittker's eye (his letter asking for a reprint has hung framed on the wall of Lee's several offices for the past 24 years) probably resulting in Bittker's honoring Lee by asking him first (with two others) to Collaborate on his Treatise. That endeavor lead Lee to Alan Gunn's work and the first steps beyond doctrine. Alan has helped Lee over the years take more. So has Lee's colleague and friend, Charles Koch, always good at the mot juste as well as beau geste.

269. Cincinnati, 424 F.2d at 572. The opinion also noted that "[t]he 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." Id. The court found that the distortion was nil by comparing "both on a year-to-year basis and on a 17-year overall basis, the
The Eighth Circuit in *Iowa-Des Moines National Bank* implicitly endorsed such a balancing approach: "where the prospective benefit is very slight, capitalization is not easily supported." Again Judge Posner summed it up well in *Encyclopaedia Britannica* in rationalizing the current deductibility of steady-state recurring expenditures: "the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization."

Congress, too, has approved on occasion a balancing approach as to capitalization versus expensing issues. For instance it authorized Treasury to take just such that approach to fashioning exceptions under legislative regulations to the uniform capitalization rules: "The [Section 263A] regulations may adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits." The Service based the Notice 88-62 safe harbor on just that easing of administrative complexities. The Notice granted an elective safe harbor for tax accounting for qualified costs incurred by authors, photographers, and other artists in producing creative properties. Eligible taxpayers could capitalize all aggregated qualified creative production costs incurred during the taxable year and deduct 50% of such costs in that year and 25% of such costs in each of the two succeeding tax years. The Service explained in Notice 88-62 that this creative costs safe harbor was provided in response to Congress’ (a) awareness of possible administrative complexities of application of Section 263A (and depreciation now under Section 167(g)) and (b) its grant of rulemaking authority under Section 263A to "adopt . . . other simplifying methods" under a balancing test of costs and burdens of literal compliance outweighing the revenue benefits, similar to that proposed in this article. It did not hurt that Congress was in the process of disallowed minimum rule expenses . . . to the amount of depreciation that would have been allowed under the defendant's method." *Id.* at 571-72. See generally Gunn, supra note 23, at 456-7. Alan pointed to the exceptions to future benefit capitalization for tools, professional books and equipment, and work uniforms, concluding that

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

*Id.*

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272. S. REP. NO. 99-313, supra note 76, at 142. See *id.* at 140 ("appropriate exceptions where application of the rules might be unduly burdensome.").
273. Section 3.02, 1988-1 C.B. 548.
retroactively carving such costs out from Section 263A anyway.\(^{275}\)

Benefits of capitalization may be analyzed on several levels: (1) the horizontal equity of treating most all costs benefiting at least several tax years (i.e., 4 or more) alike. This would effect the tax policy goals of neutrality or economic efficiency and horizontal equity and is probably the position of Treasury staff. (2) Benefit to the courts applying such a balancing test to capitalization means whether over a multi-year period capitalization will yield more revenues to Treasury than expensing would. This analysis comes closest to Professor, now Judge, Sneed's tax policy of adequacy of revenues.\(^{276}\)

The burdens of capitalization can be analyzed as well on several levels. The administrative burdens to the taxpayer are greatest where no or inadequate depreciation is available or the small taxpayer for whom record keeping is difficult. Also the administrative burden is great where the Service and taxpayers have frequent audit and litigation disputes. This is then Professor now Judge Sneed's tax policy factor of simplicity.\(^{277}\)

2. Administrative Convenience

The Service has not yet explicitly adopted such a balancing approach to resolving expensing versus capitalization issues. From time to time, however, the Chief Counsel's Office has recommended adoption of one or another of the rough justice exceptions advocated in this article. Generally that Office's rationale for such recommendation has been "administrative convenience."\(^{278}\) Gen. Couns. Mem. 33,968,\(^{279}\) advocating without

\(^{275}\). Writer's Prepublication Costs, supra note 40, traces the 1987 and 1988 efforts culminating in the exclusion of "creative costs" from Section 263A.

\(^{276}\). Joseph T. Sneed, The Criteria of Federal Income Tax Policy, 17 STAN. L. REV. 567, 569-70 (1965); Edward Yorio, The President's Tax Proposals: A Major Step in the Right Direction, 53 FORDHAM L. REV. 1255, 1263 (1985) ("In its narrower sense, the adequacy criterion refers to the aggregate revenue effect of a particular provision in the tax law. If a proposed change in the Internal Revenue Code will result in a significant loss in revenues, the criterion is badly served. If the proposal will generate additional revenues, the criterion is satisfied." (Footnotes omitted).)

\(^{277}\). Sneed, supra note 276, at 573; Yorio, supra note 276, at 1256-57.

\(^{278}\). Package design procedures explicitly state that various safe harbor amortization rules are for "administrative convenience" to "minimize controversies." Rev. Proc. 90-63, Sec. 3.05, 1990-2 C.B. 664, 665; Rev. Proc. 89-17, Sec. 3.02, 1989-1 C.B. 827. (Rev. Rul. 89-23, 1989-1 C.B. 85, required capitalization of package design cost with a useful life of greater than one year.) Since Rev. Proc. 90-63 the Service's Examination Division has allowed taxpayers to change their method of tax accounting for package designs and elect any one of the 3 methods outlined in the revenue procedure. This practice was formally approved in the Food ISP, Sept. 20, 1992, available in LEXIS, Fedtax Library, TNT File, 93 TAX NOTES TODAY 179-33 (Aug. 27, 1993). Commentators have referred to Rev. Proc. 90-63 as "administrative grace". Hal Gann & Roy Strowd, INDOPCO — Time for the Second Shoe To Drop, 69 TAX NOTES 1045 (1995). Then Assistant Chief Counsel (Income and Tax Accounting) Glenn Carrington held up the package design settlement as a model for capitalization issues. IRS Environmental Cleanup Guidance May Be Out By July, Official Says, 1993 DAILY TAX REPORT 89 d15 (May 11, 1993)
success a current deduction safe harbor for writer’s prepublication costs, extensively discussed the concept of administrative convenience. The GCM pointed out that there was ample legal precedent for capitalizing such prepublication costs because they yield future benefits in the form of a manuscript intended to produce royalties.\(^\text{280}\)

While there would thus appear to be a sound legal basis for requiring authors to capitalize all of their expenses, such a requirement gives rise to considerable practical difficulty in the case of a professional author, whose work over a period of time will encompass numerous literary projects. Particularly where such an author works on several projects during a taxable year, as may often be the case, it would be most difficult for him to capitalize and allocate to particular projects all of his recurring-type costs, such as rent, supplies, and secretarial assistance. To make such an allocation with any degree of accuracy would in many cases require the use of a rather complex cost-accounting system, based on careful records of time spent on various projects. And in many cases the actual tax effect of recovering expenses through capitalization would be little different from recovering them through current deductions, since a professional author would appear to have a sound legal basis in section 263(a), since it can be said that expenses incurred by an author in writing a book are costs of improving the value of property, i.e., the manuscript, within the meaning of section 263(a). There is even considerable legal support for requiring capitalization of overhead-type expenses, such as office rent and secretarial salaries.

\[\text{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." Id. It might be noted that the Service had gone through a few gyrations in treatment of package design costs before arriving at this resolution. Rev. Rul. 89-23 requires package design costs incurred after 1986 to be capitalized. The ruling originally stated that the cost of package designs could not be amortized under Treas. Reg. § 1.167(a)-3 because a useful life could not be ascertained. Rev. Proc. 90-63 revoked Rev. Proc. 89-16, 1989-1 C.B. 822, and Rev. Proc. 89-17, 1989-1 C.B. 827. 279. Gen. Couns. Mem. 33,968 (November 18, 1968). The ruling to be published should make clear that the decision to permit current deduction of overhead-type expenses is based on administrative, rather than legal considerations, so that the Service will not be prejudiced in litigating cases involving taxpayers other than professional authors in which it is deemed appropriate to take a position that overhead-type expenses should be allocated to acquisition of a capital asset rather than deducted. Id. 280. Gen. Couns. Mem. 33,968 (November 18, 1968). The principal published rulings on this point, I.T. 1287 and Rev. Rul. 68-194, indicate a Service position to the effect that an author may never currently deduct expenses incurred in writing books, but must capitalize all expenses by allocating them to his basis in particular manuscripts. This position would appear to have a sound legal basis in section 263(a), since it can be said that expenses incurred by an author in writing a book are costs of improving the value of property, i.e., the manuscript, within the meaning of section 263(a). There is even considerable legal support for requiring capitalization of overhead-type expenses, such as office rent and secretarial salaries. Id.}\]
may be expected to have continuing income from his writing over the years, as well as continuing expenses of an overhead nature.

... In view of the foregoing considerations, we believe the Service should adopt an administrative policy of permitting professional writers to deduct currently their expenses of a continuing nature, and we recommend publication of a ruling to state such a policy. 281

Gen. Couns. Mem. 34,262 indicates the nature of some of Chief Counsel’s administrative concerns in this area. That GCM recommended that the Service “administer the deductions attributable to the cost of such elements [e.g., purchased customer lists covered twenty-three years later in Section 197] with rulings or revenue procedures rather than have the courts do it on the authority of Cohan. The latter type determinations (Manhattan is an example) are not predictable.” 283 The Chief Counsel’s Office has

281. Id. Note the emphasis on burden to the taxpayer and minimal increase in revenues to the Treasury. No ruling was ever issued; instead the Government lost its denial a refund claim by a professional writer for a deduction as to prepublication costs. To similar effect as Gen. Couns. Mem. 33,968, see Gen. Couns. Mem. 38,410 (June 18, 1980). In articulating “the proper standard for determining whether a cost is a capital expenditure under I.R.C. § 263,” it stated that

We previously considered these cases in G.C.M. 35,116. *** I-4895 (Nov. 14, 1972) and in a proposed G.C.M. in *** I-4178 and expressed the opinion that any expenditure resulting in either the acquisition of an asset having an economically useful life beyond the taxable year of acquisition or the securing of an advantage having a life greater than one year constitutes a capital expenditure. We also noted that the recurrent (or nonrecurrent) nature of the expenditure is an appropriate basis on which to distinguish capital from ordinary expenses. Applying these standards, we concluded that the expenses incurred in *** were nonrecurring expenses that would substantially benefit future periods through acquisition of the core of a credit system and were, therefore, capital expenditures. Further, we concluded that, with the exception of timetable costs and station rentals, the expenses in *** were nonrecurring expenditures that would substantially benefit future periods and, therefore, were capital expenditures.

While we believe our position has substantial merit, we accept your [separate asset] approach as outlined above and its application to these cases in view of the practical considerations involved, including the lack of sympathetic appeal of our position due to the total denial of deductions and the continued losses in the circuit courts. See Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973); Jack’s Cookie Co. v. United States, 597 F.2d 395 (4th Cir. 1979). This, of course, will not resolve the myriad questions concerning what is and is not a separate asset or property interest that will have to be answered in future cases.

Id. (Emphasis added).


283. The GCM has attached a Tax Court Division of Chief Counsel’s Memorandum dated November 19, 1969, which is the source of the quotation in text and which offered the following equitable solution.

Third, inasmuch as the amount of litigation in this area is increasing, it may be appropriate to discuss the question with the Assistant Commissioner (Technical) to determine whether some of the problems can be handled with rulings or procedural guidelines rather than litigation. It may be that some portions of the cost of an asset traditionally considered to be a “mass asset” represent depreciable elements of such asset. In the long run it may be
to the interest of the Service to administer the deductions attributable to the cost of such elements with rulings or revenue procedures rather than have the courts do it on the authority of Cohan. The latter type determinations (Manhattan is an example) are not predictable: We cannot determine without a litigation how much of the cost of a particular “mass asset” represents a depreciable element. Nor are we presently aware of an accepted factual basis upon which such an apportionment of costs can be made. We think that a precedent establishing the use of Cohan on this issue will lead to excessive litigation. Generally, the taxpayer will come away with something and therefore it will be to his interest to litigate. Moreover, for similar reasons we also suggest that some consideration be given to the problem of the useful life of each particular element of the depreciable portion of the “mass asset,” assuming that the Manhattan approach is followed. Specifically, would it not be feasible to allow taxpayers to establish an average useful life by proving the useful life of a representative number of the elements of such asset. Using Manhattan as an example, and accepting the Tax Court’s determination that 75 percent of the cost of the laundry customer list is allocable to depreciable elements, would it not be feasible, from the administrative point of view, to allow the taxpayer to establish the period over which such asset is to be written off by showing the useful life of the representative number of customers on the list. Thus, if the taxpayer was able to show that the length of time he will continue doing business with the customers in the representative sample is five years, an amortization period of five years could be used rather than requiring him to prove the useful life of the data relating to each and every customer on the list. It may also be possible for taxpayers to establish statistically that a specified percentage of the elements of the “mass asset” will be consumed by the end of a time certain. An amortization period could be based upon such a “fail rate” and would produce the “reasonable allowance” required under section 167. Compare sections 1.47-3, 1.47-4, and 1.47-5 of the regulations and Rev. Rul. 67-378, 1967-2 C.B. 45, the latter containing the standard mortality dispersion table which taxpayers may use to compute the qualified investment in mass assets in lieu of data from their own experience.


285. [W]e recognize that based solely on administrative convenience your conclusion has some merit. To achieve the correct legal result herein would cause great difficulty in preparing Forms W-2 and for data processing operations, since the Form W-2 generally controls the amount of compensation received in a year. Adoption of the conclusion we believe to be correct could force a time consuming reprogramming effort and force agencies to confer with individual employees before preparing year-end Forms W-2.

Thus, because of these administrative considerations we have no objection to your position. However, if it is challenged in court, we will have much difficulty defending it. Therefore, we suggest that you reconsider publication of this ruling.


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Similarly, Gen. Couns. Mem. 35,109 (Nov. 10, 1972), recommended hiding the ball in Rev. Rul. 73-188
This contradistinction between administrative convenience and the conceptually pure rule may have been part of the reason why the Commissioner frequently, even mostly, ignored the Chief Counsel's recommendations of simple solutions to the tax treatment of expenditures benefitting present and future tax years.\textsuperscript{286} Another issue may be that audit does not have to face the courts as Chief Counsel does. As discussed above,\textsuperscript{287} these solutions should be viewed instead as rough justice or equitable solutions, easier to administer and fair on the average, in lieu of more theoretically correct rules. This is especially so where the standard is clear reflection of income. Rough justice rules implement the more practical minimum distortion of income gloss. An oblique indication that the Chief Counsel's Office may be coming around to balancing burdens and benefits of capitalization/depreciation may be seen in TAM 96-38-002\textsuperscript{288} where for the first time a TAM cited Iowa-Des Moines for the proposition that where the future benefit is slight the burdens of capitalization/depreciation will outweigh such benefit, resulting in a current deduction. Unfortunately the strength of TAM 96-38-002 is undercut by the issuance of Rev. Rul. 96-62 in an almost digest form.\textsuperscript{289}

3. Clear Reflection of Income Authority

Other Chief Counsel's Office analyses of rough justice expensing/capitalization rules do indeed focus on the Commissioner's broad enforcement by stating that the useful life of a depreciable "business advantage" (governmental mandated improvements benefitting and paid for by the taxpayer but belonging to the governmental unit when really he period stated was only the period over which the taxpayer had to make the payments. Much more defensible was Chief Counsel's reasoning in Gen. Couns. Mem. 36,074 (Nov. 11, 1974), considering Rev. Rul. 75-62, 1975-1 C.B. 188: "In view of the lack of any demonstrable legislative purpose or legal reason, we think it appropriate to consider questions of administrative convenience."\textsuperscript{286} Chief Counsel suggested administrative convenience safe harbor rulings (that were never published) as to minimum capitalization, current deduction of writer's prepublication expenses, and separate asset test as to business expansion, see notes 291-94 and 307 infra and 279-280 and note 18, supra respectively.

287. See supra notes 254-56.

288. Tech. Adv. Mem. 96-38-002 (June 3, 1996); see Tech. Adv. Mem. 96-45-002 (June 21, 1996) (cited Iowa-Des Moines for the proposition that "expenditures to produce current income are deductible currently even though some incidental future benefit may result"). Both TAMs are very well written and reasoned as well as a joy to deconstruct. Georgetown Law Center Professor Peter Weidenbruch, Jr., then director of the LLM in Taxation program and later Assistant Commissioner Technical in charge of IRS rulings, taught Professor Lee to turn to law reviews first for research and turned him on to Section 355 and deconstructing regulations. Auditing now Emeritus Professor Art White's Tax Research Methods at William and Mary (in preparation for teaching it), further honed tea leaf reading of Government documents. LEXIS research over the past few years in the Fedtax Library, Memos and Rels files has added immeasurably to my understanding of how the Office of Chief Counsel institutionally approaches issues. Lee is ever thankful to our Law Librarian Professor Jim Heller and LEXIS.

289. See notes 18 and 208-11 supra and accompanying text.
authority under the clear reflection of income standard. That standard lies at the heart of capitalization as ably recognized by the Court of Claims in *Cincinnati, New Orleans & Texas Pacific Railway v. United States* following Judge Tannenwald's lead in his *Fort Howard* opinion. In General Counsel Memo 34,959 Chief Counsel's Office recommended a "minimum capitalization rule," derived from *Cincinnati, New Orleans & Texas Pacific Railway v. United States*, that would have provided a practical guide for any taxpayer having small items used in her trade or business or in the production of income. Purchases under $100 could automatically be expensed while larger amounts benefitting future years also could be expensed if such method of tax accounting "is generally accepted by the accounting profession for that industry and produces no distortion of income." The GCM bottomed this rule on the clear reflection of income standard of Section 446 which also underlies the capitalization rules.

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

Code §§ 446 and 461 provide the general authority to prohibit deductions in the year the expense item is paid or incurred if to allow the deduction in that year would not clearly reflect income. See G.C.M. 34547, *** I-3029 (July 1, 1971), at 2. However, Code § 446(b) and (c) provides the Commissioner with very broad authority to determine (1) whether a particular taxpayer's method clearly reflects income, and (2) whether particular methods of accounting generally may be used by various taxpayers even though such methods may deviate in certain respects from traditional tax accounting methods. Thus, while we believe those provisions provide authority for the Commissioner to prohibit deductions where such is necessary to prevent a distortion of taxable income, we also believe they provide authority for the Commissioner to permit certain deductions where a deduction is seemingly proscribed by a particular

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290. *Cincinnati*, 424 F.2d at 569 ("this court agrees that the capitalization and depreciation provision . . . and the method of accounting provision . . . are 'inextricably intertwined' and must be used in conjunction in deciding the ultimate success of the taxpayer's method in clearly reflecting income.").


292. *Cincinnati*, 424 F.2d at 571-2, approved a minimum expensing rule of $500 which ICC required railroad companies' accounting systems to follow. Gunn, *supra* note 23, at 457 n.61, points out that the 1954 ALI Draft Code contained a $500 minimum capitalization rule expenses. That would be more than $2,500 in current dollars.

provision of the Code.

We recognize that by regulations and longstanding ruling practice the Service has definitely limited the Commissioner's discretion in this area. However, we are unaware of any such limits that would prevent the exercise of the discretion we now propose. As we suggested in G.C.M. 34547, pp. 9-12, we believe section 461 gives the Commissioner authority to direct the timing of deductions in a manner that will clearly reflect income. Although the exercise of this authority has generally been aimed at proscribing methods that fail to clearly reflect income, there is little doubt that it is broad enough to permit the recognition of additional methods that allow a clear reflection of income, even though such methods may appear to be a variance with a narrow interpretation of specific language of the Code.

Code § 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," with respect to the types of items frequently included within the category of "small items" (for example, materials and supplies), Treas. Reg. § 1.162-3 provides that a deduction may be taken in the year such items are actually consumed and used in the production of income. With respect to incidental items for which physical inventories are not kept, however, that provision also states that "it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method." Although it might be argued that this provision assumes that the items in question have a useful life of less than one year, although that life may extend into a second taxable year, we believe that it provides direct support for a "small item carve-out." Furthermore, Treas. Reg. § 1.461-1(a)(3) provides, in part, that when in a going business there are overlapping deductions, if they do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account. Both provisions are recognition that there is no absolute rule that capital expenditures, in the strict traditional sense, must in all cases be capitalized. Rather, the rule is that such expenditures may be currently deducted if such treatment does not materially distort income. 294

In General Counsel Memorandum 34547,295 the Service examined the treatment of contributions to pension and profit sharing plans attributable to the taxpayer's production process. The Memorandum reasoned that "section 461 gives the Service the authority to direct "the timing of any deduction

294. Id. at 12-4.
in such a manner as to clearly reflect the income of the taxpayer. Based on this interpretation pension and profit sharing contributions should be capitalized (and accordingly depreciated or amortized) as part of the self-constructed assets to which they relate. This area is now covered by Section 263A.

Administratively and judicially the period of amortization of intangibles has been on a case-by-case basis. Sixty years of experience with depreciation of tangible property has taught that uniform lives is the only administrable way. The Service should employ in determining first in rulings and after refinement later in regulations whether the standard life for classes of such amortizable expenditures would be as short as sixty months or as long as fifteen years. General Counsel Memorandum 34,547 read Section 446's mandate that the taxpayer's "method of accounting . . . clearly reflect income" together with Section 461's requirement that "[t]he amount of any deduction or credit . . . shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." Thus, "section 461 gives the Service authority to direct the timing of any deduction in such manner as to clearly reflect the income of the taxpayer. This confirms the view expressed above that the accounting sections should be considered to govern the taxable period in which deductions permitted by the Code are to be taken." The Service based this reading of a clear reflection of income mandate into Section 461 upon a thorough tracing of the legislative history of Section 461 and its predecessors stretching back to that fateful first tax reform act, the Revenue Act of 1921, and the first technical corrections revenue bill, the Revenue Act of 1924. Thus, IRS/Treasury has authority for de minimis
and recurring rules and authority in determining that, for example, 60-month amortization clearly reflects income whereas neither an immediate deduction nor capitalization without amortization does.

E. The Case for "Rough Justice"

1. Rough Justice as Simplicity and Equity on a Group Basis

The core idea of "rough justice" for purposes of this article is the use of simple administrable rules that work well enough on the average in lieu of either (a) detailed rules pursuing theoretical purity or (b) case-law uncertainty. The general principle in capitalization is clear reflection of income.

"The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212 or 232. The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed under section 212 or 232, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." (emphasis added)

The following highly instructive statement regarding the above provision is contained in the committee reports relating to the 1924 Act:

"In subdivision (d) of this section authority is granted to the Commissioner to allow or require deductions and credits to be taken as of a year other than that in which 'paid' or 'accrued' when, in his opinion, it is necessary in order to clearly reflect the income. The Revenue Act of 1921 in sections 214(a)6 and 234(a)4 authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year rent or rental payments or other times for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should." (emphasis added)

H.R. REP. NO. 68-179 (1939); 1939-1 C.B. (Pt. 2) 241, 249 (1939). To the same affect see S. REP. NO. 68-398 (1939), 1939-1 C.B. (pt. 2) 266, 273 (1939). It is noted that section 214(a) of the 1924 Act (Deductions Allowed Individuals) and section 234(a) (Deductions Allowed Corporations) both contained the same "shall" directive as in the present deduction sections. It is important to mention that the "unless" clause in section 200(d) of the 1924 Act (underscored above), remained in the law until the enactment of the 1954 Code. And, although the clause is not contained in section 461, it is clear from the 1954 Code committee reports that no substantive change in prior law was intended, and that section 461 is simply a rewritten version of its predecessors. See H. Rept. No. 1337, 83d Cong., 2d Sess. (1954), which states at p. A161 the following:

"Section 461 adopts the provision of section 43 [which included virtually the identical language which first came into the law in section 200(d) of the 1924 Act] of the 1939 Code in rearranged form. The timing of deductions and credits otherwise allowable is determined by the taxpayer's method of accounting. The method must clearly reflect the income of the taxpayer."

income; the “rough justice” implementation is minimum distortion of income taking into account (1) the revenue advantages to Treasury of more exact matching of expenses with income and (2) the burden of capitalization (and especially amortization) to the taxpayer. Case-law precedent, commentators and the “rough justice”/simplification policies advocated by Commissioner Fred Goldberg support this approach. Any other approach short of legislation most likely will run aground on the shoals of judicial adoption of rules of practicality. Distortion of income can arise from a difference in timing of a deduction or a difference in character between the tax treatment of the deduction (ordinary) and the related income (capital gain or exemption preference). Underlying timing distortion, therefore, is the notion of matching of expenses with income, which is no longer in vogue in the literature or in Congress when such matching would produce substantial deferral of income. But INDOPCO reiterated such matching as the case-law standard for capitalization of expenditures to prevent timing distortions. Congress recently approved the matching of expenses with income notion to defer deductions until related income is realized in the new Section 167(g) codifying the income forecast method of depreciation.

All of the proposed deduction, capitalization and amortization rules are designed to effect “rough justice” rather than theoretical purity where the practical burdens of such purity are great and the revenue benefits are minor. This balancing and “simplification” approach has been followed by the IRS/Treasury in the past as well as the courts and on rare

302. See note 7 supra.
303. Mundstock, supra note 241, at 1184, speaks of the “current fad in tax policy is. . . the financial accounting notion of ‘matching.’” He tellingly points to the tax treatment of pre-paid income and attributable future expenses. See also Alan Gunn, Matching of Costs and Revenues as a Goal of Tax Accounting, 4 VA. TAX REV. 1 (1984).
304. Congress in the legislative history to Sections 167(g) and 263A speaks of matching expenses to related income (by capitalizing and depreciating them). H.R. REP. NO. 104-586, at 140 (1996) (“in theory, the income forecast method is an appropriate method for matching the capitalized cost of certain property with the income produced by such property.”), and S. REP. NO. 99-313, supra note 76, respectively. See also Gen. Couns. Mem. 38,034 pp 34-6 (Aug. 7, 1979).
305. Supra note 6.
306. See note 304 supra.
307. E.g., Gen. Couns. Mem. 34,959 (July 25, 1972) (small); Gen. Couns. Mem. 38,618 (January 23, 1981) (recurring costs of short-lived computer software deductible); Gen. Couns. Mem. 39,483 (March 5, 1986) (recurring); Gen. Couns. Mem. 38,410 (June 18, 1980)(separate asset); Gen. Couns. Mem. 39,743 (July 14, 1988), considering Rev. Rul. 88-57 (“Consideration could perhaps be given to developing some mechanical rule for determining whether a cyclical repair should be treated as capital. Thus, for example, if the taxpayer spends 50 percent (or more) of the original cost of the asset, the expenditure would be capitalized.”); Gen. Couns. Mem. 33,968 (Nov. 18, 1968) (prepublication costs of professional writers while conceptually capitalizable because they produce a manuscripts benefitting future years should be currently deductible for administrative convenience.).
308. See note 20 supra.
occasions Congress. In practical effect these proposed rough justice rules constitute simplified tax accounting rules. As such, this article maintains that solely as a matter of substantive tax policy these rules for simplification should be limited to the classes of taxpayers to whom Congress traditionally limits simple tax accounting rules such as the cash method, i.e., small business excluding tax shelters. But as a matter of procedural tax policy, i.e., administerability and revenue, as well as tax politics, this article suggests that the Service/Treasury should extend the simplification regulatory rules to large C corporations as well because that is where the largest dollar volume of controversy over capitalization and expensing currently arises.

The then novel Treasury and IRS “Business Plan 1992” announced that “[w]ithin the framework of existing law,. . . [the] overall objectives are to enhance voluntary compliance and reduce taxpayer burden.”

To that end the plan considered the following:

- Our highest priority is simple, practical, and user-friendly guidance.
- In carrying out Congressional intent, we should assume that Congress intended to enact administrable and workable laws.

308. See note 20 supra.

309. H.R. REP. NO. 100-795, at 531 (1987) (accompanying then unenacted provision; enacted with retrospective effect in 1988), succinctly stated the case for administrative costs outweighing the benefits of capitalization/depreciation of writers prepublishing costs:

[The application of the uniform capitalization rules to authors, photographers, and artists is unduly burdensome for those authors, photographers, and artists who do not elect the simplified method provided by the Internal Revenue Service. The otherwise deductible expenses of these authors, photographers, and artists must be allocated among each project and generally are deductible over the period that income is estimated to be derived from the project.

Id. The clear implication of this passage is that application of the elective simplified three-year front-loaded depreciation method was not unduly burdensome in the eyes of the Committee. Representative Thomas Downey, in introducing the 1988 legislation which explicitly exempts “qualified costs” from Section 263A pointed out that in 1987 “the Committee on the Budget report concluded that the application of the uniform capitalization rules to free-lance writers and photographers is unduly burdensome.” 134 CONG. REC. E 1245 (1988) (Extension of Remarks of Rep. Thomas Downey) (quoting H.R. REP. NO. 100-391, at 1533 (1987)). Downey continued that “very substantial administrative and accounting burdens, including allocation and income forecasting requirements that are unlikely to be manageable by either taxpayers or the Internal Revenue Service would be imposed on freelance writers, photographers, and artists by the uniform capitalization requirements.” Id. He concluded that: “[t]here is little question that any theoretical benefit of applying capitalization requirements to the expense of professional free-lance writers, photographers, artists, and small independent film and video makers is far outweighed by the countervailing burden imposed on these taxpayers by the rules.” Id. See also Senator Pete Domenici, in his 1988 introduction of S. 2351, which became Section 263A(h), exempting “qualified creative costs” from section 263A, which provides an excellent exposition of the administrative problems of artists in capitalizing and then depreciating their creative costs under the income forecast method, where the allocation administrative problems rival the forecasting administrative problems. 134 CONG. REC. S5244-45 (Remarks of Sen. Pete Domenici, R-N.M.).

Our interpretation of the tax law should be driven by our commitment to administrability, common sense, and fair play, not by revenue considerations.

We should make do with "rough justice" and accept the fact that life is messy rather than be motivated by a quest for theoretical purity.

General principles are often better than detailed rules. All too often, detailed rules result in the worst of both worlds — they suffocate the many taxpayers who try to do what's right, while providing a road map for the few with larceny in their hearts.  

"Rough justice" in regulation drafting was Commissioner Fred Goldberg's avowed goal; all of the above are variations on that theme. His starting point early on was concern about the health of tax administration today, as we emerge from a decade of unprecedented legislative activity . . . [T]here is a dark side to the frenzy of tax legislation during the past ten years [the 1980s]. The cumulative impact of repeated law changes — coupled with a statutory, regulatory and administrative focus on theoretical purity — have imposed a staggering burden of complexity, uncertainty and administrative costs on many large and small businesses and all too many individuals.

He sought to lift "from taxpayers the oppressive burden of seeking answers to metaphysical questions." Commissioner Goldberg drew upon his
experience as "a private practitioner and as the IRS Chief Counsel, as well as ... [his then] current role as Commissioner of Internal Revenue" to offer the Senate Finance Committee in a 1991 Hearing on Tax Simplification the following "general observations on the subject of tax simplification":

2. **Simplification versus certainty.** Some suggest that the price of simplification is more uncertainty. To the contrary, simplification is the one true prerequisite for certainty. The 1980's were devoted to a well-meaning effort to provide certainty through detailed laws and regulations. With the benefit of hindsight, I am convinced that the quest was doomed to failure. Each new rule spawns its own measure of uncertainty, unintended consequences, and the need for special exceptions. We have generated thousands of pages of laws, regulations and rulings — and a system that is rife with uncertainty.

3. **Simplification versus equity.** Some suggest that the price of simplification is greater inequity. The complexity imposed by current law is hardly fair or equitable. Providing "equity" for this particular taxpayer or that particular taxpayer through a special provision in the law may appear fair from the perspective of that taxpayer. But the net result is to impose "inequity" on all other taxpayers who must understand and deal with that provision. No matter how careful, well-intentioned, and skillful we may be, our efforts to fine tune rules to deal with special circumstances are sure to visit unintended inequities, costs, and burdens on other taxpayers in the system.

I urge the Committee, as well as those of us responsible for implementing regulations, to embrace rough justice and beware of the purists. By background and training, many of us tend to chase the theoretically complete answer. We seek to resolve every imaginable question, address every imagined loophole, deal fairly with every special circumstance. We are sure to fail — and leave the American public with an unworkable and unadministerable system.

We should remember that the tax system is a means, not an end in itself. We should be content with general rules and straightforward provisions that meet our overall objectives, and not worry about the edges. As the saying goes, the best approach is often to "Just Say No!" When we hear of the special case, the need for the special exception, the unanswered question, or the potential abuse — we should remember that our efforts to do something may not succeed, and that the rules we write are sure to be everyone else’s burden and everyone else’s transaction cost.314

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314. *Hearings on Tax Simplification Bills (S. 1364, S. 1394, and H.R. 2777) before the Senate Finance Subcommittee, 102d Cong. 319-20 (1991) (Prepared Statement of Commissioner Goldberg); see*
Transaction costs constituted Commissioner Goldberg's root concern:

The Service now treats the issue of tax simplification differently. In drafting guidance, the Service now asks: “What is it doing to the taxpayer? What are the implications in terms of record keeping, administrative costs, transaction costs?” Goldberg emphasized that the Service must understand that a modification that saves the government a dollar, but costs the taxpayer two dollars, is a “bad deal” and that “we can’t make those kinds of deals.”

. . . .

He recounted the initial attempts to craft the new rules and recalled the difficulties he encountered in changing old habits. For example, Goldberg indicated that, in formulating rules for an employee’s first business trip of the day, various concepts “involving the number of miles driven, minimum distances, the distance between home and business, and the reimbursement of increments” were tossed around and referred to as the “Donut Rule,” the “Jelly Donut Rule” and the “Roll Your Own Rule.”

There also was a suggestion, he said mockingly and in falsetto voice, that there can be “a time value of money concept” when cash is advanced to an

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[The greatest challenge our tax system faces during the 1990s is to ease the burden on the American public. I think the cost, the burden on the private sector of living with the tax system as it exists today is simply unacceptable. . . . I urge the committee to embrace rough justice and to beware the purists. We all have a tendency to chase the theoretically complete answer. We have a tendency to worry about the outlier case. I believe that those are two of the primary cause of the complexity in our system. Write a simple, straightforward rule; don’t worry about the edges.

Id. “The Service also must ‘buy into a notion of rough justice,’ Goldberg said. ‘Many of the problems we have in the [tax] system right now are traceable back to an honest, genuine, but terribly misguided quest for theoretically pure answers.’ Continuing, he commented that we ‘really cannot live with theoretically pure answers. [We need, instead,] to be looking for simplifying assumptions.’ He added, ‘[w]riting a rule to take care of one individual or one company or one set of problems [is a bad deal] if the net result . . . is to consume tens of thousands of hours . . . and millions of dollars of other people’s time and money . . . trying to figure out what the rules are.’”


Former Assistant Treasury Secretary Frederic Hickman of Hopkins Sutter Hamel & Park complained that "hyperintelligent, hyperinexperienced" Treasury staff had a propensity to draft elaborate rules because they tried to take care of every contingency. "We were mostly hyper, and singleminded about being correct," quipped Hickman’s partner and former Treasury staff attorney Mark Perlis. "We lose simple consistency in the pursuit of correctness." Hickman and others decried the fanatical devotion among tax staffs of getting the correct result without regard to the administrative headaches it would cause.

employee. “Well now,” Goldberg sighed, “that’s really pretty sick.”

Commissioner Goldberg was particularly concerned about the transaction costs to the Service/Treasury of establishing rules by litigation in the capitalization arena. Professor George Mundstock’s landmark *Taxation of Business Intangible Capital* bottoms the basic tax policy criterion of simplicity on transaction costs. “A tax provision is sound when it is simple for taxpayers to comply with and for the I.R.S. to enforce. Simplicity assures that the provision does not impose undue administrative costs upon those complying with and enforcing the provision.”

Many commentators use the term “rough justice”; few attempt any definition other than context. In the literature, the core concept of “rough justice” is use of rules that are simple to apply, eliminating expensive factual inquiry, and achieving rational or just results in most cases. In short, “rough justice” is an atavar of the factor of simplicity. A trade-off is that “rough justice” for groups does not effect perfect justice for each individual. “Rough justice” often applies general principles rather than

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315. Spellman, supra note 314.
316. See supra note 303.
317. Mundstock, supra note 303, at 1182.
318. Professor Lee searched “rough justice” in the LEXIS; Law review library allrev File. He also searched Fed tax Library, TNT, and Casrel Files.
319. Elizabeth Warren, *Formal and Operative Rules under Common Law and Code*, 30 UCLA L. REV. 898, 932 n. 190 (1983) (explaining the basis of rough justice as “the assumption that a rule of law may eliminate expensive factual inquiry and yet achieve results that are rational in most cases,” but failing to define the term “rough justice”); Bernard S. Jackson, *The Development of Law in the Ancient Near East: Modeling Biblical Law: The Covenant Code*, 70 CHI.-KEN. L. REV. 1745, 1812 (1995) (describing how the “‘arbitrary’ tests” of the Covenant Code do “(rough) justice in the majority of cases, the remaining cases of injustice being the price that is paid for the advantage of efficient processing of the more typical cases.”); Peter H. Schuck, *Mass Torts: An Institutional Evolutionist Perspective*, 80 CORNELL L. REV. 941, 960 n.93 (1995) (criticizing alternative methods of claims aggregation that suppress “a claim’s individual characteristics in the interests of systematic efficiency, a ‘rough justice’ version of horizontal equity.”); 1991 *Hearings on Intangibles*, supra note 32, at 51 (Statement of Fred T. Goldberg, Jr., Commissioner, Internal Revenue) (“The ideal solution here [amortization of purchased intangibles] is one that is broad in scope and uniform in application; that is, one that minimizes the distinctions in the treatment of the intangibles that are covered.”).
320. Paul Savoy, *The Spiritual Nature of Equality: Natural Principles of Constitutional Law*, 28 HOW. L.J. 809, 878 (1985) (assessing affirmative action and noting that “a society which operates on the basis of rough justice for groups, and then insists on perfect justice for individuals when it comes to evaluating entitlements to affirmative action, is practicing the most insidious form of racial discrimination.”); T.A. Smedley, *Some Order Out of Chaos in Wrongful Death Law*, 37 VAND. L. REV. 273, 294 (1984) (“the laws of intestate succession may well achieve a good measure of ‘rough’ justice — ‘rough’ in that the operation of such a broad general rule will not always accurately satisfy the legitimate needs of each particular survivor.”); *Clear Reflection of Income*, supra note 16, at 25 (“a common shortcoming of ‘talismans’ [e.g., 1-year rule, separate asset rule, new business vs. existing business]: promoting rough justice in commonplace application, but yielding inequities in borderline areas.”).
detailed rules, but it connotes as well an approximation of the just result. In some cases “rough justice” denotes a tax “second best” surrogate or proxy tax, but generally its goal is to effect better results than an unjust result—fair on the average for a class of taxpayers but

321. For instance, a percentage exclusion of capital gain has been argued as “rough justice” alternative to indexing. Noël B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 TAx L. Rev. 319, 340, (1993) (concludes historical exclusion was “so rough as to provide no justice”). They are too right. Lee, Capital Gains Contentions, supra note 53, at 4 (nominal capital gains of top 1% of families are 50% to 80% economic on the average in good market years, whereas nominal capital gains of bottom 80% on the average are all inflation gains—they often suffer an economic loss taking account for inflation. The economic gains of the rich often nicely even out the economic losses of the moderate income. But we always knew that the rich get richer and the poor get poorer.).

322. See note 109 supra.

323. William A. Klein, Tailor to the Emperor with No Clothes: The Supreme Court’s Tax Rules for Deposits and Advance Payments, 41 UCLA L. Rev. 1685, 1731 (1994) (discussing the effects of shifting the tax burden of disguised interest from one party in a transaction to the other and suggesting that “this ‘surrogate taxation’ may result in rough justice (and rough economic neutrality”). When amortization was denied for goodwill prior to Section 197, it served as a proxy for no ordinary income recapture. Cf. Panel Discussion, Accounting Principles or Pooling of Interests, 25 Tax LAW. 29, 54 (1971) (statement by Assistant Secretary of Treasury for Tax Policy Edwin S. Cohen). Cohen explained that the underlying basis for the Service’s opposition to buyer amortization of purchase premium historically had been that if the Treasury:

[W]here to allow a write-off of purchased goodwill over a long period of time as a deduction from ordinary income while the sale of goodwill would produce capital gain, we would have a situation in which the purchaser would be able to write-off the goodwill against ordinary income, but the seller would always have capital gain.

I think one of our problems is whether we could ever change one rule without changing the other.

I think that people would be rather reluctant to see the sale of goodwill treated as an ordinary income item under section 1245 or otherwise, and it might be necessary to take the bitter with the sweet. This is part of the problem that would face us.

Id. Similarly, some have argued that pre-Section 197 lack of amortization for purchased intangibles offsets the “improper” deduction for developing the intangible further, such as advertising with respect to purchased goodwill. See, e.g., Gerard, supra note 148, at 99 (criticizing the “double deduction” argument that contends “‘rough justice’ would be achieved under the Mass Asset Rule since taxpayers are permitted to expense the cost of attracting the new customer who is offsetting the loss of a previously purchased customer.”). Professor George Mundstock debated a related point with Professor Eugene Seago in the 1991 House Hearings on Intangibles. 1991 House Hearings on Intangibles, supra note 32, at 318-20. At the time of the 1991 House Hearings, Professor Mundstock had spent six years studying the taxation of business intangibles and wrote a landmark article on the topic. See Mundstock, supra note 241. Professor Seago, who had been writing about intangibles for nearly twenty years at the time of the Hearings, represented the American Taxation Association and called for a provision like Section 195. Professor Seago would play a role in the evolution of Section 197, particularly in its interface with the partnership provisions.

necessarily just as to each affected taxpayer— and above all in the context of federal income taxation, to effect rules that are easier to apply by the taxpayers and tax administrators alike than more theoretically perfect substantive rules.

Jurisprudentially, “rough justice” may viewed as equity versus rule (or law in the Anglo-American lexicon) or substance versus form— an age-old battle between the letter and the spirit of the law. Under this view “rough justice” is “equity” once again overriding the rule of law. For goodwill wastes. Thus, specifying a recovery period for the cost of goodwill is arguably appropriate in that it would provide a measure of “rough justice.”). Interestingly, Justice O’Connor in Hillsboro Nat’l Bank v. Commissioner, 460 U.S. 370, 380 n.11 (1983), in effect employed a “rough justice” rationale to support a year 2 balancing entry adjustment under the tax benefit and related doctrines: “While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction— far superior to none— in the current year, analogous to the practice of financial accountants. . . . This concern with more accurate measurement of income underlies the tax benefit rule and always has.” This is not surprising since both the balancing entry doctrines and expense/capitalization/amortization doctrine are most soundly based on notions of avoiding distortion of income. See Lee & Murphy, supra note 28, at 504-09 (Professor Lee had worked out the core of the balancing entry model [except for the role of the Crane doctrine] including the characterization aspect manifested in Arrowsmith and the “origin of the claim” doctrine in the mid-1970s); accord Note, The Transactional Approach to the Origin of the Claim Doctrine: A Proposed Care for Chronic Inconsistency, 35 BROOK. L. REV. 905 (1989). This thesis is more fully spelled out in Lee & Bader, supra note 231, at 173, 207-09 (1987) (discussing all of these doctrines as ultimately based on the clear reflection of income principle manifested in the least distortion of income rough justice rule). See note 142 supra. Both Professor Bittker and Judge Tannenwald played leading roles in this story, too.

325. See Smedley, supra note 320, at 294 (explaining how intestacy laws sometimes fail to provide justice for each survivor). See Packwood Says Taxpayers Must Choose between Simplicity and Fairness, 90 TAX NOTES TODAY 248-9 (December 7, 1990):

Responding to criticism of the tax code for being neither simple nor fair, Senate Finance Committee ranking minority member Robert Packwood, R-Ore., asked attendees at the Tax Foundation’s annual conference December 5 if they really knew what they wanted. “Which do you want? Simplicity or fairness. Ladies and gentlemen . . . you cannot have both,” said Packwood. Using a flat tax as an example, he explained that the more simple a tax system it, the less fair it becomes.

“When we tried to do the 1986 tax reform bill, when we were forced to a decision, we opted for fairness rather than simplicity, and we knew what we were doing,” said Packwood. “In 1986 we were driven by one overriding desire, we wanted people to make investments from an economic standpoint.” He explained that, by eliminating deductions and reducing the number of tax brackets, simplicity and progressivity increased. But if exemptions were granted to each special interest that could arguably prove that the tax system had placed it at a disadvantage, then the 1986 act’s simplicity and rough justice would soon be lost.

Id.


328. Id. at 820-21 (rigor of the law and yielding of mercy/equity).

one, perhaps the paramount, feature distinguishing the Anglo-American legal system from the various civil law systems is the bifurcation of judicial processes between law and equity. The origins of this split are historical and largely accidental. The early English law courts developed elaborate rules of pleading which, by Elizabethan times, had led to the modern notion of the law as a body of rules which could be applied to a given set of facts.\textsuperscript{330} By contrast, the chancery courts were less concerned with rules and precedent and more determined to reach an equitable resolution of a particular case, frequently blurring law and fact in the process. The essence of equity, thus, was the absence of binding rules.\textsuperscript{331}

In the context of complex statutes including the Internal Revenue Code, regulations, and ad hoc line drawing, courts, however, generally are reluctant to override the rules with equity.\textsuperscript{332}

\textsuperscript{330} J.H. Baker, An Introduction to English Legal History 122 (3d ed. 1990).

\textsuperscript{331} Id. at 126. The famous observation on these proceedings, attributed to John Selden, was that if the measure of equity was the chancellor’s conscience, one might as well determine the measure of a foot by the length of the chancellor’s foot. Id. (citing Table Talk of John Selden 43 (F. Pollack ed. 1927)).

\textsuperscript{332} Monongahela Valley Hospital, Inc. v. Louis W. Sullivan, M.D., 945 F.2d 576, 593 (3d Cir. 1991) (“In this complex area of regulation, ad hoc determinations, invocations of the ‘spirit and purpose’ of the regulations, and ‘rough justice,’ however appealing, simply will not do.”); Philadelphia & Reading Corp. v. United States, 944 F.2d 1063, 1076-77 (3d Cir. 1991) (Becker, J., dissenting) (“Applying equitable principles or rough justice to tax refund cases would do inestimable mischief to the rigorous statutory scheme”); Fruit Of The Loom, Inc. v. Commissioner, 68 T.C.M. (CCH) 867 (1994), T.C. Memo 1994-492:

We decline to adopt a position that would thwart the purpose of the period of limitations and convert the mitigation provisions into a form of general equitable relief that applies in any case involving an arguable double tax benefit. Incorporating rough justice or equitable principles into the elaborate scheme of the mitigation provisions would add inestimable mischief to the rigorous statutory scheme. Adherence to the detailed requirements of this scheme is obligatory for respondent and taxpayers alike.

\textit{Id.} The \textit{Cohan} doctrine was an exception to this bias, but increasingly has been limited in the last two decades.
In many respects, the search for the ideal regulatory structure is the attempt to balance the law court concept of fixed and definitive rules with the equity concept of delivering justice in a particular factual situation. Professor Kenneth Davis' *Discretionary Justice* convincingly argues that rules and principles can be combined by laying out rules for effecting of the general principles along with balancing tests or weighting procedures for applying such rules. Rules for expensing and capitalizing with standard life amortization self-created intangibles based upon such notion are set forth below.

Over the past quarter of a century when Congress has addressed capital recovery areas where the existing rules were fragmented, varying class of taxpayer by taxpayer or even taxpayer by taxpayer, it has repeatedly opted for the simplification of one or just a few sizes fit all. The legislative pattern of Section 167 Asset Depreciation Range, Section 168 Accelerated Cost Recovery System, and Section 197 amortization of purchased intangibles make the case for rough justice rules as to (a) expensing and (b) amortizing over standard periods, the costs of self-created intangibles.

2. Theoretical Purity: Economic Efficiency

The core notion of economic efficiency in the context of federal income taxation is that such tax system should "interfere with private decisions about resource allocation as little as possible." Treasury I, the landmark 1984 Treasury Study which launched the Tax Reform Act of 1986, explained the theory of economic efficiency or neutrality as follows:

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334. Confronted with similar chaos in the area of tangible assets, Congress usefully intervened in the Accelerated Cost Recovery System (added by the Economic Recovery Tax Act of 1981) that allowed cost recovery over predetermined recovery periods fixed by statute rather than the useful lives of tangible assets. The Senate Committee Report explained that one of the reasons for the change to predetermined recovery periods was that "the committee had heard copious testimony that the present rules are too complex. These rules require determinations on matters, such as useful life . . ., which are inherently uncertain and thus too frequently result in unproductive disagreements between taxpayers and the Internal Revenue Service." We have concluded that the best solution for taxpayers and the Service is a simple, stable, "rough justice" legislative solution.

1991 *House Hearings on Intangibles*, supra note 32, at 52 (Prepared Statement of Commissioner Fred Goldberg) (footnote omitted). In the earlier simplification step of Asset Depreciation Range ("ADR") Congress focused on easing administration. H.R. REP. No. 92-533 at 32 (1971) ("Many of elements contained in the ADR system (including the repeal of the reserve ratio test) are designed to achieve significant simplifications in the administration of the depreciation rules by substantially limiting the number of situations in which disputes are likely to arise based on the particular facts and circumstances of the individual taxpayer's situation. It is contemplated that these elements of the ADR system will be incorporated by the Treasury into the class life system provided by your committee bill."); see S. REP. No. 92-437, at 48 (1971).
One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. For example, market forces lead business firms to produce what consumers want in ways that are relatively efficient and economical. Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not unduly favor leisure over work, or consumption over saving and investment. It would not needlessly cause business firms to modify their production techniques or their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. It would not discourage competition by granting special preferences only to one industry or one type of financial institution. In short, an ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy — an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed.

Economic neutrality is furthered by a few simple rules of tax design. Perhaps most importantly, income from all sources should be taxed equally; otherwise, too many resources will be devoted to activities subject to the lowest taxes. For the same reason, tax liability should not depend on how income is spent. Uniform treatment of all sources and uses of income requires a comprehensive definition of income for tax purposes.336

The Joint Committee Staff in describing the House version of the Tax Reform Act of 1986 succinctly explained the underlying economic theory:

The output of the economy depends not only in the size of the capital stock but also on its composition. In the absence of taxes, the operation of a competitive economy causes capital to flow to sectors where it is expected to earn the highest rate of return. This results in the allocation of investment that produces the largest amount of national income. However, if non-neutral taxes are imposed, potential output may be reduced because too much capital will tend to accumulate in lightly taxed sectors, and too little capital will be invested in highly taxed sectors. Thus, in evaluating the effects of tax reform on capital formation it is necessary

336. 2 TREASURY I, supra note 4, at 13. Professor Mundstock pointed out the difficulties in determining economic efficiency or inefficiency of particular tax provisions and, therefore, used "the more modest neutrality criterion." Mundstock, supra note 241, at 1183 n.14.
to examine both the level and allocation of investment. 337

Judge Richard Posner, a leading academic and judicial proponent of law and economics, applied an economic efficiency analysis to expensing versus capitalization in *Fishman v. Commissioner*: 338

[I]f a member of this panel rents a safe-deposit box to keep his securities in, he can deduct the annual rental under section 212; but if he buys a safe he must capitalize its purchase price — he can’t just deduct the price from his investment income in the year of purchase. Otherwise taxpayers would have an incentive unrelated to the efficient use of resources to buy rather than rent safe places for their securities.

The same thought lies behind Justice Blackmun’s capitalization of depreciation costs as to equipment used in self-constructing depreciable assets in *Idaho Power v. Commissioner*. 339 Blackmun noted that the purpose of depreciation accounting is allocation of the cost of using an asset to the various tax years benefited by the asset: 340

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

An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor’s equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the

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338. 837 F.2d 309, 312 (7th Cir. 1988).

339. 418 U.S. 1, 16 (1973). The Court reasoned that the purpose of capitalization under Section 263 (and corresponding 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.” Id.

340. Id. at 10.
entire cost, of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals' holding would lead to disparate treatment among taxpayers because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost including the depreciation charged to it by the contractor. 341

Thus, while the depreciation cost of trucks used to transport workers to the work site of a self-constructed power plant was presently incurred, because it related to the future rather than day-to-day operations it had to be capitalized as part of the cost of the anticipated revenue stream from the new plant. Otherwise the tax system would favor self-construction over contracting out construction, for example, of power plants. 342 Of course many large corporate taxpayers today may find that the advantages of concentrating on a core business and out sourcing other activities dictates using outside contractors rather than self-constructing tangible assets despite any tax advantages to the latter.

Professor Mundstock builds a strong case that expensing of self-created intangibles provides "more generous treatment for many expenditures related to intangible capital than for economically similar expenditures related to tangible assets." 343 He contrasts the tax treatment of the cost of institutional advertising, which the economic literature shows in many cases has effects for some years after incurred, 344 with the cost of a tangible piece of equipment of equivalent life. 345 At the same time Professor Mundstock appears less critical of other self-created intangibles such as R&D or investment in human capital. 346 The economic evidence on the latter is mixed, even negative, in some cases. 347 Professor Gene Seago pointed out in his submission on behalf of the American Taxation Association that a broad reading of INDOPCO and slow or no amortization would result in the cost of creating intangibles being tax disfavored. 348

341. Id. at 11, 14.
342. NCBN 1, 651 F.2d at 951-52.
345. Id. at 1193-95, 1228-32.
346. Id. at 1205.
348. As a result of INDOPCO, justification for capitalization may be easily found. Indeed, one of the cases cited by the seventh circuit as a situation where the courts were reluctant to
Professor Calvin Johnson also shows that taking account of time value of money is more correct "conceptually" in the words of Assistant Solicitor General Kent Jones than the more pragmatic current deduction of recurring expenditures, even if steady state. Professor Johnson criticizes the "steady state fallacy." Judge Chabot's dissent in Von Raden v. Commissioner supports Professor Johnson's view. This raises the fundamental issue whether the theoretical purity of capitalization and amortization of self-created intangibles should yield to a more simple and easier administrable "rough justice" current deduction? And if so, when?

require capitalization, Briarcliff Candy Company v. Commissioner of Internal Revenue, was effectively overruled by INDOPCO. In Briarcliff the taxpayer was allowed to deduct the cost of change in the method of distributing its products and expanding its markets. Those costs would now be deemed capital expenditures because of the significant future benefits but not subject to amortization because of the indefinite useful life of those benefits.

It follows that the capitalization of expenditures for all unattached expected future benefits will result in overcapitalization — that is, the capitalization of some costs that will not produce future benefits. The capitalization of an expenditure that will not in fact produce future benefits and the failure to properly amortize those costs that do produce future benefits increase the effective tax rate on investments in these types of expenditures. Thus, while one commentator argued that the pre-INDOPCO law favored investments in intangibles (which includes unattached expected future benefits) as compared to the tax impact on investment in tangible assets, the opposite may now be true.

ATA Submission, supra note 235.

349. While capitalization is conceptually necessary for all expenses that create a material future benefit, the goal of achieving an accurate measure of net income is a pragmatic one. Expenses of advertising and maintenance create both present and future benefits, but capitalization is not required as a practical matter even though some future benefit results, because the current benefit predominates and the expense is a regularly recurring one, so you achieve essentially the same statement of income whether you deduct the entire expense in the current year or whether you amortize a portion that relates to the future benefit each year. Since the current deduction for those kinds of recurring expenses would not materially misstate income, they are allowed.

INDOPCO Oral Argument Transcript, supra note 104, at 25 (Argument of Kent Jones).


351. Stretched too far, however, the rule of consistency could produce distortion of income as shown by Judge Chabot's dissent in Van Raden v. Commissioner, 71 T.C. 1083, 1117 (1979) (Chabot, J., dissenting):

[T]here is a big difference between showing that deductions even out over a period of years and showing that tax consequences even out over a period of years. This difference can result from, among other things, the time value of money (e.g., accelerated depreciated deduction provisions designed to encourage investment in depreciable property by reducing the current "value" of the investors' overall tax liabilities), changes in marginal tax brackets (a deduction in a high marginal tax bracket year is worth more than a deduction in a low marginal tax bracket year), and different methods of tax treatment (as illustrated in Spitalny by the playoff of ordinary deductions against nonrecognized gains). We may assume that, if the tax distortions truly canceled out over a number of years in the case before us, the case before us would not be before us.

71 T.C. at 1118-19.
3. **Rough Justice Versus Theoretical Purity**

The short answer is yes, where under a cost/benefits analysis, the burden of taxpayer and IRS compliance costs of capitalization and amortization outweighs the revenue (and in some cases the perceptional) benefits. Precisely such conditions underlay judicial and Commissioner Goldberg's adoption of rough justice rules over theoretical purity in the capitalization versus expensing controversy. The argument is well stated by practitioner Steven Gerard.

[W]hile capitalizing and amortizing periodic customer development expenditures may have some theoretical appeal, as a practical administrative matter it is not feasible. More importantly, this treatment is not even necessary to achieve a proper accounting of periodic net income. For an on-going business entity with a steady level of customers, the annual expense deductions related to periodic customers development expenditures should be roughly the same as amortization deductions. This also should be the case even for companies with a growing number of customers, since amortization periods for capitalized new customer development expenditures typically would be much shorter than amortization periods for purchased customers. For example, it is well-known in the newspaper publishing industry that only a small percentage of new subscribers actually renew their subscriptions enough times to become "seasoned" subscribers with expected lives of approximately 15 to 25 years, as are at issue in *Newark Morning Ledger*. Furthermore, it would be impracticable to identify and capitalize the proper portions of those periodic expenditures that contribute to customer development.352

Professors Mundstock and Johnson, of course, are theoretically correct. (1) Many intangible expenditures provide benefits over a period of years, so that a current deduction not only reduces transaction costs but also provides a tax subsidy or preference — a two-for-one. (2) While the condition of steady state recurring expenditures reduces such distortion of income from such tax preference, taking account of time value of money is more correct theoretically.

This article nevertheless advocates adoption of rules of practicality or reason. The guidestone should be Bittker & Lokken's focus on clear reflection of income over definitional rules. Such clear reflection should be measured by a cost/benefit analysis of burdens and benefits of capitalization.

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and depreciation versus current deduction. This process supported by a number of cases and reasoning in a number of private rulings as well on occasion by Congress, for determining whether the "rough justice" of a current deduction should override the theoretical purity of capitalization and amortization. It almost goes without saying that if amortization is not available for most wasting assets, then a current deduction is in order as less income distorting. Professor Lee and others have been preaching that message for over 20 years. For the last ten years Professor Lee has propounded the corollary that the Service's striving for that result in litigation often leads to courts awarding the taxpayer a current deduction as "rough justice." With more irregular and substantial expenditures the better "rough justice" would be capitalization and amortization over some period. Words can not express his pleasure in seeing these lessons applied in recent Service rulings, e.g., the story of Technical Advice Memorandum 9315004 and Revenue Ruling 94-38.

4. Political — Packwood Principle

Widescale base broadening is said to said to require universal application. Showdown at Gucci Gulch recounts the telling story of the willingness of Senate Finance Chair Bob Packwood, R-Ore., to see elimination of special capital gains treatment for timber (Section 636(c)) "as long as there is 'equal treatment' for all industries", i.e., all share the pain. Ron Pearlman, who was there, has expressed to Professor Lee profound admiration for Chair Packwood's principled position. Lee agrees, believing it was one of Senator Packwood's finest hours. Nevertheless,

353. This process should NOT be implemented case-by-case but instead in regulations providing bright-line "rough justice" tests of de minimis, short-lived or recurring for current deductions and uniform amortization periods for irregular or substantial costs.

354. See note 281 supra and accompanying text.

355. Gene Seago reaches the same conclusion in his Submission.


357. Id. Cf. 1991 House Hearings on Intangibles, supra note 32, at 58 (colloquy between Assistant Secretary Gideon and Representative Robert Matsui, D-Cal.). and Explanation of Section 197 exceptions. Section 197 applies to most intangible assets acquired after the date of enactment; the 15-year amortization provision generally does not apply to self-created intangibles, churned assets, and certain specified intangibles (such as separately acquired mortgage servicing rights, sports franchises, and off-the-shelf computer software. Similarly PAL provides an exception for oil and gas, I.R.C. § 469(c)(3). So there can be a few exceptions, perhaps broadened later as in the case of the real estate operator exception of section 469(c)(7).

358. TRA 1986 did achieve on individual side as to capital gains and tax shelters and on the corporate side by the uniform capitalization rules and to a lesser extent by the alternate minimum tax provisions. Lee, Entity Classification, supra note 80, at 136-37.

359. Just as the finest hour of Senate floor manager (soon to be formally Senate Finance Committee Chair) Senator Russell Long, D-La., was his 1964 rejection on the Senate Floor of House
the Tax Reform Act of 1986, and some subsequent reform tax legislation reveal a pattern of significant exceptions not preventing attainment of the overall goal of more horizontal equity. Sometimes "exceptions" for specific industry or constituent group win out. In summary, horizontal equity appears as a necessary ingredient for fundamental tax, particularly in this era of "paygo."

Some view "rough justice" in the tax world as a rule hurting some taxpayers or interest groups while benefitting others. Public choice theory holds that interest groups competing against each other for that result is as good as legislation or regulation gets in a special interest world.

Ways and Means Committee Chair Wilbur Mills' 1963 overly complicated two-step two-classes of capital gain preference with the well-taken populist point that the rich already did well enough with capital gains (at low 20% effective rate at the highest income individual level when nominal top individual rates were in the 70%’s and 80%’s). See supra note 53, at 60-61 n.218. This started out as a typo and Professor Lee liked its sound and import.

Cf Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456, 486 (1981) (Stevens, J., dissenting) (noting that the statute at issue was enacted by the Minnesota legislature to "promote the economic interests of the local dairy and pulpwood industries at the expense of competing economic groups"); Hearing on Tax Treatment of Intangible Assets (S. 1245, H.R. 3035, and H.R. 4210) before the Senate Finance Comm., 102 Cong., 2d Sess. 131 (1992) (prepared statement of Duane A. Sues on behalf of the Coalition for Open-years Election)

A single life for all intangible assets is "rough justice." Some taxpayers will have assets with somewhat longer lives, others will have assets with shorter lives, and others will be able to amortize goodwill that previously was nondeductible. In exchange for a single life for all intangible assets, taxpayers and the government will have much desired certainty and efficiency. Valuation, allocation, and useful life questions will be virtually eliminated. Taxpayer and government resources will no longer be spent unproductively in an attempt to answer questions that have no clear answers.

Id. 1991 House Hearing on Intangibles, supra note 32 (Statement of Rep. Raymond McGrath) ("this 'one size fits all' approach of 3035 [bill first considering § 197], the 14-year, fixed statutory period, that there are a lot of winners and losers all over the place."); id. at 22 (Statement of Rep. Bill Archer, R-Tex.) ("In this case, since we’re talking about creating potentially large winners and losers, we need to hear from those who would be affected by these bills, in both directions.").

Paygo tax legislation is the ideal under this view. A minority of practitioner representatives claim, however, that “rough justice” always hurts the taxpayer. To the contrary, sometimes IRS/Treasury is able to

incentives for politicians to enact laws that serve private rather than public interests, and hence statutes are supplied by lawmakers to the political groups or coalitions that outbid competing groups”); Ernest Gellhorn, Public Participation in Administrative Proceedings, 81 YALE L.J. 359, 377 (1972) (explaining how public interest groups have “drew agency attention to new techniques for fulfilling their mandate”); Frederick R. Anderson, Revisiting the Constitutional Status of the Administrative Agencies, 36 AM. U. L. REV. 277, 284 (1987) (explaining that the “democratic process ideal presumes the value of interest group competition and representation in the political process”); Jeffrey A. Schoenblum, Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals, 12 AM. J. TAX POL’Y 221, 227 (1995) (pointing to the impact of special interest groups on the distribution of funds); Mark R. Killenbeck, A Matter of More Approval? The Role of the President in the Creation of Legislative History, 48 ARK. L. REV. 239, 248 (1995) (discussing the impact of a “lawyer-lobbyist” on legislative history). Commentators have criticized interest group competition as leading to economic “waste.” Jerry L. Mashaw, The Economics of Politics and the Understanding of Public Law, 65 CHI.-KENT L. REV. 123, 132 (1989) (discussing the history of interest group involvement in agency and noting that critics have seen interest groups as “pursuing their own ends”); Dennis Honabach & Roger J. Dennis, The Seventh Circuit and the Market for Corporate Control, 65 CHI.-KENT L. REV. 681, 725-28 (1989) (explaining how the “interest group approach . . . views legislation as the product of compromise among competing interest groups” and arguing that the court’s role should be to enforce the bargain struck between the interest groups as reflected in the legislation.); Douglas M. Branson, A Corporate Paleontologist’s Look at Law and Economics in the Seventh Circuit, 65 CHI.-KENT L. REV. 745, 753 (1989); Lynn A. Baker, Direct Democracy and Discrimination: A Public Choice Perspective, 67 CHI.-KENT L. REV. 707, 737 (1991) (criticizing the notion that “legislation enacted by a representative body is . . . more likely to realize ‘the common good’”). Other commentators criticize such competition as preserving the status quo. Ethan Fishman, Loper, Begging and Civic Virtue, 46 ALA. L. REV. 783, 794-95 (1995) (explaining that “[w]hen civic virtue is defined by competing interest groups, it becomes possible for cohesive minority interests to have a disproportionate influence on public policy”).

364. Lee, Capital Gains Contentions, supra note 53, at 57 (“[T]he ‘pay-as-you-go’ or ‘paygo’ procedures of OBRA 1990, as extended by OBRA 1993, require revenue decreases to be offset by (a) increases in revenues, which is unlikely due to the Republican aversion to tax increases, or (b) decreases in spending, so there is no net increase in the deficit.”) (footnotes omitted). But the potential for legislative complexity is doubled with both a new tax expenditure provision and a new revenue raising provision, both with opportunities for exceptions.

365. Unofficial Transcript of IRS Hearing on Uniform Capitalization Regs, 93 TAX NOTES TODAY 246-30 (December 3, 1993) (Statement of Michael Frankel representing the American Institution of Certified Public Accountants).

MR. FRANKEL: I always liked these bright lines, these rough justice ideas, that leads to simplification. At the same time, it’s amazing to me how simplification always hurts the taxpayer.

Ever since rough justice came in with the loss disallowance rules, I have given up on that idea.

(Laughter.)

Id. Other AICPA representatives “[o]ver the past several years ... have been pleased with the approach to ‘rough justice’ generally espoused in the Treasury Department and the Internal Revenue Service, and we hope that will continue.” Hearings on President Clinton’s Proposals for Public Investment and Deficit Reduction, 103d Cong. 519 (1993) (Part 1). (Statement of Leonard Podolin immediate past Chairman of the Tax Executive Committee of the AICPA’s Tax Division).

Commissioner Goldberg has emphasized “that the private sector must share the blame. Small groups of taxpayers have pushed for laws and regulations that have imposed inappropriate burdens on the system — all in the name of equity, certainty, transition relief, or special circumstances. And all too often, the private sector views simplification as a one-way street — support it when it reduces taxes and oppose it when it increases taxes. That road is a dead end. Once again, simplification entails rough justice —
achieve "rough justice" by offsetting rules that hurt the same class of taxpayers with rules that benefit it. 366 Indeed, Treasury and taxpayer representatives viewed Section 197 (amortization of purchased intangibles), the closest analogue to expensing and capitalizing self-created intangibles, in just that light. 367 Moreover, on occasion Treasury has advocated a "rough justice" measure that might allow some taxpayers to have an unwarranted tax advantage so long as "it would achieve the economically correct . . . results for taxpayers who are legitimately trying to [carry on

some short cuts that raise revenue, other short cuts that lose revenue. Hearings on Impact of TRA 1986, supra note 174 (Statement of Commissioner Goldberg).

366. Sheppard & Evans, supra note 314 ("IRS Associate Chief Counsel (Technical) Kenneth Klein insisted that simplicity in the regulations had arrived. 'Simplification invariably hurts someone, so we make the changes in groups that both hurt and help taxpayers, and that way we get rough justice,' he said."); Hearings on Impact of TRA 1986, supra note 174, at 53 (Statement of Commissioner Fred Goldberg)

A. The Joys of Rough Justice — If tax legislation were a team sport, then the trade of the century would have been the [1986 Code's] elimination or curtailment of numerous itemized deductions and passive losses, plus strengthening the minimum tax, in exchange for higher standard deductions and lower rates. Many taxpayers have benefited from this exchange, others have not. In the aggregate, however, the net result has been dramatic simplification for many taxpayers . . .

The Tax Reform Act of 1986 taught Professor Lee also to think in these terms; he has long viewed that Reform Act as fair on the average although not perfect justice in the case of every individual taxpayer.

367. MR. VANDER JAGT: Mr. Gideon, you are attracted to the simplicity and the clarity which H.R. 3035 provides to the Code, and I am, too. But I think from you answers to questions, you do agree that this one-size-fits-all approach of H.R. 3035, the 14-year fixed statutory period, results in a lot of winners and losers all over the place.

MR. GIDEON: There are asset winners and losers. It is less clear, Mr. Vander Jagt, that there are company winners and losers. I think that we probably heard over here from one category like that. But in many cases, the people who benefit and the people who lose are the same folks, and I think that's the reason why the bill basically makes sense.

If you are in the situation where you're on both sides of the issue here, you may decide that the certainty of 14 is a pretty fair cut, and you'll take the certainty rather than arguing over what the pieces are.

MR. VANDER JAGT: There will be instances like that. But you will have companies that have a useful life that can be shown that's three years and if they have to write it off over 14, that company would be a loser.

MR. GIDEON: But surprisingly, to me at least, the number who seem to be in that category seem to be fairly discreet.

MR. GIDEON: ... I think that most people we're not hearing from for the reason that most people are really on both sides of this issue. When they look at the businesses they acquire, they see that they have some customer lists, they see that they have some goodwill, they see that, yes, they have some other things that might be shorter, but they say "On balance, 14 years is a pretty good cut for me, simply because when I look at this average and the fact that I'm no longer going to have to litigate, I'm going to know what my answer is, I'll live with that."

I think that's the reason why, for many, many people, they find themselves in this bill both winners and losers and on balance they accept the simplification and the clarity of the result.

their business affairs] in a cost-effective way."

5. Simplified Accounting Methods and Small Taxpayers

In essence the "rough justice" approaches called for are nothing more than simplified tax accounting methods. That strongly suggests as a broad tax policy matter that they be limited to the same class of taxpayers to whom such simplified methods traditionally have been granted to reduce transaction and tax costs. The statutory limitations on use of the cash method of income tax accounting under Section 448 constitutes a congressional highlighting of the classes of taxpayers for whom it believes the burdens of more complex rules outweighs the clearer reflection of income. Conceptually even closer are the limitations on expensing of small amounts of depreciable assets under Section 179. Therefore the "rough justice" proposals should be explicitly barred to tax shelters. Rather than

369. Section 448(a) and (b) first bar the use of the cash method to corporations and tax shelters and then except farms, qualified personal service corporations and entities with gross receipts of not more than $5,000,000. The Supreme Court in Catto v. United States, 384 U.S. 102, 110-11 (1966), describes the traditional administrative permission for farmers to use cash accounting even where "inventories" of farm animals as based on the need "to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure" even though such method distorted the farmer's income. The Joint Committee Staff put it well:

Small businesses generally are provided exceptions from normative tax accounting rules in order to alleviate their record-keeping burdens. In most instances, these simplified methods also reduce the tax liability of the qualified small business. Thus, the simplified methods of present law serve the dual purpose of easing the administrative burdens of, and providing a tax subsidy to, small businesses.

370. Section 179 allows elective expensing (first year deduction) instead of capitalizing and depreciating the costs of tangible personal property up to a relatively small dollar amount (increasing from current $18,000 to $25,000 by 2003) reduced dollar for dollar by purchases over $200,000. Sections 179(b)(1) and (2) and (d)(1). In addition to the dollar limitations aimed at smallness, other limitations are aimed at tax shelters, viz, the non-coverage of real estate and of non-corporate lessors of equipment. Section 179(d)(1) and (5).

Section 179 was enacted as part of the Technical amendments Act of 1958, which added other tax provisions targeting toward benefitting small businesses, including treating losses on certain small business stock as ordinary rather than capital losses; extending the carryover period for net operating losses; instituting subchapter S; increasing the minimum accumulated earnings credit (since repealed); and providing an extension of time from payment of estate tax attributable to investments in closely held enterprises.

379. Joint Committee Staff, Small Business Taxation, infra note 379, at *n.16.

The present-law section 179 expensing allowance also is viewed as a simplification measure for small businesses because annual depreciation calculations and records become unnecessary for expensed property. However, this simplification goal is fully achieved only if the amount of the taxpayer's qualified investment for the taxable year does not exceed the $17,500 limitation. Otherwise, the taxpayer must identify, and properly account for, property to which the expensing allowance applies and property to which it does not.

Id.
adopt the statutory definition of "tax shelter," this article advocates that in the case of pass-through entities at least 50% of the ownership interests must be held by members who materially participate in its business (or perhaps a related business).

The argument that simplified expensing and uniform capitalization lives should not be extended to tax shelters is supported by the Public Choice theory of statutory interpretation to those code sections as well. Where the factfinder — the Service in rulings and the courts in litigated cases — can determine that a particular tax provision is the product of private compromise and produces asymmetrical benefits, as with simplified expensing and uniform capitalization lives, the terms of the statutory "contract" should not be extended to other similar tax items. Instead, taxpayers are entitled to the preferences Congress awards by relying on form even where little or no economic substance exists apart from tax preferences.

Further, the factfinder may impose "equitable" doctrines even to the items covered by the contract, such as business purpose or economic substance, to increase transaction costs. Where a statute does not betray such origins or use, such as where it is "public-regarding" rather than "rent-seeking," the factfinder should utilize a traditional fill-the-gap approach. The creative role of the factfinder should be particularly broad where the legislative history specifically carves out an explicit role for the judiciary or the Service, particularly as an exception to a private compromise provision. The "clear reflection of income" standard constitutes such a role.

This argument, like the Tax Court's "generic tax shelter" rules of interpretation, reflects the public choice theory by narrowly interpreting special interest legislation. Classic public choice theory views legislation as a private contract between legislators bent on re-election and private interest groups. "Public Choice [is] the economic study of nonmarket decisionmaking, or simply the application of economics to political science."

Under the public choice theory, where the special interest groups and Congress acted against a backdrop of a reserved judicial or agency overview power, that power should be applied broadly.

371. For example, a real estate operator renting self-constructed property who materially participates in the development and construction of the property more than in renting.
374. See Easterbrook, Foreword: The Court and the Economic System, 98 HARV. L. REV. 4 (1984). Easterbrook posits that the "more detailed the law, the more evidence of interest-group
Some critics argue that empirical evidence does not support key public choice tenets.375 Lee's study of the history of the Tax Reform Act of 1986,376 as well as of earlier tax acts, and subsequent budget reconciliation tax acts leads to the conclusion that in the case of federal tax legislation, distinctions between private interest (or "rent seeking") and public interest (or "public regarding") origins can only be made provision-by-provision, not tax act by tax act. While public choice theory is subject to many telling criticisms in practice, the analysis provides insights into the competence of courts to supplement and correct congressional and agency law.377 Increasing our understanding of judicial statutory interpretation, it alerts judges to the misdirection of the legislative process.378

The far harder question is whether expensing and amortization safe harbors should also be limited to small income taxpayers. The Joint Committee Staff recently pointed out small businesses are granted many exceptions from the normal tax accounting rules, i.e., tax preferences.

Small businesses generally are provided exceptions from normative tax accounting rules in order to alleviate their record-keeping burdens. In most instances, these simplified methods also reduce the tax liability of the qualified small business. Thus, the simplified methods of present law serve the dual purpose of easing the administrative burdens of, and providing a

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375. Farber & Frickey, in Classic Jurisprudence of Public Choice, 65 Tex. L. Rev. 873, 883 (1987), conclude (1) that "[a]lthough it is true that legislators are influenced by special interests, and that legislatures are faced with the possibility of incoherence, legislatures need not be mere pawns of special interests, nor are they doomed to chaos." (2) "[T]he behavior of members of Congress is dictated by three basic goals: achieving reelection, gaining influence within the House, and making good public policy." Id. at 589. (3) "The economic theory of legislation ... does not perform well empirically." Id. at 895. (4) "Our best view of the political process ... is a mixed model in which constituent interest, special interest groups, and ideology all influence legislative conduct. In addition ... , political parties and chief executives, among other forces, also influence outcomes." Id. at 873 and n.165. I would add that popular press and, in particular, investigative tax reporting also can influence outcomes.

376. Contrary to Doemberg & McChesney, On the Accelerating Rate and Decreasing Durability of Tax Reform, 71 Minn. L. Rev. 913 (1987), I agree with Professor Eskridge, that the Tax Reform Act of 1986 on the whole was public-regarding, with some industry exceptions (oil and gas, insolvent savings and loans, and corporate use of real estate) and, of course, except for rifle-shot transition rules.

377. Id. Eskridge, supra note 374, at 280.
378. Id. at 280-81.
tax subsidy to, small businesses. . . . The perceived difficulty of some of the tax accounting methods from which small businesses are granted exceptions are a result of the need to measure income under the present-law income tax. These methods generally attempt to match income and expense by requiring capitalization of costs that benefit future periods and providing when and how these capitalized costs are taken into account.  

Sections 446 and 179 as well as 263A, the uniform capitalization rules also manifest a pattern of exceptions from more complex and more theoretically correct rules for small business (under the general policy of simplicity). Section 263A holds true to the model of administrative convenience exceptions to more clearly reflect income capitalization rules for small taxpayers. Senator Pete Domenici, (Republican from New Mexico) noted Section 263A’s exception for small manufacturers and retailers.  

Representative Thomas Downey (Democrat from New York), more broadly reasoned that:

[A] review of the legislative history behind section 263A suggests that the thrust of the provision was to require various producers of tangible property already capitalizing direct and some indirect costs to more comprehensively capitalize other indirect costs. Congress meant to exempt from the new uniform capitalization rules those taxpayers, or expenditures, that were already exempted under prior law from the general capitalization rules. For instance, farmers and ranchers were exempted. The exemption for research and experimental expenditures was continued. The exemption from uniform capitalization for the timber industry and the ornamental trees industry was continued. Hadley versus Commissioner correctly held that free-lance writers were exempted from the pre-1986 rules. Therefore, the rules should not apply to writers and their counterparts in the creative fields of photography, film, and the arts.

In addition to casting light on whom Congress generally targets with


380. 134 CONG. REC. S5243.

As a result of tax reform, the artists, sculptors, writers and photographers were put in the same category as manufacturers and anyone else who has overhead expenses. On the surface that makes some sense under the theory that taxpayers with the same tax circumstances and types of deductions should be treated the same. However, the Tax Reform Act of 1986 was not internally consistent because it exempted the small manufacturer and retailer with sales of less than $10 million.

The 1987 Ways and Means Committee Letter, *supra*, had made previously this point: “subjecting individual creators to these requirements is totally inconsistent with our decision in closely-related areas — e.g., permitting individual taxpayers in all cases to utilize cash method accounting and exempting retailers with $10 million or less in annual sales from uniform capitalization rules.”

381. 134 CONG. REC. E 1245.
simplified tax accounting rules, other administrative tax accounting exceptions illuminate factors taken into account in determining clear reflection of income. The commonality with capitalization issues is that clear reflection of income in tax accounting does not require exact matching of income and economic benefit. Taking account of an item in one year or the next does not distort income. This parallels the proposed regularly recurring exception to future benefit capitalization. Pursuant to the exercise of the Commissioner's discretion under Section 446, Revenue Procedure 71-21,\(^{382}\) provides that, in limited circumstances, an accrual method taxpayer can defer taking into income amounts actually received in one taxable year for services to be performed by the end of the next taxable year.\(^{383}\) Under this approach, payments received for services to be performed in the future are treated similarly for tax and financial reporting purposes in order to "facilitate reporting and verification of such items from the standpoint of both the taxpayer affected and the Internal Revenue Service."\(^{384}\) Although deferral of income is limited to the succeeding taxable year, clearer reflection of the taxpayer's income is still achieved through matching income with the costs associated with the production of these revenues by deferring recognition of income until the services are completed.\(^{385}\) Despite the somewhat parallel treatment of deferred revenue with respect to contracts for performance of services, the Service has refused to extend the same approach to income associated with rents or property rights.\(^{386}\)

Similarly to avoid disrupting normal business and accounting practices, Congress provided an exception in Section 461(h)(3) allowing a taxpayer to treat certain recurring expenses, in which the accrual accounting method "all events test" for determining the tax year in which an item of income or


\(^{383}\) See also Treas. Reg. § 1.451-5 (as amended in 1986), concerning advance payment for goods, which provides another limited instance in which deferral is allowed.

\(^{384}\) Rev. Proc. 71-21, 1971-2 C.B. 549. ("The purpose of this Revenue Procedure is to reconcile the tax and financial accounting treatment of such payments in a large proportion of these cases without permitting extended deferral in the time of including such payments in gross income for Federal income tax purposes.").

\(^{385}\) This treatment comports closely with financial accounting treatment in which the amount received for services would be recorded as a liability until the obligation to perform the service has been discharged. Income is then recognized pro rata as services are rendered and income is thereby earned. See JAN R. WILLIAMS ET AL., INTERMEDIATE ACCOUNTING 189-90 (3d ed. 1989).

\(^{386}\) See e.g., Gen. Couns. Mem. 39,177 (Mar. 5, 1984) (Payments under a television contract to broadcast taxpayer's games were made in exchange for property rights and not services, and therefore under Rev. Proc. 71-21 may not be deferred for income tax recognition to the succeeding taxable year); Gen. Couns. Mem. 39,434 (Oct. 25, 1985) (Annual credit card membership fee paid to taxpayer relates to the acquisition of a property right—the right to use money— and may not be deferred under Rev. Proc. 71-21).
expense is accounted for\textsuperscript{387} is otherwise met, as incurred in year 1, even though economic performance with respect to the item does not occur until a subsequent tax year. The four statutory preconditions availability of the "recurring" expense exception\textsuperscript{388} suggests the tax policies that the Service/Treasury should consider in fashioning any recurring expense exception to capitalization of future benefits. Indeed the consideration under Section 461(h)(3)(iv) of concepts of materiality and proper matching of expense against income would seem to be analogous to notions of clear reflection of income with exceptions for small recurring items in the capitalization arena. Allowing the treatment of an item for financial reporting to be taken into account for determining the item's materiality for income tax purposes would ensure that any liability that is material under GAAP would also be material for income tax purposes\textsuperscript{389} Surely to this limited extent GAAP could be controlling. Thus smaller taxpayers would not have to be concerned with the disparate treatment of certain liabilities reported under GAAP for income tax reporting purposes. However if the item is immaterial under GAAP, it may still be material for purposes of Section 461,\textsuperscript{390} ensuring a more theoretically accurate reflection of income. For example, assume that a calendar-year taxpayer enters into a one-year maintenance contract on July 1, 1985. If the amount of the expense is prorated between 1985 and 1986 for financial statement purposes, it should also be prorated for tax purposes. If, however, the full amount is deducted in 1985 for financial statement purposes because it is not material under generally accepted accounting principles, it may (or may not) be considered an immaterial item for purposes of this exception.

In some circumstances, items that are not material for financial accounting purposes may be treated as material items under this provision.

\textsuperscript{387} The all events test is met if all events have occurred which determine the fact of liability of the taxpayer, or of an obligor of the taxpayer as to an income item, and the amount of such liability or income can be determined with reasonable accuracy. I.R.C. § 461(h)(4) (1996).

\textsuperscript{388} These four conditions are:

(1) the all events test applied, without regard to economic performance, is satisfied with respect to the item during the taxable year;

(2) economic performance occurs within a reasonable period (but in no event more than 8 1/2 months) after the close of the taxable year;

(3) the item is recurring in nature and the taxpayer consistently treats items of that type as incurred in the taxable year in which the all events test is met; and

(4) either —

(a) the item is not material, or

(b) the accrual of the item in year one results in a better matching of the item with income to which it relates than would result from accruing the item in year two in which economic performance occurs.


\textsuperscript{389} Treas. Reg. §§ 1.461-5(b)(4)(ii) and (iii) (as amended in 1995).

\textsuperscript{390} Id.
For example, an item of expense which is immaterial for purposes of consolidated financial statements that combine a corporate taxpayer’s financial data with those of affiliated companies may be material if the taxpayer is viewed separately. Also, an item of expense, which is immaterial for purposes of the financial statements but which is significant in terms of absolute dollar size, may be treated as material under this provision.

Congress intended that where the item is directly related to an activity, the materiality of the item will be separately determined with respect to that activity. The materiality of overhead expenses that relate to several activities of the taxpayer will be measured against those collective activities.

Should capitalization regulations draw a similar distinction between big and small incomes? Approaching the question solely from a perspective of a cost/benefit analysis as to the taxpayer, Professor Lee would answer yes. Hopefully apart from his general populist perspective in his more recent work, Lee has advocated a two-track regulatory system with simpler rules where greater numbers of smaller taxpayers are affected. Elaborate, more theoretically correct rules may be okay for those who can handle them. Arguably that is the case for more theoretically correct, but frightfully complex provisions such as Section 263A (and Section 453A and above all the time-value-of-money provisions and their small business exceptions). But this article concludes that the proposals should apply to large corporate taxpayers for one statutory interpretation reason, one practical reason, and two policy reasons—political and transaction costs from the Service’s perspective.

First the practical. Capitalization and expensing issues are significant audit issues only at the big, usually public, C corporation level. If that “niche” is excluded from the simplification proposals, then all of us have put a lot of work into a pointless project. More significantly that sector is where the revenue is—80% of C corporate sector income and 56% of combined C corporation sector and sole proprietorship sector.

The second reason is that an interpretative regulation can rise not higher than the statute and its case-law glosses. Unlike Congress the authorities have tended not to draw independently big/little taxpayer distinctions except for the notion, often having the same effect, that absolute size as well

393. See note 80 supra and accompanying text.
as relative size is a factor in substantiability.394 Where the taxpayer is small so that burden of capitalization is heavy, especially if useful life is difficult/costly or impossible to establish, a current deduction should be allowed.