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Start-Up Costs, Section 195 and Clear Reflection of Income: A Tale of Talismans, Tacked-on Tax Reform and a Touch of Basics

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START-UP COSTS, SECTION 195, AND CLEAR REFLECTION OF INCOME: A TALE OF TALISMANS, TACKED-ON TAX REFORM, AND A TOUCH OF BASICS

*John W. Lee**

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I. INTRODUCTION

Section 162(a) of the Internal Revenue Code of 1954 provides a current deduction for the ordinary and necessary expenses of carrying on a trade or business.¹ However, the deduction of start-up and analogous costs, incurred prior to commencement of revenue-generating operations in a new business, as an ordinary business expense is traditionally denied on the relatively mechanical ground that the taxpayer is not yet carrying on a trade or business; the denial is based on the "preparatory" doctrine.² Once capitalized,

¹ I.R.C. § 162(a).

² Section 195(c)(1) (1984) (like its predecessor § 195(b) (1980)) of the Code encompasses both investigatory and pre-opening costs within the generic term "start-up expenditures." See *infra* note 315. Some commentators agree with the approach adopted by the Code. See, e.g., Buell, *Business Start Up Costs: Analyzing and Planning for Current Deductibility*, 43 J. Tax'n 278 (1975); Erbacher, *Start-Up Costs: Are They Deductible by a Corporation for Federal Income Tax Purposes?*, 48 Taxes 488, 496 (1970); Roth, *Trade or Business Requirement of Sec. 162 and the Deductibility of Preoccupancy Expenses Incurred in Rental Real Estate Projects*, 57 Taxes 33 (1979); see also *infra* note 175. However, other commentators distinguish between (a) investigatory costs and (b) pre-opening expenses, which are often called start-up costs. See, e.g., Lee, *Pre-Operating Expenses and Section 174: Will Snow Fall?*, 27 Tax Law. 381, 384 (1974); Seago, *The Tax Treatment of Start-Up Costs*, 9 Tax Adviser 410 (1978). Proper tax treatment (current deduction versus capitalization) of the two classes of expenditure may differ in some instances under a deep structure analysis. See *infra* note

such start-up costs are also inequitably held to be nonamortizable after the business commences.³ In contrast to this traditional "definition approach," a "functional approach" to the treatment of such costs would deny a deduction, based upon a lack of business status, only to non-profit-motivated and investment expenditures. The functional approach opens the way for consideration of the structural question⁴ of the distinction between currently deducti-

443.

Under the preparatory doctrine, a current deduction of both classes of expenditures is denied because the activity is not yet functioning as a going concern. See *infra* notes 175-187 and accompanying text. The preparatory doctrine still finds adherents. See, e.g., *Aboussie v. United States*, 779 F.2d 424, 428 (8th Cir. 1985). Increasingly, however, decisions base denial of a current deduction of start-up costs on the rationale that they constitute capital expenditures. See, e.g., *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228 (1985). Start-up cost issues are frequently raised on audit. Hearings on H.R. 6883, H.R. 5616, H.R. 5729 [60-month amortization of start-up costs], H.R. 6039, H.R. 6140, H.R. 6247, H.R. 6824, and H.R. 7009 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 2d Sess. 45, 101-02 (1980) [hereinafter 1980 Hearings] (statements of Charles M. Walker, Chairman, Section of Taxation, A.B.A., and Samuel M. Chase, Jr., Chairman, Legislative Ad Hoc Subcommittee on Real Estate Securities, Nat'l Ass'n of Realtors, respectively).

³ Capitalized start-up costs are usually added to one of three items. First, they are added to the nonamortizable basis of the business created in part by them. E.g., *Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977); *Kennedy v. Commissioner*, 32 T.C.M. (CCH) 52 (1973); cf. *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986) (start-up costs "are part of the cost of establishing the enterprise"). Second, they are added to a nonamortizable permit required to operate as a business. E.g., *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), rev'd and remanded, 382 U.S. 68 (1965); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985). Third, they are added to amortizable business assets used in the created business. E.g., *Cagle v. Commissioner*, 539 F.2d 409 (5th Cir. 1976); *Shainberg v. Commissioner*, 33 T.C. 241 (1959); see also cases cited *infra* note 112.

⁴ A structural question involves a basic concept of the Code. See Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 Yale L.J. 861, 861 (1976) (arguing that "difficulty in understanding tax law most frequently arises from failure by those who use basic concepts to grasp their meaning, rather than from any excessive attempt at statutory precision").

The deep structure analysis in the start-up and business expansion cost area must start with "Congress' fundamental policy decision to tax net income calculated annually, with minimal distortion. To arrive at a figure for annual net income for a given tax year, it is necessary to reduce gross revenues *for the year* by the costs of producing *those revenues*." *NCNB Corp. v. United States*, 651 F.2d 942, 947 (4th Cir. 1981) ("*NCNB I*"), vacated and remanded en banc, 684 F.2d 285 (4th Cir. 1982); see also *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), cert. denied, 463 U.S. 1207 (1983); Note, *Commissioner v. Lincoln Savings & Loan Association: "Separate and Distinct Asset" As a Condition Sufficient for Capitalization*, 2 Va. Tax Rev. 315 (1982). A net annual income is supported by the legislative history. 50 Cong. Rec. 3,849 (1913) (statement of Senator Williams).

ble or "ordinary" expenses and capital expenditures. The emerging functional answer turns on whether current deductibility will substantially distort the taxpayer's income.⁶ If so, the expenditure should be capitalized and concomitantly its cost amortized or deducted ratably over the expenditure's useful life. The conflict between the definitional approach and the functional approach continues as to start-up-type costs incurred after commencement of revenue-generating operations. Under the "separate, saleable asset" definitional tack, start-up-type expenditures incurred in expanding an existing business are currently deductible if they do not enhance or create property convertible into cash,⁶ whereas a functional approach continues to ask whether a current deduction will produce a substantial distortion of income as contrasted with capitalization and gradual amortization.

The case-law development of the tax treatment of start-up business expansion and analogous costs epitomizes the hazards of a bright-line definitional approach, particularly in the multi-jurisdictional tax world.⁷ It may produce the correct result on the narrow facts to which first applied, but upon further talismanic extension generates functional inequities. These inequities, like a blocked river seeking new channels, often force other resolutions. Thus, some tribunals seeking to maintain the definitional precedents while obviating such inequities multiplied nonfunctional distinctions, distorted other tax concepts, or adopted further definitional tests. Other tribunals more forthrightly, but in direct conflict with the definitional tests, applied a functional approach. All of this ne-

⁶ See 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 20.4.1, at 20-66 to -67 (1981). Professor Bittker concludes that:

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 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.

Id. at 20-67 (footnotes omitted); see Gunn, *The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C. Indus. & Com. L. Rev. 443, 452 (1974); Lee & Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. Rich. L. Rev. 473, 474-75, 544-45 (1981); Note, *Deductibility of Start-Up Expenditures Under Section 162—The "Clear-Reflection-of-Income" Test*, 61 Cornell L. Rev. 618, 630-31, 638-39 (1976).

⁶ See, e.g., *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973); accord *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974).

⁷ Tax controversies may be tried in the Tax Court, federal district courts, or the Claims Court. See generally 4 B. Bittker, *supra* note 5, ¶ 115.1.

gates the prime, if not sole virtue of a definitional approach: predictable results.⁸

The frequent controversies between taxpayers and the Internal Revenue Service under these definitional approaches, as well as the disparate tax treatment of identical expenditures by new and existing businesses, led Congress⁹ in 1980, as part of the then nascent tax reform and simplification efforts,¹⁰ to enact section 195,¹¹ which provides for elective sixty-month amortization of start-up costs incurred by a taxpayer in a new active business.¹² Unfortunately, the new Code provision utterly missed a basic goal of such simplification: attainment of a reasonably certain conclusion without expenditure of excessive research time.¹³ Instead of remedying this failure, the 1984 amendments to section 195¹⁴ sadly compounded it. Additionally, the section continues the perverse tax disparity of favoring existing businesses over new businesses,¹⁵ al-

⁸ Cf. *Hoopengartner v. Commissioner*, 80 T.C. 538, 550 (1983) (Cohen, J., dissenting), *aff'd* mem., 745 F.2d 66 (9th Cir. 1984). Judge Cohen stated that:

To say that the contract is the income-producing asset and the expenses relating to that are deductible is to create chaos among those attempting to decide cases on principle [the preparatory doctrine] rather than on the level of imagination utilized by the taxpayer. In my opinion, the approach of the majority will create new 'incongruities in this area of the law,' which can only constitute a renewed inducement to controversy and an impediment to settlement of litigation.

Id. (footnote omitted).

⁹ See, e.g., S. Rep. No. 1036, 96th Cong., 2d Sess. 13, reprinted in 1980 U.S. Code Cong. & Admin. News 7293, 7303.

¹⁰ See, e.g., Committee on Tax Policy, Tax Section, N.Y. State Bar Ass'n, A Report on Complexity and the Income Tax, 27 Tax L. Rev. 325 (1972) [hereinafter N.Y. Bar Report]; Krane, Depreciation, Investment Tax Credit, Capitalized Versus Deductible Expenditures, and Prepaid Expenses, in *Federal Income Tax Simplification* 295 (C. Gustafson ed. 1979); McDaniel, Simplification Symposium—Federal Income Tax Simplification: The Political Process, 34 Tax L. Rev. 27 (1978) and commentary cited at 27 n.1. This superficial treatment of start-up costs was probably considered by the drafters of § 195. Compare Krane, at 310-11 with S. Rep. No. 1036, *supra* note 9, at 10-14, reprinted in 1980 U.S. Code Cong. & Admin. News at 7300-04.

¹¹ Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 102(a), 94 Stat. 3521, 3522 (codified as amended at I.R.C. § 195).

¹² I.R.C. § 195(b)(1) (1984); I.R.C. § 195(a) (1980).

¹³ Simplification to practitioners means that a reasonably certain conclusion can be determined by diligent and expert research without excess expenditure of time and dollars. See N.Y. Bar Report, *supra* note 10, at 327. (This is not generally the case with start-up costs and analogous expenditures before or after § 195, as this article abundantly evidences.)

¹⁴ Tax Reform Act of 1984, Pub. L. No. 98-369, § 94(a), 98 Stat. 494, 614-15 (codified at I.R.C. § 195).

¹⁵ Section 195 requires new businesses to amortize or deduct ratably over at least a 60-

though new businesses are already at a disadvantage in both the capital and credit markets.

Two mistakes made by its drafters make section 195 a deeply flawed provision and a substantial step backwards from simplicity. First, embodying a drafting technique widely advocated in calls for tax reform and simplification,¹⁶ section 195 constitutes a bare-bones generalized statute leaving to the regulations, yet to be promulgated, the fleshing out of the necessary details. Congress, however, apparently unwilling to remove its thumb from the scales, provided detailed guidance in the 1980 Committee Reports.¹⁷ Unfortunately, this "legislative history" incorporated by reference "present law" in an astounding number of controversial, uncertain areas, fatally eroding the certainty sought by the statute. Second, the drafters failed to consider an even more fundamental need in

month period expenditures that an existing business can currently deduct in "operation" (previously, could currently deduct in "expansion"). I.R.C. § 195(b)(1) (1984); cf. I.R.C. § 195(a) (1980). As a witness pointed out at the 1980 Hearings on § 195 and other "minor" tax bills, as to the pre-section 195 tax disparity between a new business and an existing business:

An interesting point is that the same costs which are not deductible in starting up a new business become deductible once the business has reached going concern status. Then those same types of costs, not deductible or depreciable to the preoperating venture, become deductible under our tax laws. Thus, our tax policy currently warns an entrepreneur who is interested in investing and starting a new business or a new economic entity: You will have to finance all of these costs with after-tax dollars, but just as soon as you can demonstrate you have become a going concern, then we will let you finance the identical types of costs with pretax dollars. In our judgment, this is an excellent illustration of a cart-before-horse policy.

1980 Hearings, *supra* note 2, at 107 (statement of Gerald W. Padwe, Associate National Director, Tax Services, Touche Ross & Co.).

Sixty-month amortization is still less beneficial than an immediate deduction, notwithstanding the rationalization that a new business may be in a loss situation and, hence, find deferral simpler since it corresponds "more closely to the earnings growth of a new business." 126 Cong. Rec. 24,813 (1980) (statement of Rep. Conable, introducer of H.R. 5729); see *NCNB Corp. v. United States*, 684 F.2d 285, 295-96 (4th Cir. 1982) (en banc) ("*NCNB II*") (Murnaghan, J., dissenting), vacating and remanding, 651 F.2d 942 (4th Cir. 1981). The 60-month amortization undoubtedly was a compromise between the all-or-nothing (immediate deduction or capitalization without amortization) definitional rules of pre-1980 case law. See Krane, *supra* note 10, at 310-11) (suggesting just such a § 248-like compromise to the "intractable" start-up controversy). Section 248 was unmistakably the basis for the original bill. Compare H.R. 5729, 96th Cong., 2d Sess., reprinted in 1980 Hearings, *supra* note 2, at 181 with I.R.C. § 248.

¹⁶ See N.Y. Bar Report, *supra* note 10, at 348-49.

¹⁷ See, e.g., S. Rep. No. 1036, *supra* note 9, at 10-14, reprinted in 1980 U.S. Code Cong. & Admin. News at 7300-04.

such reform—deep structure analysis¹⁸ of ordinary and capital expenditures. Consequently, the efficacy of original section 195 fatefully hinged upon the fallacious premise that all targeted start-up costs would be currently deductible if they had been incurred after commencement of the business, with no apparent awareness of the capitalization role of the clear reflection of income doctrine. The 1984 amendments still displayed the drafters' confusion of ordinary and capital expenditures.

The demarcation, predominantly judicially fashioned, between ordinary and capital expenditures probably is the most difficult to draw in the tax field.¹⁹ Accordingly, in order to lay an analytical framework on which to examine start-up costs, Part II of this article analyzes the minimum distortion of income rationale for capitalization and the acquisition cost rationale, which when misapplied itself produces distortion of income. This section also proposes a model reconciling these two approaches with respect to start-up costs by treating the expenditure itself as a free-standing, amortizable asset. Part III evaluates the case-law development of start-up and business expansion costs in light of this model, focusing on (a) the judicial development of, and responses to, the conflicting definitional and functional tests, (b) the rejection of an approach substantially similar to the model, and (c) the substantial impact of the enactment of section 195. Part IV critically examines section 195, both as enacted and as amended, against the backdrop of this case-law development and the model, paying particular attention to the statute's attributes of legislation by committee report, codification of case-law conflicts, and lack of deep structure analysis.

II. CAPITALIZATION AND CAPITAL RECOVERY: A DEEP STRUCTURE ANALYSIS

A. *The Model*

An ordinary business or investment expense is currently deducti-

¹⁸ See Kingson, *supra* note 4, at 861.

¹⁹ See, e.g., *Seligman v. Commissioner*, 84 T.C. 191, 201 (1985), *aff'd*, 796 F.2d 116 (5th Cir. 1986); accord *Iowa-Des Moines Nat'l Bank v. Commissioner*, 68 T.C. 872, 878 (1977), *aff'd*, 592 F.2d 433 (8th Cir. 1979); *Boagni v. Commissioner*, 59 T.C. 708, 712 (1973). See generally Lee & Murphy, *supra* note 5, at 473.

ble in the tax year incurred or paid.²⁰ A capital expenditure, in contrast, may be deducted from ordinary income only²¹ through (a) amortization or depreciation, usually ratably, over the useful life of

²⁰ Section 162(a) provides a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a). Section 212 provides individual taxpayers a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income." I.R.C. § 212. The courts have assigned several major functions to the term "ordinary and necessary." See 1 B. Bittker, *supra* note 5, ¶ 20.3.2. The two most important of these functions have been (1) to limit deductions to normal or habitual expenditures (shading into "public policy") and (2) to distinguish between currently deductible and capital expenditures. See *Raymond Bertolini Trucking Co. v. Commissioner*, 736 F.2d 1120 (6th Cir. 1984). *Bertolini Trucking*, however, pointed out that the Supreme Court announced that the "'principal function of the term 'ordinary' . . . is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.'" 736 F.2d at 1123 (quoting *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966)).

The confusion as to the meaning of "ordinary" stems from the fact that both approaches are "to a certain extent correct, and are not mutually exclusive." 736 F.2d at 1124. An unusual expense is often capital "because it is a purchase of an asset requiring an unusually large cash outlay," and "an expenditure may be so abnormal as not to logically be connected to the taxpayer's particular business at all," in which case it is not necessary. *Id.* at 1124-25. These questions—"normal" or "habitual"—are but tools for getting at the prime question: whether the expenditure should be deducted currently or capitalized. *Id.* at 1125. See generally Wolfman, Professors and the "Ordinary and Necessary" Business Expense, 112 U. Pa. L. Rev. 1089, 1096 (1964). The term "expense" in both §§ 162 and 212 may also serve the same function as "ordinary." See *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971). See generally 1 B. Bittker, *supra* note 5, ¶ 20.4.1, at 20-65; Roth, *supra* note 2, at 34. These provisions are backstopped by § 263, which denies any (current) deduction for, among other items, "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." I.R.C. § 263(a)(1) (which overrides §§ 162(a) and 212). See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16-17 (1974). These provisions also appear to be the inspiration for the test adopted in *Lincoln Savings & Loan*. See *infra* note 233 and accompanying text.

While § 263 has been broadly interpreted to deny any deduction for capital expenditures, "[i]t serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing." *Idaho Power*, 418 U.S. at 16. In fact, "capitalization is a basic principle of income taxation rather than a technical requirement imposed by specific statutory language." Gunn, *supra* note 5, at 450; see also 1 B. Bittker *supra* note 5, ¶ 20.4.1, at 20-66. Section 446(b), with its requirement that the taxpayer's method of accounting clearly reflect income, also applies to this area. See Treas. Reg. § 1.446-1(a)(4)(ii) (expenditures made during the year must be properly classified between capital and expense); 1 B. Bittker, *supra* note 5, ¶ 20.4.1, at 20-65.

²¹ The Code and, on occasion, the regulations have provided a mechanical current deduction for capital expenditures below an administrative benchmark. See, e.g., I.R.C. § 179; Treas. Reg. § 1.167(a)-11(d)(2)(iii).

the asset acquired, created, or improved by the expenditure,²² or (b) upon destruction or abandonment prior to the end of such life as a loss under section 165.²³ This timing aspect of capitalization is

²² Amortization of the "cost" of property used in a trade or business, or held for the production of income, traditionally has consisted of first determining the useful life of the intangible asset acquired, created, or enhanced by the expenditure, under Treas. Reg. § 1.167(a)-3, and then allowing ratable, annual "depreciation" or amortization deductions, under § 167 of the Code, equal to the amount of that expenditure over such life. Such ratable charge generally is not directly tied, tax year-by-tax year, to the income produced. See 1 B. Bittker, *supra* note 5, ¶ 23.1.1, at 23-5; Note, *supra* note 4, at 331.

In the case of depreciation of *tangible* assets, useful life rules are similar to (albeit more lenient, under Treas. Reg. § 1.167(a)-1(a)), but more rapid (in early years of use) than, ratable methods of recovery (i.e., accelerated depreciation), although recently class-life treatment has been increasingly available. See 1 B. Bittker, *supra* note 5, ¶ 23.3.4. Under the Accelerated Cost Recovery System ("ACRS") provided by § 168, which also is limited to depreciable *tangible* property, the recovery method is front-loaded and the recovery period a small fraction of actual useful life. See, e.g., 2 Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President 154-55 (1984) [hereinafter Treasury Report]. In addition, for most taxpayers all assets fall into one of three classes: real estate, cars and trucks, and other equipment. See I.R.C. § 168(b)(2).

Terminology in this area is "confused," with the Code using "depreciation" to refer to the cost of tangible and intangible property covered by § 167, while "amortization" refers to statutory provisions allowing ratable deductions of cost faster than permitted under § 167 (see, e.g., I.R.C. § 169), or of costs not deductible under § 167 (see, e.g., I.R.C. § 195). Commentators and cases, however, limit "depreciation" to cost recovery of tangible property and "amortization" to cost recovery of intangibles. E.g., 1 B. Bittker, *supra* note 5, ¶ 23.1.1, at 23-4.

The function of classic depreciation and amortization is "to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use (excluding maintenance expense) of the asset to the periods to which it contributes." *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960). In short, depreciation and amortization are the "indispensable corollary" of capitalization to prevent distortion of income. See 1 B. Bittker, *supra* note 5, ¶ 23.1.2, at 23-7. Historically, they served to spread the deductions of the capitalized expenditure over the tax years benefited, thereby "matching" income and the cost of producing the income. For discussion of the controversy over whether capitalization to prevent distortion of income is appropriate where neither depreciation nor amortization is available (e.g., due to inability to prove a "limited useful life"), see *infra* notes 65-95 and accompanying text. For discussion of the different thrust of ACRS, see *infra* notes 30-32 and accompanying text.

²³ 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). 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(c). 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 I.R.C. § 165(f). As a practical matter, non-theft or -casualty losses must arise from the asset becoming worthless or being abandoned. See 1 B. Bittker, *supra* note 5, ¶ 25.8.2. For special problems where nonrecourse liabilities are

dictated by a basic policy of the tax system to tax net income annually with minimum distortion of income.²⁴ 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.²⁵ 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.²⁶ Under judicially adopted accounting concepts,²⁷ capitalization—when coupled with depreciation or amortization—serves to match (albeit usually roughly) an expenditure generating future income with such income.²⁸

Accelerated costs recovery methods, e.g., the Accelerated Cost Recovery System ("ACRS") enacted as section 168 of the Code²⁹ (unavailable for intangible assets), are a major departure from the economic model. This departure at best economically matches resultant income and the expenditure only in very high inflation tax years.³⁰ This distortion in accelerated cost recovery methods resulted in the open abandonment of the pretense of trying to measure income³¹ and instead was intended to eliminate the income tax on capital, at least for personal property.³² Such methods fuel

present, see *Freeland v. Commissioner*, 74 T.C. 970 (1980); accord *Middleton v. Commissioner*, 77 T.C. 310 (1981).

²⁴ See *supra* note 4. See generally *Gunn*, *supra* note 5 (discussed *infra* note 37).

²⁵ See Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 Mich. L. Rev. 1, 13 (1979).

²⁶ See *id.* at 3.

²⁷ Matching costs with revenues produced in a particular period is a basic financial accounting concept under Generally Accepted Accounting Principles ("GAAP"). See Dubroff, Cahill & Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 Alb. L. Rev. 354, 358-59 (1983) [hereinafter Dubroff]. Judicial acceptance of this basic financial accounting concept should not involve the adoption, as well, of the GAAP hierarchy of expense principles. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979). But see *NCNB I*, 651 F.2d at 948-49, vacated and remanded en banc, 684 F.2d 285 (4th Cir. 1982). See generally *infra* notes 258-63 and accompanying text.

²⁸ *Idaho Power*, 418 U.S. at 16.

²⁹ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 203-18 (codified as amended at I.R.C. § 168).

³⁰ See Treasury Report, *supra* note 22, at 155-56.

³¹ See Steines, *Income Tax Allowances for Cost Recovery*, 40 Tax L. Rev. 483, 501, 518-19, 531-32, 536 (1985); Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 Tax Law. 549 (1985).

³² Steines, *supra* note 31, at 518, 531, 537; Warren, *supra* note 31, at 554 (1982-86 combination of investment tax credits, depreciable basis, and acceleration of depreciation for

real estate tax shelters, particularly in low inflation tax years, and virtually eliminate corporate-level income taxes in some capital intensive industries.³³ Classic depreciation of tangible property and current amortization of *intangible* property, on the other hand, conceptually consist of allocating a capitalized cost (usually ratably) to the tax years to which it contributes to production of income, i.e., its useful life.³⁴ Capitalization coupled with amortization is therefore necessary to prevent the distortion (here, understatement) of the taxpayer's net income that would result from deducting the entire cost currently of an expenditure "properly attributable, through amortization, to later tax years when the capital asset becomes income-producing."³⁵

In ascertaining the period in which to deduct a cost benefiting several tax years, the fact that it benefits future years is not alone determinative. As one commentator notes

if 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."³⁶

three- and five-year ACRS property equivalent to expensing at ten percent discount rate); see S. Rep. No. 494, 97th Cong., 2d Sess. 123, 126, reprinted in 1982 U.S. Code Cong. & Admin. News 781, 888, 891.

³³ The new separate basket limitation on the deductibility of passive activity losses, also included in the new minimum tax, will serve as a surrogate to curb overuse of tax shelters. Under new § 469 of the Code, after Dec. 31, 1986, individuals, estates, trusts, and close and personal service corporations may not use net losses and credits from passive trade or business activities to offset other income (e.g., salary, portfolio income, and active business income), but may use them to offset income from passive activities. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a) (to be codified at I.R.C. § 469). The new minimum tax imposes this limitation on all taxpayers, corporate as well as noncorporate. See *id.* at § 701(a) (to be codified at I.R.C. § 58(b)).

³⁴ See, e.g., *Massey Motors*, 364 U.S. at 104.

³⁵ *Idaho Power*, 418 U.S. at 16.

³⁶ 1 B. Bittker, *supra* note 5, ¶ 20.4.1, at 20-67 (quoting *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971)). Precisely the same point was made (indeed, using the same example) subsequently in *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982) (dictum). See *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785-86 (2d Cir. 1973); *Southland Royalty Co. v. United States*, 582 F.2d 604, 617 (Ct. Cl.

The critical question is whether current deduction of an expenditure will result in more than minimal distortion of income.³⁷ If not, and the burden of capitalization and amortization will be heavy, the expenditure should be currently deducted in its entirety in the year made.³⁸ Such minimal distortion is produced by the current deduction of an expenditure with future benefits where the expenditure (1) is not substantial in relationship to the taxpayer's overall income for the year or its useful life is short, (2) recurs regularly, or annually in roughly equivalent amounts, and the future benefit is short or uncertain, or (3) cannot be clearly associated with either current or future tax years.³⁹

However, another basis for capitalization, derived from a different line of authorities than those preventing a mismatch in the *timing* of costs and attributable income, seeks to prevent a mismatch in the *character* of the deduction of an expenditure incurred in connection with the acquisition or disposition of a capital asset.⁴⁰ To prevent the income distortion generated by the coup-

1978).

³⁷ The seminal commentary in the area of capital expenditures developed the thesis that "a determination of whether capitalization of an expenditure is necessary to clearly reflect income . . . [should be] substituted for the usual process of determining whether the expenditure produces an asset," and that expensing small items does not distort the taxpayer's income. Gunn, *supra* note 5, at 452; accord Lee & Murphy, *supra* note 5, at 541-44; see *infra* notes 53-60 and accompanying text. Gunn also raised the possibility that capitalization is not appropriate in this context when amortization is not available. Gunn, *supra* note 5, at 492-95; cf. Note, *supra* note 5, at 621 n.21, 625 n.42 (proposing as an alternative factor to future benefit the question whether the expense is recurring, in the context of distortion of income; but principally arguing that reliance upon Generally Accepted Accounting Principles ("GAAP") for determining current deduction versus capitalization would avoid distortion of income). Essentially, this was the approach taken in *NCNB I*, 651 F.2d at 961; see *infra* notes 253-58 and accompanying text. One thesis of this article is that accounting concepts, e.g., treating a cost as an amortizable deferred charge, are useful in clearly reflecting income, but "currency" or even "capitalization" does not incorporate GAAP *per se*. See *infra* notes 87-95 and accompanying text.

³⁸ See *Cincinnati, N.O. & T.P. Ry. v. United States*, 424 F.2d 563 (Ct. Cl. 1970); see also *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979); *Southland Royalty*, 582 F.2d at 618. Some tribunals overstress the "burden" of capitalization/amortization in attempting to distinguish between current and future use. E.g., *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 234-35 (1985); cf. *NCNB I*, 651 F.2d at 961 (vacated panel opinion). These courts focus on the "burden" rather than determining the total period benefited (useful life). See *infra* notes 253-58 and accompanying text.

³⁹ For discussion of each of these categories in turn, see *infra* notes 53-66, 67-79 & 80-108 and accompanying texts.

⁴⁰ See *Woodward v. Commissioner*, 397 U.S. 572 (1970). See generally Lee & Murphy, *supra* note 5, at 474-75, 484-99.

ling of a current ordinary deduction for the cost of acquiring or disposing of an asset and a pre-1987 capital gains deduction upon disposition of the asset against the attributable capital gain unreduced by the expenditures, the "origin-of-the-claim," also known as the acquisition cost, doctrine requires capitalization of such expenditures in order to match the *character* of the expenditure and the income.⁴¹ This doctrine is compatible with the timing-minimum distortion of income doctrine only so long as the expenditure does not produce benefits for a shorter period than the asset to the basis of which it is added. If, however, the expenditure's benefits last for a shorter period than the useful life of the capital asset acquired, capitalization of the expenditure and its addition to the basis of the asset acquired itself produces distortion of income through depreciation or amortization over a longer period than that benefited by the expenditure, or at worst, by no amortization at all.

In addition to the "origin-of-the-claim" doctrine, avoiding such distortion of income also requires the use of a judicially approved accounting concept. This concept, under the model, treats the expenditure as a separate asset, a "deferred charge" in accounting terms,⁴² and its cost is then amortized over the period benefited.⁴³ If the period benefited is short or highly variable, so that amortization is difficult or impossible, and the expenditure is at least "steady-state"⁴⁴ recurring, then the cost treated as a separate asset should be expensed in its entirety in the year made.⁴⁵

Additionally, the role of the courts should be modified under the model. Many courts improperly permit a current deduction of (business expansion) costs, creating intangibles benefiting future

⁴¹ See *Sharples v. United States*, 533 F.2d 550, 554 (Ct. Cl. 1976). For taxable years beginning after Dec. 31, 1986, the present 60% capital gains deduction provided by § 1202(a) is repealed. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301. In addition, the alternate corporate capital gains rate of 28% provided by § 1201(a) is conformed to the top rate for corporations. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 311.

⁴² *NCNB I*, 651 F.2d at 949.

⁴³ See *Wolfsen Land & Cattle*, 72 T.C. at 13. The vacated *NCNB I* panel opinion in essence called for this approach with regard to start-up or expansion costs (which it properly believed should be treated identically), although the panel was confused regarding the actual tax mechanisms for amortization. See *infra* notes 258-68 and accompanying text.

⁴⁴ See *infra* note 75 and accompanying text.

⁴⁵ See *Iowa-Des Moines Nat'l Bank*, 592 F.2d at 436; *Southland Royalty*, 582 F.2d at 618. For discussion of the "origin-of-the-claim" or acquisition cost doctrine and deferred charge approach, see *infra* notes 116-61 and accompanying text.

years under the definitional "separate, saleable asset" doctrine,⁴⁶ in order to prevent distortion of income where they believe amortization will not be available if the expenditure were capitalized. However, under the model the courts' flexibility in avoiding distortion of income as to start-up and business expansion costs instead should lie in (a) approximating or estimating useful lives under *Cohan v. Commissioner*,⁴⁷ or (b) determining that a current deduction produces minimal distortion of income.⁴⁸

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

B. Currently Deductible Future Benefit Expenditures Not Distorting Income

The allowance of a current deduction for an expense generating future benefit depends on several factors, including the insubstantiality or short life of the expenditure⁴⁹ and its regular steady-state recurrence.⁵⁰ A further issue is raised when an expenditure cannot be clearly associated with either current or future tax years.⁵¹ In light of these considerations, courts and commentators alike have attempted to establish grounds for allowing a current deduction for such expenditures. In contexts where income is distorted, however, amortization based on "estimation" of useful life is the appropriate remedy.⁵²

1. Insubstantiality or Short-Lived Expenditure

Cincinnati, New Orleans & Texas Pacific Railway v. United

⁴⁶ See *infra* notes 225-43 and accompanying text.

⁴⁷ 39 F.2d 540 (2d Cir. 1930).

⁴⁸ See *infra* notes 116-61 and accompanying text.

⁴⁹ See *infra* notes 54-66 and accompanying text.

⁵⁰ See *infra* notes 67-79 and accompanying text.

⁵¹ See *infra* notes 80-108 and accompanying text.

⁵² See *infra* notes 109-115 and accompanying text.

*States*⁵³ was the first decision to allow the current deduction of an expenditure benefiting future years under a distortion of income analysis. There the government argued that: (1) since the expenditures at issue admittedly had a useful life in excess of one year, they had to be capitalized under the predecessor to section 263⁵⁴ as a "betterment"; and, (2) the method of accounting provisions (the predecessor to section 446)⁵⁵ were subordinate to the capital expenditure and depreciation provisions.⁵⁶ The Court of Claims (now the Federal Circuit) disagreed, reasoning that capitalization, depreciation, and the requirement that the taxpayer's method of accounting clearly reflect income were all so "inextricably intertwined"⁵⁷ that the ultimate question was whether the taxpayer's (tax) accounting method clearly reflected its income,⁵⁸ and not whether the benefits generated by the expenditures extended beyond the tax year, although that was a relevant inquiry.⁵⁹ The Court of Claims relied most heavily on the insubstantiality of the expenditures in relation to both the taxable income and the balance sheet of the taxpayer, concluding that the taxpayer's method did clearly reflect its income.⁶⁰ Critical to the court's conclusion was the fact that the burden of capitalizing and depreciating each purchase with benefits extending beyond the tax year would be

⁵³ 424 F.2d 563 (Ct. Cl. 1970). See generally *Gunn*, supra note 5, at 454-57.

⁵⁴ Section 263 generally denies a current deduction for expenditures for new buildings or permanent improvements or betterments. I.R.C. § 263; see also supra note 20. Commentators believe that the capitalization requirement is broader than any particular section of the Code. See, e.g., *Gunn*, supra note 5, at 450; accord 1 B. Bittker, supra note 5, ¶ 20.4.1, at 20-66.

⁵⁵ Section 446(a) and (b) provides that the taxpayer's income is to be computed under his regular method of accounting unless he fails to employ a method or the method used does not clearly reflect income. I.R.C. § 446(a)-(b). In either case, income will be computed under such method as does clearly reflect income in the opinion of the Secretary of the Treasury. *Id.*

⁵⁶ 424 F.2d at 567-68. The useful life was assumed to be ten years. *Id.* at 571; *Gunn*, supra note 5, at 456 n.55.

⁵⁷ 424 F.2d at 569.

⁵⁸ See supra note 55.

⁵⁹ 424 F.2d at 568. In this determination of clear reflection of income, "the one year rule will be given adequate, though not conclusive, weight." *Id.* The taxpayer's method of accounting for these items was required by the Interstate Commerce Commission. *Id.* at 565. Courts tend to give considerable weight to the requirements of applicable regulatory accounting in determining clear reflection of income. See *id.*; *NCNB II*, 684 F.2d at 292; see also *Dubroff*, supra note 27, at 396-97.

⁶⁰ See 424 F.2d at 571-72; *Gunn*, supra note 5, at 456-57.

heavy; "at the same time, the clearer reflection of income would be exceedingly slight if there were any at all."⁶¹

The Tax Court similarly pointed to the regulation permitting a farmer to currently deduct the full cost of inexpensive *or* short-lived tools in the year of payment despite their capital nature, as supporting the current deduction of the minor costs of a license by an attorney admitted to one state bar to practice in another state notwithstanding its future benefits.⁶² Commentators also largely rationalized the repair-maintenance rules (under which expenditures made to keep property in ordinarily efficient condition are currently deductible but must also be capitalized)⁶³ under such a distortion of income approach. The proper criterion for nondeductibility of a "repair" expenditure is whether it is sufficiently substantial in relation to the taxpayer's entire business so that deduction all at once will produce a distortion of income.⁶⁴ In short, determining net income annually with minimum distortion of income entails a balancing process under which taxable income is not distorted by currently deducting a cost producing future benefit so long as such cost is insubstantial or the future benefit is short-lived, particularly if capitalizing and then amortizing such cost will be burdensome.

The difficulty in the "insubstantiality" test lies not in its theory, which is recognized by certain statutory provisions,⁶⁵ but rather in determining "insubstantiality" as to the particular taxpayer and the tax year. While the cases explicitly relying on the doctrine have involved a \$20-\$500 range, the Claims Court has viewed \$15,000 as

⁶¹ 424 F.2d at 572. For the same balancing approach as to recurring expenditures, see *infra* notes 75-78 and accompanying text.

⁶² *Sharon v. Commissioner*, 66 T.C. 515, 527 (1976), *aff'd*, 591 F.2d 1273 (9th Cir. 1978), cert. denied, 442 U.S. 941 (1979); accord *Diffley v. Commissioner*, 48 T.C.M. (CCH) 547, 549 (1984); *Galazin v. Commissioner*, 38 T.C.M. (CCH) 851, 853 (1979); Treas. Reg. § 1.162-12(a). Similarly, the regulations provide that "[a]mounts currently paid or accrued for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted." Treas. Reg. § 1.162-6. *Cincinnati, New Orleans & Texas Pacific Railway* noted the "insubstantiality" underlying the current deductibility by mine operators of the cost of items of plant and equipment necessary to maintain the mine's normal output. 424 F.2d at 569; see also Treas. Reg. § 1.1612-2(a).

⁶³ See Treas. Reg. § 1.162-4.

⁶⁴ *Gunn*, *supra* note 5, at 457-60; *Lee & Murphy*, *supra* note 5, at 541-43; see *NCNB I*, 651 F.2d at 961 n.39.

⁶⁵ See *supra* note 21 and accompanying text.

insubstantial (at least compared to \$300,000).⁶⁶

2. *Recurring Steady-State Expenditures*

Several decisions analyzed the current deduction of recurring expenses benefiting several tax years as not distorting the taxpayer's income. In *Southland Royalty Co. v. United States*⁶⁷ the taxpayer, an oil and gas company, currently deducted the cost of an oil and gas reserve survey used in current operations, with an uncertain and short useful life. The government disallowed the current deduction for the survey, but disavowed prior survey decisions that capitalized such survey costs as part of some underlying property,⁶⁸ instead arguing that the cost must be capitalized because the survey itself had a useful life lasting beyond the taxable year.⁶⁹ The Court of Claims allowed the deductions because they were "functionally part of, and indistinguishable from, expenditures for ordinary management planning,"⁷⁰ noting that the reserve survey was not used to determine whether oil drilling was feasible, prior to acquiring the mineral interest. If the company had obtained the mineral interest, the survey cost would have constituted part of the cost of such interest (under the acquisition cost doctrine).⁷¹ The court looked to "matching expenditures to the income resulting from a capital transaction" as a function of capitalization, but found amortization inappropriate because the surveys were subject to change at any time and were updated every few years, and hence, capitalization without amortization would distort the taxpayer's income.⁷²

⁶⁶ Compare *Cincinnati, N.O. & T.P. Ry. v. United States*, 424 F.2d 563 (Ct. Cl. 1970) with *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985).

⁶⁷ 582 F.2d 604, 618 (Ct. Cl. 1978). Surveys of the kind at issue, while providing some future benefits (three to four years), were used in current operations to make income projections, develop short- and long-term budgets, arrange financing, and prepare reports to shareholders and regulatory authorities.

⁶⁸ *Id.* at 616. Misidentification of cost with nonamortizable assets has been a longstanding problem. *Gunn*, *supra* note 5, at 446.

⁶⁹ 582 F.2d at 616-17.

⁷⁰ *Id.* at 617.

⁷¹ For discussion of the treatment of recurring expenditures incurred in the acquisition of capital assets, see *infra* note 284 and accompanying text.

⁷² The *Southland Royalty* court noted that:

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

In essence, the current deduction of expenditures recurring in normal operations, even if producing future benefits, does not produce a distortion of income so long as the expenditures are not an acquisition cost of some underlying property with a useful life coterminous with such benefits. Analogously, the Seventh Circuit in *Encyclopaedia Britannica, Inc. v. Commissioner*⁷³ proffered (in dictum) a distortion of income analysis as supporting a series of decisions⁷⁴ allowing authors to currently deduct their expenses even though incurred in the creation of long-lived assets (the books being written). The court stated:

*We can think of a practical reason for allowing authors to deduct their expenses immediately, one applicable as well to publishers though not in the circumstances of the present case. If you are in the business of producing a series of assets that will yield income over a period of years—which is the situation of most authors and all publishers—identifying particular expenditures with particular books, a necessary step for proper capitalization because the useful lives of the books will not be the same, may be very difficult, since the expenditures of an author or publisher (more clearly the latter) tend to be joint among several books. Moreover, allocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code desiderates, because the taxable income of the author or publisher who is in a steady state (that is, whose output is neither increasing or decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book—on each book expenses and receipts will be systematically mismatched—but the same on average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization*⁷⁵

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.

582 F.2d at 618 (footnote omitted); see also *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979).

⁷³ 685 F.2d 212 (7th Cir. 1982).

⁷⁴ *Faura v. Commissioner*, 73 T.C. 849 (1980); accord *Snyder v. United States*, 674 F.2d 1359, 1365 (10th Cir. 1982). See generally Note, Tax Treatment of Prepublication Expenses of Authors and Publishers, 82 Mich. L. Rev. 537 (1983).

⁷⁵ 685 F.2d at 215 (emphasis added). This balancing of the benefits of capitalization versus administrative costs where income will not be distorted by current deduction is also a

However, the Seventh Circuit questioned whether there is a tension between the author expense cases and *Commissioner v. Idaho Power Co.*,⁷⁶ where the Supreme Court ruled that expenses, regardless of character, must be capitalized if incurred in creating a capital asset. *Encyclopaedia Britannica* balanced this reservation with the observation that capitalizing an expenditure producing future income or benefits, if taken "seriously," would force the capitalization of virtually every business expense, even the salary of the salespeople whose selling activities create goodwill, yielding income beyond the year in which the salary is paid or accrued. This is "a result courts naturally shy away from."⁷⁷ The Seventh Circuit viewed the administrative costs of such "conceptual rigor" as too great:

The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be. Whether the distinction breaks down where, as in the case of the conventional publisher, the firm's entire business is the production of capital assets, so that it is literally true that all of its business expenses are capital in nature [under *Idaho Power*], is happily not a question we have to decide here, for it is clear that *Encyclopaedia Britannica's* payments . . . were of a nonnormal, nonrecurrent nature.⁷⁸

The tension between *Idaho Power* and the current deduction under a clear reflection of income analysis of recurring expenditures made in connection with an acquisition of a capital asset, noted in *Encyclopaedia Britannica*, largely disappears under further analysis.⁷⁹

3. *No Clear Association with Current or Future Tax Years*

The distortion of income, resulting from capitalization without subsequent amortization or an expenditure benefiting both the current and future tax years, calls for a determination of whether a

critical element in the insubstantial cost exception to the rule requiring capitalization of costs that produce future benefits. See *supra* note 61.

⁷⁶ 418 U.S. 1, 16 (1974).

⁷⁷ 685 F.2d at 217; see *supra* note 36 and accompanying text.

⁷⁸ 685 F.2d at 217.

⁷⁹ See *infra* notes 134-61 and accompanying text.

current deduction of such an expenditure is mandated when amortization is impractical or unavailable. Courts and commentators have espoused the following positions: (1) Generally Accepted Accounting Principles ("GAAP") are determinative as to the timing of deductions; (2) capitalization and amortization are subordinate to clear reflection of income, so that a current deduction is preferable to capitalization without amortization; (3) capitalization and amortization are separate questions; and, (4) where both current deduction and capitalization without amortization produce distortion of income, the appropriate remedy is creative use of amortization through "estimation" of useful life—the alternative this article advocates.⁸⁰

a. GAAP and Tax Accounting

The regulations regard the taxpayer's method of accounting, as *ordinarily* "clearly reflecting income" for purposes of section 446(b)⁸¹ if it "reflects the consistent application of generally accepted accounting principles . . . , provided all items of gross income and expense are treated consistently from year to year."⁸² GAAP consists of the conventions, rules, and procedures used in financial accounting to define: (1) those economic resources and obligations which should be recorded as assets and liabilities, (2) which changes in them should be recorded, and (3) how and when these changes should be measured.⁸³

GAAP calls for "recognition" of an expenditure as an expense in the year paid if it cannot be associated with revenue in a later year, preferably on the basis of either cause and effect or, if that is not possible, on the basis of systematic and rational allocation.⁸⁴ If

⁸⁰ See *infra* notes 109-115 and accompanying text.

⁸¹ Under § 446(b), if the taxpayer's method of accounting does not clearly reflect income, the Service may recompute the taxpayer's taxable income under a method which the Commissioner believes does clearly reflect income. See Dubroff, *supra* note 27; Note, Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion, 83 Colum. L. Rev. 378, 387-98 (1983).

⁸² Treas. Reg. § 1.446-1(a)(2) (based upon S. Rep. No. 1622, 83d Cong., 2d Sess. 300, reprinted in 1954 U.S. Code Cong. & Admin. News 4621, 4939).

⁸³ Dubroff, *supra* note 27, at 366.

⁸⁴ See, e.g., Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, Accounting Principles Board Statement No. 4, ¶¶ 147, 157-60 (1970) [hereinafter APB Statement No. 4]. This Statement, relied upon by the NCNB I panel in describing the three principles mentioned in ¶ 161, provides in pertinent part that:

an expenditure is not so immediately recognized as an expense, it is carried forward on the balance sheet as an asset, acting as a deferred charge to be expensed in whole or in part in future peri-

¶ 147. . . . Expenses are determined by applying the expense recognition principles on the basis of relationships between acquisition costs and either the independently determined revenue or accounting periods From the perspective of income determination, costs are divided into (1) those that have "expired" and become expenses and (2) those that are related to later periods and are carried forward as assets in the balance sheet.

. . . .

¶ 157. . . . [Associating cause and effect.] Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

¶ 158. Several assumptions regarding relationships must be made to accumulate the costs of products sold or services provided "Attaching" costs . . . often requires several allocations and reallocations of costs

¶ 159. . . . [Systematic and rational allocation.] In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided. If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

¶ 160. . . . [Immediate recognition.] Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

Application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense

Id. (quoted in *NCNB I*, 651 F.2d at 952-53 & n.18).

ods.⁸⁵ The GAAP hierarchy of expense recognition rules reflect the underlying accounting concept of matching expenses with revenues in a particular period.⁸⁶

Although adherence to GAAP in most cases does clearly reflect income for tax accounting purposes, GAAP is neither determinative nor even presumptively correct regarding tax issues.⁸⁷ As the Supreme Court pointed out in *Thor Power Tool Co. v. Commissioner*,⁸⁸ no such presumption is supportable in light of the vastly different goals of financial and tax accounting.⁸⁹ GAAP financial accounting rules and tax accounting rules vary in a number of specific transactions regarding timing of income and of expenses or deductions.⁹⁰

Moreover, while financial and tax accounting both seek to match costs with attributable revenue in the appropriate period, the mechanisms utilized differ. In tax accounting, unlike financial accounting, capitalization and depreciation/amortization do not operate to match expense and income on a cause and effect basis, nor does depreciation take account of actual market declines in the

⁸⁵ *NCNB I*, 651 F.2d at 949; *Gunn*, supra note 5, at 445-46.

⁸⁶ *Dubroff*, supra note 27, at 359 n.19.

⁸⁷ One commentator notes that "financial accounting principles tend to err on the side of understating income, which may not be tolerable for income tax purposes." Warner, *Deductibility of Business Expansion Expenses—NCNB Corp. v. U. S.*, Tax Mgmt. Mem. No. 81-22 (BNA) 2, 6 (1981); see Note, *Taxation: Start-up Cost Treatment Under § 195: Tax Disparity in Disguise*, 36 Okla. L. Rev. 449, 463 (1983). See generally *Dubroff*, supra note 27, at 383-88, 400-02.

⁸⁸ 439 U.S. 522, 542-44 (1979).

⁸⁹ The Court stated that:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect those parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc.

439 U.S. at 542. See generally *Dubroff*, supra note 27, at 377-79.

⁹⁰ *Dubroff*, supra note 27, lists a number of such areas in which financial and tax accounting vary, including the following more common examples: (1) prepaid income and expenses, (2) "all events" limitation on accountability of contingent expenses, and (3) inclusion of "contingent" income under the "claim of right" doctrine. *Id.* at 360-63, 385-86, 386; see also, *Jensen*, *Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance*, 37 U. Fla. L. Rev. 444 (1985). Tax and financial accounting, in fact, differ as to the treatment of start-up costs. See *Intangible Assets*, Accounting Principles Board Opinion No. 17 (1970); *Case Note, Deductibility of Cost of Establishing Merchandising Outlets*, 34 Ohio St. L.J. 906, 909-13 (1973).

value of the depreciable asset.⁹¹ Rather, under classic tax depreciation/amortization concepts the expenditure's "useful life"⁹² is "estimated" in the year incurred and its costs allocated to the tax years of that useful life under one of several allowable methods (e.g., straightline or ratably declining balance).⁹³ Only over the entire useful life of the expenditures is the cost matched with the income it generates, and the results of any particular year may not actually reflect income so clearly.⁹⁴ In short, blind resort to GAAP as supplying the answers to the capital/ordinary controversy works as too facile a panacea,⁹⁵ since GAAP rules do not always accord with the tax policy (here, the minimum distortion of income). Nevertheless, rather broad accounting *concepts*, such as "matching" income and expenses and a deferred charge as constituting an amortizable asset, are useful in effectuating such tax policy.

b. Current Deduction if Amortization Unavailable

The Federal Circuit correctly believes that capitalization, depreciation, and clear reflection of income are "inextricably intertwined," with the ultimate question being the success of the taxpayer's method of tax accounting in clearly reflecting income.⁹⁶ Not surprisingly, therefore, the Court of Claims (predecessor to the Federal Circuit) held in *Southland Royalty Co. v. United States* that capitalization without amortization was inappropriate where the recurring expenditures produced highly variable and relatively short-lived benefits,⁹⁷ because such capitalization would distort the taxpayer's income. The distortion of income arising from capitaliz-

⁹¹ See 1 B. Bittker, *supra* note 5, ¶ 23.1.1, at 23-5; see also *Kansas Power & Light Co. v. Burlington N.R.R.*, 740 F.2d 780 (10th Cir. 1984).

⁹² Treas. Reg. § 1.167(a)-2, -3.

⁹³ See I.R.C. § 167(b); see also *supra* note 22.

⁹⁴ 1 B. Bittker, *supra* note 5, ¶ 23.1.1, at 23-6.

⁹⁵ For discussion of variances between the book and tax accounting systems, see *supra* note 90. The *NCNB I* panel opinion hoped that book accounting rules will resolve the start-up expansion cost conflicts. 651 F.2d at 948 & n.11. Commentators assumed the same. Note, *supra* note 5, at 619, 633-38. The better approach is to look at book accounting concepts to fashion tax accounting rules, such as the amortization of recurring costs as a free-standing "asset." See *infra* notes 134-40 and accompanying text.

⁹⁶ *Cincinnati, N.O. & T.P. Ry. v. United States*, 424 F.2d 563, 569 (Ct. Cl. 1970) (relying on the decision in *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283-84 (1967)). See generally *Gunn*, *supra* note 5, at 453-54.

⁹⁷ *Southland Royalty Co. v. United States*, 582 F.2d 604, 618 (Ct. Cl. 1978).

ing an investigatory or start-up expenditure—with future, but temporally limited, benefits—incurred while expanding an existing business and then adding such cost to the basis of a nonamortizable asset also clearly motivated the courts considering the bank credit card and branch progeny of *Briarcliff Candy Corp. v. Commissioner* to adopt the “separate, saleable asset” rule.⁹⁸ This definitional rule calls for current deduction of expansion costs, notwithstanding future benefits, if no separate, transferable asset is created or enhanced by the expenditure. An unarticulated premise is that a saleable or transferable asset usually will have a determinable life and, hence, be amortizable.⁹⁹

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.”¹⁰⁰ However, a taxpayer can make substantial payments creating a nontransferable asset that benefits an extended or indefinite period. Current deduction of such expenditures, e.g., the substantial cost of a computer program designed for the taxpayer with a five-year life or acquisition costs of a license with an indefinite life,¹⁰¹ under talismanic¹⁰² application of the transferability test will clearly distort the taxpayer’s income. This illustrates a common shortcoming of “talismans”: promoting rough justice in commonplace application, but yielding inequities in borderline areas.

⁹⁸ See *infra* notes 225-44 and accompanying text.

⁹⁹ See Warner, *supra* note 87, at 8.

¹⁰⁰ *Id.* See, e.g., *Colorado Springs Nat’l Bank v. United States*, 505 F.2d 1185, 1185 (10th Cir. 1974) (recurring computer charges for customer accounting entries, advertising, and credit checks); accord *First Nat’l Bank v. United States*, 413 F. Supp. 1107, 1109 (D.S.C. 1976) (charges for recurring consulting fees, salaries, rent, office expenses, and advertising), *aff’d per curiam*, 558 F.2d 721 (4th Cir. 1977).

¹⁰¹ See *First Sec. Bank v. Commissioner*, 592 F.2d 1050, 1053 (9th Cir. 1979) (Duniway, J., concurring in part and dissenting in part) (recurring costs of advertising, etc., properly deductible, but cost of computer program used for five years and costing substantial amount should be capitalized and amortized over that period rather than currently deducted under the majority’s separate, saleable asset test); see also *NCNB II*, 684 F.2d 285 (current deduction of cost of branch banking permit with indefinite life). *Contra Central Tex. Sav. & Loan Ass’n v. United States*, 731 F.2d 1181 (5th Cir. 1984).

¹⁰² The *NCNB I* panel majority viewed a definitional rule, such as the separate, saleable asset test and the start-up of new business/expansion of old business dichotomy, as a “talisman,” a rule operating mechanically without considering the underlying policy. 651 F.2d at 955.

Immediate deduction of such intangibles benefiting an extended period might, however, be justified on a different policy basis. Under pre-1987 ACRS, coupled with investment tax credits ("ITC")¹⁰³ and the effects of leverage, the function of cost recovery shifted from matching of income and expenses to immediate deduction, in practical effect protecting capital from taxation.¹⁰⁴ Thus, from 1981-86, the separate, saleability prerequisite effected rough parity between amortization of intangible and tangible property.¹⁰⁵ Explicit reliance on such policy, however, might betray too much judicial legislation,¹⁰⁶ particularly in light of the 1985-86 tax reform process. Additionally, such a judicial grant of a tax benefit (current expensing of intangibles) might ignore trade-offs and bargains struck in that process.¹⁰⁷

Nevertheless, a current deduction of temporally limited expenditures does produce less distortion of income than capitalization *without* amortization.¹⁰⁸ However, under the model, the answer is to supply amortization through liberal approximation of useful life, rather than a current deduction that is more income distorting than amortization over the approximate period benefited.

c. Capitalization and Amortization as Separate Questions

Some commentators maintain, contrary to the separate, saleable

¹⁰³ See I.R.C. §§ 38, 46.

¹⁰⁴ See *supra* notes 31-32 and accompanying text.

¹⁰⁵ Congress repealed the regular ITC for property placed in service after Dec. 31, 1985. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a) (to be codified at I.R.C. 49(a)). With this repeal, cost recovery of tangible personal property is no longer equivalent to immediate expensing, although the "reasonable allowance for depreciation" itself for most tangible personal property remains much the same as under pre-1987 ACRS.

¹⁰⁶ Statements abound that courts may not legislate in the tax area to cure omissions or inequities. E.g., *Bidart Bros. v. United States*, 262 F.2d 607, 609 (9th Cir. 1959); *Estate of Yantes v. Commissioner*, 21 T.C. 830, 833 (1954), *aff'd per curiam sub nom. Ohio Nat'l Bank v. Commissioner*, 220 F.2d 754 (6th Cir. 1955). Nevertheless, courts in fact have fashioned many equitable doctrines. See, e.g., *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967); see also *infra* notes 170-71 and accompanying text.

¹⁰⁷ The 1985-86 tax reform primarily constituted a balancing of individual tax reductions over a specified period with corresponding increases in corporate taxes over the same period, coupled with some restructuring of tax burden within classes of taxpayers (both individual and corporate).

¹⁰⁸ A commentator has suggested that a current deduction should be allowed "whenever capitalization would distort income more than current expensing." Note, *supra* note 4, at 333. If this is the only choice, the author agrees.

asset doctrine, that concern regarding the lack of amortization is not a basis for allowing a current deduction that itself will produce distortion of income. They maintain instead that the remedy is congressional allowance of amortization.¹⁰⁹ Similarly, the government has argued that the presence of any future benefits mandates capitalization, but any inability to determine useful life is immaterial to capitalization.¹¹⁰ Proper resolution of this view with the conflicting views as to the importance of the ability to amortize in the capitalization determination should lie in the analysis of why amortization is inappropriate in a particular case. If amortization is unavailable because the expenditure produces highly variable and largely shorter-term benefits (in which case the expenditure usually recurs frequently), then a current deduction is appropriate under the model.¹¹¹

If amortization is unavailable because an expenditure producing a determinable temporal benefit is associated with the acquisition of an asset with a longer or indeterminable life, then the expenditure itself should be treated as a free-standing asset that is then amortizable or currently deductible under the model. Many of the capitalized start-up costs denied amortization, because they are added to the nonamortizable basis of the business created,¹¹²

¹⁰⁹ One commentator has argued that:

If prepaid interest creates a capital asset, and if the Code precludes amortization in certain cases, and if the deduction is lost, the solution is not to disregard the capitalization concept, but rather to fill the gap left by Congress in the statutory scheme by an amendment to the Code allowing amortization in this situation.

Asimov, *Principle and Prepaid Interest*, 16 U.C.L.A. L. Rev. 36, 61 (1968); see also Note, *An Inquiry into the Nature of Goodwill*, 53 Colum. L. Rev. 660, 719 (1953).

¹¹⁰ *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1192 (10th Cir. 1974).

¹¹¹ See APB Statement No. 4, *supra* note 84, ¶ 160; see also *NCNB I*, 651 F.2d at 962; cf. *Encyclopaedia Britannica v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982); 1 B. Bittker, *supra* note 5, ¶ 20.4.1, at 20-67.

¹¹² The bulk of the start-up and investigatory cost decisions in contrast simply denied the claimed deduction as a pre-operating "capital" expense without indicating the asset, if any, which the capitalized cost should reflect. See, e.g., *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986) (cost of establishing the enterprise); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228 (1985) (rationale of classic start-up cases is capital investment in business as a whole); *Bennett Paper Corp. v. Commissioner*, 78 T.C. 458, 469-70 (1982), *aff'd per curiam*, 699 F.2d 450 (8th Cir. 1983); *Davis v. Commissioner*, 45 T.C.M. (CCH) 1070 (1983); *Lardy v. Commissioner*, 41 T.C.M. (CCH) 217 (1980). A few decisions have expressly left open the question whether pre-operating expenses created (amortizable) assets with determinable useful lives benefiting taxable years following the start of business operations. E.g., *Goodwin v. Commissioner*, 75 T.C. 424, 432 n.8 (1980), *aff'd mem.*, 691 F.2d 490 (3d Cir. 1982); *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 564 n.15 (1979),

should be either currently deductible or amortizable under this separate, amortizable asset approach.

However, if amortization is unavailable because the expenditure must be added to the basis of an asset with a long—but not definitely determinable—life (because their benefits are coterminous), the expenditure should be capitalized if a current deduction would distort the taxpayer's income.¹¹³ Distortion of income from lack of amortization in such circumstances should be addressed through remedial legislation or more liberality in "estimating" useful life,¹¹⁴ not through a current deduction that would also distort income.¹¹⁵

C. Detailed Analysis: Acquisition Cost as Basis for Capitalization

1. "Origin-of-the-Claim"

Under the "origin-of-the-claim" doctrine, a taxpayer must capitalize those expenses arising from a capital transaction, for example, the acquisition or disposition of a capital asset.¹¹⁶ This rule "rests on the belief that all expenses which stem from a capital transaction should rationally be 'matched' or equated with all gains from the same capital transaction and the expenses should receive identical tax treatment as the gains."¹¹⁷ The origin-of-the-claim doctrine is designed to prevent the distortion of income arising from a mismatch of the (pre-1987) character of the income and

aff'd, 633 F.2d 512 (7th Cir. 1980); *Kennedy v. Commissioner*, 32 T.C.M. (CCH) 52 (1973). A few others have added pre-operating or investigatory costs to the basis of a capital asset constructed at the same time. E.g., *Odom v. Commissioner*, 44 T.C.M. (CCH) 1132 (1982); see *Cagle v. Commissioner*, 539 F.2d 409, 416 (5th Cir. 1976) (semble); *Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977) (semble). Where the costs were found to be preparatory because a necessary business permit had not yet been obtained, the courts have readily and wrongly added the start-up or investigatory cost to the basis of the nonamortizable permit. *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), remanded on other grounds, 382 U.S. 68 (1965); accord *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181 (5th Cir. 1984); *Cleveland Elec. Illuminating*, 7 Cl. Ct. at 229.

¹¹³ See *Gunn*, supra note 5, at 494 n.230.

¹¹⁴ See infra notes 116-61 and accompanying text.

¹¹⁵ But see Note, supra note 4, at 333; Note, Costs of Expanding an Existing Business: Current Deductions Versus Capital Expenditures—*North Carolina Nat'l Bank Corp. v. United States*, 18 Wake Forest L. Rev. 1127 (1982).

¹¹⁶ *Woodward v. Commissioner*, 397 U.S. 572 (1970); *Lee & Murphy*, supra note 5, at 484-99.

¹¹⁷ *Sharples v. United States*, 533 F.2d 550, 555 (Ct. Cl. 1976). See generally, *Lee & Murphy*, supra note 5, at 474, 484, 488-89.

the deduction. Such prevention is accomplished by ensuring that the taxpayer does not deduct against ordinary income expenses that arise from a capital transaction, but instead adds such costs to the basis of the capital asset acquired or subtracts such costs to reduce the proceeds of the disposition of the capital asset.

The overlap of the origin-of-the-claim and the timing-distortion of income doctrine produces conflicts. On the one hand, if the capitalized expenditure is added to a depreciable asset, amortization produces an ordinary deduction of the acquisition cost so that superficially the character is not matched.¹¹⁸ Conversely, if an expenditure which benefits a finite period is added under the origin-of-the-claim principle to the basis of an asset with a substantially longer useful life, the slower amortization of the capitalized expenditure results in distortion of the taxpayer's income. Distortion is even greater where the capitalized limited life expenditure is added to the basis of a nonamortizable asset.¹¹⁹

Nevertheless, the origin-of-the-claim or acquisition cost doctrine is used to capitalize, and add to the basis of the asset acquired,¹²⁰ the recurring short-lived costs incurred in connection with the acquisition of an asset used in the taxpayer's business. Such usage occurs although identical costs incurred after, and unrelated to,¹²¹

¹¹⁸ Under pre-1987 rules, gain from the sale of depreciable property (subject to complex netting rules under § 1231(a)(3)-(4) and loss recapture rules under § 1231(c)), constituted capital gains. See I.R.C. § 1231(a)(1). Such gains were subject in turn to depreciation recapture in whole or in part under §§ 1245 and 1250. See generally, Lee, *Capital Gains Exception to the House's General Utilities Repeal: Further Indigestions from Overly Processed Corn Products*, 30 Tax Notes 1375, 1378, 1384 n.51 (Mar. 31, 1986).

¹¹⁹ See Note, *supra* note 4, at 322-23, 332.

¹²⁰ See *Shainberg v. Commissioner*, 33 T.C. 241 (1959); see also Lee & Murphy, *supra* note 5, at 482. The Claims Court explained the decisions that relied on a capitalization basis for denying current deductibility of start-up costs as follows:

Although the rationale of these decisions is not fully articulated, they appear to accept or assume the underlying theory that where a business requires substantial start-up expenditures before it can begin operations, which are not directly for the purchase of tangible assets and which will not ordinarily be recovered out of revenues for the same year, the capital investment is in the business as a whole rather than merely in the tangibles, and it includes the start-up costs.

Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228 (1985). Such rationale logically would deny, however, a current deduction for identical expenditures incurred once the business commenced. See *infra* note 131 and accompanying text.

¹²¹ Such a cost incurred after acquisition, but anticipated at that time, may be capitalized as an acquisition cost. See *Mt. Morris Drive-In Theatre Co. v. Commissioner*, 25 T.C. 272 (1955), *aff'd*, 238 F.2d 85 (5th Cir. 1956).

the acquisition are currently deducted, usually as a maintenance cost. Analyzing the farm preparatory cost doctrine,¹²² Judge Raum of the Tax Court observed:

[T]he cost of painting a building . . . generally is considered a deductible business expense. Yet the cost of putting the final coat of paint on a building in the course of construction is plainly a capital expenditure. Both involve painting and may be identical in physical character; however, one is incurred in ordinary maintenance while the other is one of the components of cost in acquiring a complete capital asset.¹²³

Similarly, the Tax Court treated cleaning expenses (paid to the contractor) incurred in preparing a shopping center for its grand opening as capitalizable acquisition costs,¹²⁴ stating subsequently that the same treatment resulted even if the taxpayer developed the center through its own efforts.¹²⁵ Additionally, the Tax Court required capitalization of recurring classic "start-up" costs, not under the theory that they constituted preparatory costs, but rather under the "general rule . . . that an expenditure in connection with the acquisition of a capital asset is a capital investment and hence not deductible as an ordinary and necessary expense of carrying on business."¹²⁶ The Claims Court in *Cleveland Electric Illuminating Co. v. United States* read these and similar cases as

¹²² For descriptions of the farm preparatory cost doctrine, see *Maple v. Commissioner*, 440 F.2d 1055, 1056-57 (9th Cir. 1971); Department of the Treasury, 91st Cong., 1st Sess., Tax Reform Studies and Proposals 153 (Comm. Print 1969) (issued jointly by the House Comm. on Ways & Means and Senate Comm. on Finance). See generally sources cited in Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 465 n.498 (1974).

¹²³ *Estate of Wilbur v. Commissioner*, 43 T.C. 322, 327 n.6 (1964), acq., 1965-2 C.B. 7.

¹²⁴ *Shainberg*, 33 T.C. at 251.

¹²⁵ See *Perlmutter v. Commissioner*, 44 T.C. 382, 403-05 (1965), aff'd, 373 F.2d 45 (10th Cir. 1967). In *Commissioner v. Idaho Power Co.*, the Supreme Court stated most strongly the requirement of tax parity between costs of self-constructed and purchased assets. 418 U.S. 1, 14 (1974). The Sixth Circuit recently reasoned "that pre-opening expenses must be treated as capital in order to maintain parity with a taxpayer whose cost of purchasing an existing business is clearly capital." *Johnsen v. Commissioner*, 794 F.2d 1157, 1161 (6th Cir. 1986).

¹²⁶ *Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977). Similarly, investigatory costs (feasibility study for office/showroom) have been capitalized under the rule that "an expenditure in acquisition of a capital asset is a capital expenditure." *Cagle v. Commissioner*, 539 F.2d 409, 416 (5th Cir. 1976). The court in *Cagle* found that costs also had a value beyond the tax year in which incurred; "[t]his alone is a persuasive argument for labeling the payments as a capital expenditure." *Id.* at 416 n.8.

apparently assuming

the underlying theory that where a business requires substantial start-up expenditures before it can begin operations, which are not directly for the purchase of tangible assets and which will not ordinarily be recovered out of revenues for the same year, the capital investment is in the business as a whole rather than merely in the tangibles, and it includes the start-up costs.¹²⁷

The error in this "business as a whole" approach lies not in the capitalization theory itself, but rather in confusion as to the "asset" to which the recurring cost should be added,¹²⁸ that "asset" was usually the business as a whole,¹²⁹ which is nonamortizable. Such capitalization of recurring, finite-term benefit costs without amortization produces the same distortion of income that generates the talismanic separate, saleable asset current deduction approach.¹³⁰ Moreover, an acquisition cost theory under the "business as a whole" concept seemingly would require capitalization, and addition to the basis of the business as a whole, of substantially similar costs incurred in the expansion of an existing business.¹³¹ The underlying rationale is that the start-up and expansion costs increase the earning capacity and hence produce future benefits.¹³² Yet the Claims Court in *Cleveland Electric Illuminating* inconsistently re-

¹²⁷ 7 Cl. Ct. 220, 228 (1985); see also *Johnsen*, 794 F.2d at 1162 (expenses incurred during start-up or pre-opening period were capital in nature because part of establishing the enterprise).

¹²⁸ *Gunn*, supra note 5, at 446 (cost itself should be viewed as amortizable asset).

¹²⁹ See supra note 112.

¹³⁰ See infra notes 230-35 and accompanying text.

¹³¹ Both sale and acquisition of a going business are "viewed as a sale of each individual asset rather than of a single capital asset." S. Rep. No. 313, 99th Cong., 2d Sess. 251 (1986). Contrary to this "separate basket" concept, some courts have treated start-up costs as a cost of the business as a whole and not of specific tangible assets. See cases cited supra note 112; cf. *Aboussie v. United States*, 779 F.2d 424, 428 (8th Cir. 1985). This can be explained in capitalization terms only on the basis of creating future earning capacity. See infra note 132 and accompanying text. If so, the increased earning capacity logically should be capitalized where incurred in expanding, operating, or starting a new business. Even if start-up costs were properly viewed as acquisition costs of the tangible assets of a new business, they would constitute acquisition costs of similar assets acquired in expanding or operating an existing business. See supra note 112. This has always been the fatal weakness in the capitalization theory for denying a current deduction for start-up costs so long as similar expansion costs are currently deductible. Cf. *Lee*, supra note 2, at 390 n.53.

¹³² See, e.g., *Mid-State Products Co. v. Commissioner*, 21 T.C. 696, 714 (1954); *Miner v. Commissioner*, 21 T.C.M. (CCH) 1173, 1177 (1962); see also *Lee*, supra note 2, at 390 n.53; *Lee*, supra note 122, at 461-63, 466.

quired capitalization of substantial training costs for employees who were to work at a nuclear power generating plant as part of the acquisition cost of the taxpayer's interest in the plant, while permitting a current deduction for significantly less substantial training costs for employees who were to work at a new conventional fossil fuel generating plant similar to four plants already in use.¹³³

2. *Free-Standing Amortizable Asset*

The distortion of income which results from adding a recurring cost to a longer-lived or nonamortizable asset, under the rationale that it constitutes an acquisition cost of the business as a whole, can be avoided by relying on the basic financial accounting concept of treating the expense itself as an amortizable asset.¹³⁴ Assets, for financial accounting or balance sheet purposes, include both the economic resources of the enterprise and certain deferred charges that are not resources. If an expenditure may not be expensed in its entirety in the year paid, the cash assets of the enterprise are reduced and the portion of the expenditure that cannot be currently expensed is treated as a separate, noncash asset on the balance sheet.¹³⁵ Thus, the *NCNB I* court noted that:

In order more accurately to reflect income, both in the present period and in future accounting periods, the carried-forward "assets" of an enterprise include, without regard to whether they are tangible or intangible, certain expenditures for benefits whose cost has already been incurred but the outlay for which is nevertheless most properly matched against some future period's revenues which the benefits will help produce.¹³⁶

In short, in financial accounting the expenditure itself may be treated as a separate asset to be expensed, or in tax terms "depreciated" or "amortized," in future tax periods.¹³⁷ In the start-up and

¹³³ 7 Cl. Ct. at 235-36. The Claims Court obviously was attempting to preserve § 195. See *infra* notes 305-19 and accompanying text.

¹³⁴ See *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 229 (1985); cf. *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 566 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

¹³⁵ *NCNB I*, 651 F.2d at 949 (vacated panel opinion).

¹³⁶ *Id.*

¹³⁷ *Gunn*, *supra* note 5, at 445 (citing De Capriles, *Modern Financial Accounting*, pt. 1, 37 N.Y.U. L. Rev. 1001, 1020-21 (1962)).

business expansion areas, such amortization of recurring costs as a free-standing asset, without regard to whether incurred in starting up a new business or expanding an existing business, provides a "golden mean" avoiding the all-or-nothing extremes of the talismanic separate, saleable asset (current deduction) or preparatory (capitalization without amortization) approaches.¹³⁸

The Tax Court in *Wolfsen Land & Cattle Co. v. Commissioner*¹³⁹ treated a recurring expenditure with a limited life as such a separate, amortizable, intangible asset to avoid the distortion of income that would have followed from associating the expenditure with the nonamortizable asset it enhanced. *Wolfsen Land & Cattle* considered the deductibility of substantial expenditures, which the taxpayer incurred every ten years, for draglining an earthenwork irrigation system with an indefinite life. These substantial expenses resulted from the taxpayer's allowing the system to deteriorate until it became almost dysfunctional, rather than annually repairing and maintaining it. The court noted:

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

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

Since a basic premise of the income tax laws is to relate expenses to the income which they helped earn, a reasonable solution to our conundrum is to hold that the expenses in issue should be written off over their useful life. In short we would subscribe independent status to those expenditures on the basis that they create a free-standing intangible asset with an amortizable 10-year life.¹⁴⁰

¹³⁸ See *NCNB II*, 684 F.2d 285, 294, 295 (4th Cir. 1982) (Murnaghan, J., dissenting).

¹³⁹ 72 T.C. 1 (1979).

¹⁴⁰ Id. at 13 (footnote omitted). Gunn, *supra* note 5, at 446, perspicaciously suggested just this approach. The *NCNB I* panel came close to this approach. See *infra* notes 250-52 and accompanying text.

The treatment of certain recurring expenses as a separate asset, even though such expenses are incurred in the acquisition of a nonamortizable asset, is not inconsistent with *Idaho Power*.¹⁴¹ The Supreme Court in *Idaho Power* required (1) capitalization of the "depreciation" allocable to equipment the taxpayer used to construct capital improvements and (2) addition of the capitalized amounts to the basis of such improvements. The Court sought to prevent the distortion of income that would result from currently deducting "depreciation" costs properly allocable to assets that in the future would produce income themselves.¹⁴² The Court also sought to maintain tax parity between a taxpayer that did its own construction work and a taxpayer that purchased the work from an independent contractor, which in turn charged its construction equipment depreciation to the taxpayer as an element of the total cost of the services.¹⁴³ However, allocation of a temporally limited expenditure to the basis of a substantially longer-lived asset, or an asset with no determinable life, produces distortion of income. If a recurring expenditure—such as employee training in a workforce with high turnover—is added to the nonamortizable basis of a new or expanded business, a distortion of income is produced;¹⁴⁴ this is not the situation in *Idaho Power*. Distortion will also exist when an expenditure with a shorter-term benefit is incurred in connection with the acquisition of an asset with a longer term; *Idaho Power* is also distinguishable from this scenario. In *Idaho Power* the expenditures in question benefited the depreciable assets, created with the machinery, over their entire useful life, in effect creating a construction cost of the assets.

The deferred charge or separate asset approach is consistent with basic tax concepts such as the "separate basket" approach to transfers of a going business and to "component" depreciation. Under the firmly established "separate basket" rule,¹⁴⁵ the sale or

¹⁴¹ The Seventh Circuit intimated a conflict between distortion of income analysis and *Idaho Power*. *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 215, 217 (7th Cir. 1982) (discussing *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974)); see also *supra* note 76 and accompanying text.

¹⁴² 418 U.S. at 14.

¹⁴³ *Id.*

¹⁴⁴ See *Madison Gas & Elec.*, 633 F.2d at 517.

¹⁴⁵ *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945). Judge Learned Hand concluded that "upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition [of 'capital assets' in the predeces-

acquisition of a business is not treated as the transfer of a single asset; rather, the business is fragmented into its components, with each asset given separate treatment on both the sale and purchase side.¹⁴⁶ Accordingly, even under an acquisition cost approach, start-up as well as internal and external business expansion costs should be separated into their components for "tax parity" purposes, with those items providing benefits for a shorter period than the useful life of the business (which usually is indefinite) being treated as separate assets to be expensed or amortized according to clear reflection of income principles. For instance, if a taxpayer purchases an ongoing business that possesses short-lived recurring assets (usually already expensed by the seller),¹⁴⁷ e.g., tools, supplies, or recurring marketing surveys, then the purchaser—under the "basket of assets" fragmentation approach, involving transfers of a going business—will be allowed to deduct currently the external cost of such items in the year of purchase. Technically, perhaps, the deduction may be considered depreciation or amortization of the cost in its entirety in the acquisition year because its determinable life is one year and as such can be amortized fully within one year under section 167.¹⁴⁸ Accordingly, treatment of *internal* costs for short-lived recurring expansion or start-up expenditures as a separate asset, to be expensed or amortized under clear reflection of income principles, does not conflict with *Idaho Power*.

The same treatment of a recurring cost as a separate, free-standing asset should apply where a depreciable asset, e.g., a shopping center or apartment project, is acquired or constructed and the (recurring) cost benefits a shorter period than the purchased or constructed asset. Under "component" depreciation an asset composed of separately replaceable components may be fragmented in computing depreciation, even though the components are interdependent parts of an integral whole. Thus, "[i]nstead of assigning a

sor to § 1221(1)]." *Id.*

¹⁴⁶ See Faber, Allocation of Purchase Price on Acquisitions; Recapture; Going Concern Value, 39 Inst. on Fed. Tax'n 6-1 (1981); Ganier, Treatment of Goodwill: Allocating a Lump Sum Purchase Price Among Mixed Assets of a Going Business, 7 J. Corp. Tax'n 111 (1980); Leighton, Tax and Accounting Problems on the Purchase of a Basket of Assets, 28 Inst. on Fed. Tax'n 75 (1970); *supra* note 131.

¹⁴⁷ Under the "tax benefit" doctrine, the seller would recognize income (probably) equal to the prior deduction. See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983).

¹⁴⁸ See *infra* note 219 and accompanying text.

single useful life to a building, for example, the taxpayer can allocate its cost among such components as the shell, roof, plumbing and wiring, heating plant, air-conditioners, and elevators and depreciate each of these elements over its own useful life."¹⁴⁹ Hence, a market survey of a rapidly changing environment, providing a shorter benefit than a depreciable (e.g., an office showroom)¹⁵⁰ or nondepreciable (e.g., a branch operating under an indefinite life permit)¹⁵¹ asset with which the survey is associated can be treated as a separate, amortizable, capitalized cost, as an asset, or as a currently expensed short- or variable-term benefit, if sufficiently recurring. If this is so, should not the "last coat of paint" be treated as a separate asset, probably currently deductible? One clear congressional trend in cost recovery for tangibles, however, is elimination of the line drawing entailed in component depreciation; the Code prohibits its use where ACRS applies.¹⁵²

While some "straws in the wind" support this approach, and hence, the model,¹⁵³ the bulk of the start-up cost and related deci-

¹⁴⁹ 1 B. Bittker, *supra* note 5, ¶ 23.3.3, at 23-41.

¹⁵⁰ But see *Cagle v. Commissioner*, 539 F.2d 409 (5th Cir. 1976) (added survey cost to basis of showroom).

¹⁵¹ But see *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181 (5th Cir. 1984) (added survey cost to basis of permits).

¹⁵² See I.R.C. § 168(f)(1) (disallowing component depreciation of buildings); see also H.R. Conf. Rep. No. 215, 97th Cong., 1st Sess. 208-9, reprinted in 1981 U.S. Code Cong. & Admin. News 285, 299. For the definition of component depreciation, see *supra* text accompanying note 149.

¹⁵³ E.g., *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982), cert. denied, 463 U.S. 1207 (1983). The Eleventh Circuit reasoned that even if the taxpayer's investigation of a target corporation's books (primarily to determine the merger stock exchange ratio) produced general market information of continuing usefulness, "that future benefit of the study might require capitalization and amortization over the period during which the study was expected to have utility." *Id.* at 1381-82 n.11. The court apparently visualized an independent benefit from use of the survey, rather than a survey used solely for acquisition, but with a benefit shorter than that of the asset acquired. In contrast, professional fees incurred in an acquisition, the benefit of which does not diminish over the period the asset is held, clearly should be added to the cost of the asset acquired. Cf. *Gunn*, *supra* note 5, at 494 n.230. The author is indebted to Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 *Tax L. Rev.* 277 (1978), for the "straws in the wind" metaphor.

This analysis suggests that *Estate of Wilbur* (last coat of paint) and *Shainberg* (grand opening cleaning expenses) were incorrectly decided. For discussion of these cases, see *supra* notes 123-24 and accompanying text. Under the model, *Schultz v. Commissioner* was probably decided incorrectly as well. 50 T.C. 688, 694-95 (1968), *aff'd per curiam*, 420 F.2d 490 (3d Cir. 1970). In *Schultz*, the taxpayer purchased quantities of bulk raw whiskey as an investment and prepaid four years' storage charges, insurance premiums, and estimated state ad valorem taxes at the time of purchase. Such expenses are usually currently deducti-

sions using an acquisition cost rationale find some asset, generally nonamortizable, with which to "associate" even a recurring expenditure.¹⁵⁴ Indeed, this error is made by the Supreme Court in *Richmond Television Corp. v. Commissioner*.¹⁵⁵ The Fourth Circuit had held that the employee staff training costs, incurred prior to a television station's obtaining its broadcasting license, were not currently deductible as pre-opening expenses incurred between the decision to establish a business and its actually beginning to function as a going concern.¹⁵⁶ Alternatively, the court had held that the staff training costs were not currently deductible because they resulted in the acquisition of a capital asset, the value of which to the taxpayer would continue for many years, even though from time to time individual staff members would leave.¹⁵⁷

The taxpayer, in response to the capitalization question, argued that the staff training costs should be added to the basis of the broadcasting permit and amortized over its useful life.¹⁵⁸ The

ble. See I.R.C. § 212. In this case the *prepaid* expenses, if deductible, should have been capitalized as a deferred charge and amortized over four years. The Tax Court found that the expenditures did not contribute an added value to the whiskey or extend its useful life. 50 T.C. at 695-96, 698. (The court's approach is analogous to the *Lincoln Savings & Loan* test. See *infra* notes 233-34 and accompanying text.) Nevertheless, the *Schultz* court found that the costs were acquisition costs of four-year-old bourbon (which through the passage of time and chemical changes is more valuable than raw whiskey), the product the taxpayer sought to acquire. 50 T.C. at 696, 699. The Third Circuit affirmed *Schultz* on the grounds that the Tax Court's determination that these normally deductible expenses "were incurred as an integral part of a capital transaction" was not clearly erroneous. 420 F.2d at 491.

¹⁵⁴ See cases cited *supra* note 112.

¹⁵⁵ 382 U.S. 68, 68 (1965).

¹⁵⁶ *Richmond Television Corp. v. United States*, 345 F.2d 901, 907 (4th Cir.), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965). Judge Sobelof fashioned this argument sua sponte, since the government relied only on a capitalization/distortion of income position. Brief for Appellant at 12-14, *Richmond Television* (4th Cir.) (No. 64-9531) (copy on file); see Lee, *supra* note 122, at 458. Judge Sobelof may have felt compelled to answer the taxpayer's "challenge":

Every business paying U. S. taxes has incurred start-up expenses, many of them repeatedly, every time they try to develop a new product or expand. Did Ford capitalize the quarter of a billion spent on the Edsel? Did Dupont capitalize the development of nylon? We challenge the Government to produce a case or a ruling which denies the deduction of start-up costs.

Reply Brief for Appellee at 13 (copy on file).

¹⁵⁷ 345 F.2d at 907-08; see *supra* note 156. The Fourth Circuit subsequently overruled this leg of *Richmond Television*. See *NCNB II*, 684 F.2d at 289.

¹⁵⁸ The government noted that:

Taxpayer, by an amendment to its complaint, alleged in the alternative that the advantage secured by its capital outlay had a useful life co-extensive with the term of

Fourth Circuit avoided this argument by pointing out that since the taxpayer was not yet in business during the tax year, the taxpayer also was not entitled to any amortization deduction.¹⁵⁹ The Supreme Court remanded for a finding of the *permit's* useful life.¹⁶⁰ The Fourth Circuit on remand held it was indefinite, in line with established precedents.¹⁶¹ No one thought of treating the employee training cost itself as the asset and then determining *its* useful life based on turnover and frequency of retraining.

D. Detailed Analysis: Cohan Approximation of Useful Life

The clear reflection of income through amortization of a separate or free-standing intangible asset or deferred charge frequently will require either the taxpayer or courts to estimate the useful life of the deferred charge. The pertinent Treasury Regulations require, as a precondition for depreciation or amortization of an intangible asset, that its useful life "be estimated with reasonable accuracy,"¹⁶² and disallow any deduction claimed "merely because in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life."¹⁶³ No similar restrictions or admonitions appear in the regulations dealing with depreciation of tangible assets.¹⁶⁴

If a taxpayer can show that the benefits produced by the expenditure are temporally limited, although he may not be able to estimate that life with reasonable accuracy, logically he proves entitlement to a deduction equal to some percentage of the cost of the expenditure. Generally, useful life cannot be estimated with reasonable accuracy; therefore, the taxpayer cannot prove exactly what percentage of the cost should be ratably deducted (e.g., ten percent if the useful life were in fact ten years or three percent if

the FCC construction permit and first regular license and accordingly claimed the right to depreciate these expenditures over a period of 58 months.

Brief for Appellant at 8; see *Richmond Television*, 345 F.2d at 908. The taxpayer should have argued that the training cost itself was the amortizable asset.

¹⁵⁹ 345 F.2d at 909.

¹⁶⁰ 382 U.S. at 68.

¹⁶¹ *Richmond Television Corp. v. United States*, 354 F.2d 410, 413 (4th Cir. 1965); see, e.g., *Commissioner v. Indiana Broadcasting Corp.*, 350 F.2d 580 (7th Cir. 1965), cert. denied, 382 U.S. 1027 (1966); *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951).

¹⁶² Treas. Reg. § 1.167(a)-3.

¹⁶³ *Id.*

¹⁶⁴ See Treas. Reg. § 1.167(a)-2. See generally 1 B. Bittker, *supra* note 5, ¶ 23.2.6.

the useful life were in fact thirty-three years). This situation calls for approximation of the useful life of the deferred charge under the doctrine of *Cohan v. Commissioner*.¹⁶⁵ Under *Cohan*, if the taxpayer proves to the court that deductible expenditures are incurred *in some amount*, the court *must* "make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making."¹⁶⁶ Thus, where the taxpayer proved that an intangible asset (an easement) was indeed a wasting asset, the Eighth Circuit held that some amortization deduction is mandated under *Cohan*.¹⁶⁷ The court read a similar, but harsher, requirement as to the limited life of an amortizable intangible, imposed by a prior regulation,¹⁶⁸ as not requiring

proof of the exact number of years the easements will continue. We believe that all that is required is definite proof that the asset is one definitely undergoing exhaustion. The evidence clearly establishes that the rights-of-way will be useful for taxpayer's purposes for only a limited period The uncertainty relates to the length of the period.¹⁶⁹

Although only rarely so acknowledged, the *Cohan* rule is an equitable one under which a court, unable to be precise in its findings, dispenses "practical justice" as best it can.¹⁷⁰ Similarly, useful

¹⁶⁵ 39 F.2d 540 (2d Cir. 1930).

¹⁶⁶ *Id.* at 544.

¹⁶⁷ *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128, 135, 138 (8th Cir. 1960).

¹⁶⁸ The regulations promulgated under § 23(l) of the Internal Revenue Code of 1939 provided that:

Intangibles, the use of which in the trade or business or in the production of income is indefinitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade or in the production of income is not so limited, will not usually be a proper subject of such an allowance. If, however an intangible asset acquired through capital outlay is known from experience to be of value in the business or in the production of income for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance.

Treas. Reg. 111, § 29.23(l)-3 (predecessor of Treas. Reg. § 1.167(a)-3).

¹⁶⁹ 277 F.2d at 135.

¹⁷⁰ See *Dowell v. United States*, 522 F.2d 708, 711 (5th Cir. 1975) (dictum); *John L. Ashe, Inc. v. Commissioner*, 214 F.2d 13, 16 (5th Cir. 1954); *Robinson v. Commissioner*, 10 T.C.M. (CCH) 571 (1951). Several courts have required a reasonable basis for judicial estimation under *Cohan*. See cases cited *infra* note 173. In general, however, courts have not permitted an "equitable" allocation not based on credible evidence. E.g., *Union Stock Farms v. Commissioner*, 265 F.2d 712, 723-24 (9th Cir. 1959); see *Gross v. Commissioner*, 48 T.C.M.

life for depreciation under one view need not be established with certainty. Only a "reasonable approximation" or even a "rough estimate" is required.¹⁷¹ Application of distortion of income analysis to the issue of current deduction versus capitalization and amortization supports the liberal use of *Cohan*. If an expenditure does benefit a number of tax years and the taxpayer proves that the value of the expenditure becomes exhausted or will only benefit a limited number of tax periods, but cannot reasonably estimate the useful life, three judicial options are presented. First, under the "rough justice" of the separate, saleable asset test,¹⁷² a current deduction is allowed if the benefits of the expenditure are not saleable, which generally will be the case if amortization is not available. However, current deduction of an expenditure benefiting a number of tax years distorts income. Second, capitalization is allowed, but amortization is denied due to inability reasonably to estimate useful life. However, this equally distorts income if the expenditure is capitalized as a cost of the business as a whole. Third, the useful life of the expenditure itself is approximated, along the lines of *Cohan*, even if a reasonable basis for the approximation is not available. Only this third option offers "practical justice," consistent with the distortion of income rationale.

The model for separating current and capital expenditures on the basis of distortion of income requires the third option. Equitable *Cohan* approximations of the useful life of intangibles avoids the all-or-nothing conflict between current expensing and capitalizing without amortizing expenditures that produce benefits for a

(CCH) 77 (1984).

A major difficulty in determining the approach followed by a particular opinion—equity or reasonable basis—is that judges are unlikely to admit that they are making *Cohan* approximations without any ascertainable basis. For instance, one dissenting opinion charged the majority with making a *Cohan* approximation without any ascertainable basis, or even a citation to *Cohan*, and hence clothing the court with the "power of an equity court" that it did not possess. *Ward v. Commissioner*, 20 T.C. 332, 345-46 (1953) (Withey, J., dissenting).

¹⁷¹ *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 654-55 (1931); cf. *United States v. Ludey*, 274 U.S. 295, 302 (1927) (considering depletion). Useful life has been determined by *Cohan* approximations implicitly or explicitly. See, e.g., *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1253-54 (5th Cir. 1973) (approximation of useful life without citing *Cohan*); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 455-56 (Ct. Cl. 1976) (same); *Wisconsin Psychiatric Serv., Ltd. v. Commissioner*, 76 T.C. 839, 852-53 (1981) (*Cohan* approximation of useful life); *Joyce v. Commissioner*, 25 T.C. 13, 15-16 (1955) (*Cohan* approximation of reasonable allowance for depreciation).

¹⁷² See Warner, *supra* note 87, at 8.

substantial period that cannot be determined with accuracy. A "rough guess" as to useful life produces less distortion of income than the "rough justice" of a current deduction. This approach is readily applicable to wasting assets such as market distribution and sources surveys and employee training. Nonwasting assets such as indefinite-life permits require a different conceptual approach to depreciation: abandoning the economic concept that depreciation measures the decline in value of an asset over its useful life. Courts, focusing instead on the necessity of allocating meaningfully the cost entailed in the use of an asset to tax years to which it contributes to income in order to avoid distortion of income, should pick some arbitrary period as the reasonable useful life of an indefinite-life asset, say twenty or even eighteen years, and provide a "reasonable allowance" for depreciation.

This liberal view of *Cohan* and, hence, this part of the model, is not without opposition in the case law. Several decisions have required the taxpayer to prove a reasonable basis for a *Cohan* approximation, particularly where the taxpayer's sole evidence as to amount was his testimony.¹⁷³ Moreover, depreciation has been denied due to a failure in establishing an asset's useful life even though the asset would physically deteriorate or someday be retired from service.¹⁷⁴ In short, a conflict exists between those authorities fashioning some deduction where allowing no deduction will produce a distortion of income and those authorities requiring a reasonable basis for estimation.

III. START-UP AND BUSINESS EXPANSION COSTS CASE LAW: CHAOS OVER SYNTHESIS

A. *Thesis: Definitional Preparatory Doctrine*

The traditional preparatory doctrine, also known as the classic start-up doctrine, denies a current section 162 deduction to recurring, otherwise deductible, expenditures when incurred before or

¹⁷³ See, e.g., *Plisco v. United States*, 306 F.2d 784, 787 (D.C. Cir. 1962); *A. Finkl & Sons v. Commissioner*, 38 T.C. 886, 904 n.15 (1962); *Masters v. Commissioner*, 25 T.C. 1093, 1099-1100 (1956).

¹⁷⁴ See, e.g., *Burlington Northern, Inc. v. United States*, 676 F.2d 566, 582 (Ct. Cl. 1982) (Kashiwa, J., dissenting) (describing the majority's finding that the assets involved were durable but would nonetheless become obsolescent); cf. *Coleman v. Commissioner*, 540 F.2d 427, 431-32 (9th Cir. 1976).

after the business is decided upon but before the taxpayer's trade or business begins to function as a going concern. The traditional approach denies a deduction on the definitional grounds that the taxpayer is not yet carrying on a trade or business,¹⁷⁶ or under per-

¹⁷⁶ *Westervelt v. Commissioner*, 8 T.C. 1248, 1254 (1947) (investigatory costs such as traveling expenses "were preparatory to entering the cattle business"); accord *Liberty Nat'l Bank & Trust v. United States*, 69-1 U.S. Tax Cas. (CCH) ¶ 9147 (S.D. Ga. 1968); *Dean v. Commissioner*, 56 T.C. 895, 902 (1971); *Abegg v. Commissioner*, 50 T.C. 145, 153-54 (1968), aff'd, 429 F.2d 1209 (2d Cir. 1970), cert. denied sub nom. *Cresta Corp., S.A. v. Commissioner*, 400 U.S. 1008 (1971); *Polachek v. Commissioner*, 22 T.C. 858, 863 (1954); *Ward v. Commissioner*, 20 T.C. 332, 343-44 (1953), aff'd on other grounds, 224 F.2d 547 (9th Cir. 1955); *Evans v. Commissioner*, 33 T.C.M. (CCH) 1192 (1974); *Ewart v. Commissioner*, 25 T.C.M. (CCH) 96 (1966). The Tax Court, in extending the "pre-operational costs" doctrine to start-up costs (e.g., pre-opening training costs in a nuclear energy electric power plant that, due to high employee turnover and engineering and safety changes after business commenced, trained new employees and retrained existing employees with equivalent scope and content as an ongoing function), capitalized these costs simply because they were pre-operational. *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 567 (1979) (amortization not considered since not timely raised), aff'd per curiam, 633 F.2d 512 (7th Cir. 1980).

For the historical development of the investigatory cost doctrine, see *Fleischer, Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment*, 14 *Tax L. Rev.* 567 (1959); *Wilberding, An Individual's Business Investigation Expenses: An Argument Supporting Deductibility*, 26 *Tax Law.* 219 (1973). For the development of the start-up cost doctrine, see *Lee, supra* note 2, at 391-96; *Lee, supra* note 122, at 464-65; *Roth, supra* note 2; *Seago, supra* note 2. The Tax Court, following the rigid conceptualism of its preparatory doctrine, permitted a father to deduct his coaching services, rendered to further his son's development as a professional baseball player, upon the son's entering the business. The court found the son to be contractually obligated to pay for such services only if he attained professional status. *Hundley v. Commissioner*, 48 T.C. 339, 347 (1967).

Most early investigatory cost decisions were based on the rationale that the taxpayer was not yet engaged in a trade or business. See *Lee, supra* note 2, at 393. Additionally, § 212 was originally intended to allow the deduction of expenses incurred for production or collection of income, not those incurred in a trade or business. See *Lang, Scope of Deductions Under Section 212*, 7 *Rev. Tax'n Individuals* 291 (1983); see also *Treasury Reg. § 1.212-1(b)* (not requiring the "production or collection of income" to be received in the same tax year as the deduction). Moreover, on its surface § 212 would appear to have been an available avenue for currently deducting start-up costs (prior to 1984 amendments to § 195). Such use was recommended early on by *Fleischer*, at 580-84. Shortly after deciding the first modern investigatory expense decisions (under the predecessor to § 162), however, the Tax Court in a landmark decision denied any deduction under the predecessors to both § 162 and § 212 for investigatory expenses incurred prior to the taxpayer's entering into a trade or business. *Frank v. Commissioner*, 20 T.C. 511 (1953). The court based its opinion on the rationale that the predecessor § 212 presupposed an existing endeavor with which the taxpayer was connected, stating that "[t]here is a basic distinction between allowing deductions for the expense of producing or collecting income, in which one has an existent interest or right, and expenses incurred in an attempt to obtain income by the creation of some new interest." *Id.* at 514.

More recently the Tax Court has applied § 212 to start-up costs (ground rent during year one for a leasehold interest where construction and rental of building on such interest oc-

haps the same test worded differently, the taxpayer is not yet holding himself out to others as engaged in the selling of goods or services.¹⁷⁶ Amortization of such capitalized expenditures is not usually available because the expenditures generally are added to the nonamortizable basis of the business entered into by the taxpayer.¹⁷⁷

Application of the definitional preparatory approach, in its modern manifestation, to *investigatory* expenses took place in the 1940s,¹⁷⁸ in cases involving expenses that were incurred prior to a commitment to enter the venture. This approach resulted in their disallowance on the ground that they were preparatory to the taxpayer's entering the business in question.¹⁷⁹ In 1965 the leading preparatory decision, *Richmond Television Corp. v. United*

curred during year two), finding the requisite year-one "existent interest" in the ground lease. *Hoopengartner v. Commissioner*, 80 T.C. 538, 541 (1983), *aff'd mem.*, 745 F.2d 66 (9th Cir. 1984). *Contra* *Johnsen v. Commissioner*, 794 F.2d 1157 (6th Cir. 1986); *Aboussie v. United States*, 779 F.2d 424, 428-29 n.6 (8th Cir. 1985). This end-run around the start-up cost doctrine was ably and justifiably criticized in Note, *Hoopengartner v. Commissioner Revisited: Does the Tax Reform Act of 1984 Solve the Pre-Opening Expense Problem?*, 4 Va. Tax Rev. 141 (1984). For the rationale behind Congress' reversal of *Hoopengartner* in the 1984 amendments to § 195, see *infra* notes 439-41 and accompanying text.

¹⁷⁶ See, e.g., *Richmond Television Corp. v. United States*, 345 F.2d 901, 905 (4th Cir.), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965); *Downs v. Commissioner*, 49 T.C. 533, 540 (1968) (also relied on preparatory doctrine); *Kennedy v. Commissioner*, 32 T.C.M. (CCH) 52 (1973).

¹⁷⁷ See *supra* note 112.

¹⁷⁸ E.g., *Westervelt v. Commissioner*, 8 T.C. 1248, 1254 (1947). The preparatory doctrine arose as early as 1929. See *Harrisburg Hosp., Inc. v. Commissioner*, 15 B.T.A. 1014, 1018 (1929); see also Lee, *supra* note 122, at 455. The Board of Tax Appeals (predecessor to the Tax Court) first ignored the Second Circuit's opinion in *379 Madison Ave., Inc. v. Commissioner*, 60 F.2d 68 (2d Cir. 1932), continuing to rely on its own precedents. See, e.g., *New Quincy Mining Co. v. Commissioner*, 36 B.T.A. 376, 383-84 (1937). In the alternative, the Tax Court facilely distinguished *379 Madison Ave.* as involving different facts. E.g., *Todd v. Commissioner*, 77 T.C. 246, 250 n.4 (1981), *aff'd per curiam*, 682 F.2d 207 (9th Cir. 1982); *Ewart v. Commissioner*, 25 T.C.M. (CCH) 96, 98 (1966). Ultimately, the Tax Court acknowledged more forthrightly that there were two "diametrically opposed" positions in the start-up cost area, with Tax Court precedents falling on one side and *379 Madison Ave.* and *Blitzer* falling on the other. See *Hoopengartner*, 80 T.C. 543 & n.9; see also *Haskins v. Commissioner*, 45 T.C.M. (CCH) 359, 362 (1982).

¹⁷⁹ See cases cited *supra* note 175. These cases adopted the position that investigating a potential new business did not constitute carrying on a trade or business but disproportionately involved businesses that never got off the ground and mixed business/personal motives that could have better been resolved on the patent lack of profit motive. See generally I B. Bittker, *supra* note 5, ¶ 20.4.4, at 20-77 to -78 and cases cited at 20-78 n.47; Lee, *supra* note 122, at 447-51; Wilberding, *supra* note 175, at 228; Note, *Investigation Costs: An Analysis and a Proposal*, 41 Temple L.Q. 81, 88, 98 (1967).

States,¹⁸⁰ extended the doctrine to "pre-opening" or start-up expenses incurred between the decision to establish a business, concluding the investigatory stage, and the actual beginning of business operations as a going concern.¹⁸¹ In *Richmond Television*, the Fourth Circuit disallowed a current deduction for the cost of training and paying salaries to the taxpayer's broadcasting staff incurred during a two-year period prior to the taxpayer's obtaining its broadcasting license, reasoning that a taxpayer was still not carrying on a trade or business under section 162 "until such time as the business has begun to function as a going concern and performed those activities for which it was organized."¹⁸² In the late 1970s, the Tax Court began to apply repeatedly and mechani-

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

¹⁸¹ *Id.* at 905. Commentators have widely criticized *Richmond Television*, with its alternate holdings of (1) no deduction because the taxpayer was not currently carrying on a trade or business, or (2) the disputed costs were capital because they provided future benefits. These commentators have usually focused on the Fourth Circuit's application of the preparatory doctrine to recurring expenditures after the business "commenced." E.g., Buell, *supra* note 2, at 280-81 (stating that the trade or business requirement should not be used to deny current deduction of costs connected with acquisition of a capital asset or prior to generation of income to which they gave rise, because the "Commissioner has other tools, including Sections 263 and 446, to prevent the current deduction of capital expenditures and the material distortion of income"); Erbacher, *supra* note 2, at 497-99 (also reasoning that if initial costs are capitalized they should be amortized over a fairly short period of time); Roth, *supra* note 2, at 48; Solomon, *Tax Treatment of Pre-Opening Expenses*, 46 *Taxes* 521, 525-28 (1968).

For a description of the arguments made by the parties and evidence that the Fourth Circuit *sua sponte* fashioned the preparatory start-up costs doctrine, see Lee, *supra* note 122, at 457-59; *supra* note 156. The author long thought that *Richmond Television's* gravest error lay in its adoption of the preparatory doctrine. See Lee, *supra* note 122, at 460. The author now realizes that an equal if not greater error was its application of the "future benefits" rule to capitalize probably recurring, short-term benefits, such as costs consisting of employee training, travel, etc., and then adding such costs to the nonamortizable federal agency license. These costs should have been treated as costs of separate assets under *Wolfson Land & Cattle's* separate free-standing asset approach and either currently deducted or amortized whenever the business commenced. See *supra* notes 139-40 and accompanying text. This determination of current deduction or amortization should depend upon the amount of such costs in relationship to the annually recurring employee training (and possibly retraining) costs, as well as the rates of employee turnover. Even when presented with sufficient data, however, the Tax Court has applied the preparatory doctrine mechanically to recurring, but pre-operational, employee training costs incurred in a new business. *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 566 (1979) (the capitalization and amortization issue not timely raised by taxpayer), *aff'd*, 633 F.2d 512 (7th Cir. 1980); see *Priv. Ltr. Rul.* 8,423,005 (Feb. 8, 1984).

¹⁸² 345 F.2d at 907.

cally¹⁸³ the *Richmond Television* nondeductibility of pre-opening expenses rule to such start-up costs as nuclear power generating plant employee training expenses before the issuance of an Atomic Energy Commission operating permit¹⁸⁴ and mortgage broker fees incurred before completion of construction or leasing of units to tenants.¹⁸⁵ Initially, various circuit courts uniformly affirmed these decisions on the basis of a mechanical application of the Tax Court's reasoning.¹⁸⁶ More recently, the circuit courts espousing the pre-opening doctrine have begun to offer more extensive reasoning. However, conflict continues over whether pre-opening expenses are nondeductible because they are capital or because the taxpayer is not yet carrying on a trade or business.¹⁸⁷

These decisions by-and-large denied amortization either because the taxpayer did not timely raise the issue of amortizing the expenditures¹⁸⁸ or because the court added the start-up costs to the basis of a nonamortizable asset¹⁸⁹ or the business as a whole.¹⁹⁰ The combination of denying both a current deduction and an amortization deduction produced distortion of income as to recurring, short-term benefits. In order to avoid such distortion yet maintain the mechanical pre-opening doctrine, courts began to carve out a number of definitional exceptions,¹⁹¹ the most impor-

¹⁸³ Bradley, *Deductibility of a Partnership's Investigation and Start-Up Expenses*, 2 J. Partnership Tax'n 233, 243 (1985).

¹⁸⁴ *Madison Gas & Elec.*, 72 T.C. at 566.

¹⁸⁵ *Goodwin v. Commissioner*, 75 T.C. 424 (1980), aff'd mem., 691 F.2d 490 (3d Cir. 1982).

¹⁸⁶ See *Goodwin*, 691 F.2d at 490 (affirming without opinion); *Madison Gas & Elec.*, 633 F.2d at 517 (holding that "expenses were nondeductible, pre-operational start-up costs," apparently viewing the issue as "whether the costs were necessary and ordinary current expenses or capital investments in future economic benefits"); see also *Todd v. Commissioner*, 682 F.2d 207 (9th Cir. 1982) (per curiam).

¹⁸⁷ Compare *Aboussie v. United States*, 779 F.2d 424, 428, 428-29 n.6 (8th Cir. 1985) (finding that the taxpayer was not carrying on trade or business, but the pre-operating expense incurred also did not represent the cost of acquiring the taxpayer's sole operating asset) with *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986) (holding that pre-operating expenses constituted a capital expenditure since they were part of the cost of establishing the enterprise).

¹⁸⁸ See *Madison Gas & Elec.*, 72 T.C. at 564 n.15; *Aboussie*, 779 F.2d at 428 n.5.

¹⁸⁹ E.g., *Richmond Television Corp. v. United States*, 354 F.2d 410, 412 (4th Cir. 1965) (on remand, start up costs added to the basis of an indefinite-lived permit).

¹⁹⁰ *Johnsen*, 794 F.2d at 1162.

¹⁹¹ See, e.g., *Hoopengartner v. Commissioner*, 80 T.C. 538 (1983), aff'd mem., 745 F.2d 66 (9th Cir. 1984). Under *Hoopengartner*, the application of § 212 to start-up costs constitutes a further definitional exception, adopted to avoid the § 162 start-up quagmire. See also *supra* note 175 and accompanying text; *infra* notes 222-24 and accompanying text.

tant of which is the "separate, saleable asset" precondition to capitalization.¹⁹²

Finally, late in the development of the start-up cost doctrine, in *Blitzer v. United States*¹⁹³ the Court of Claims challenged the doctrine's definitional functioning as putting a "going concern" gloss on section 162(a).¹⁹⁴ The court rejected, albeit in dictum,¹⁹⁵ the government's "thesis that the start of a trade or business in the sense of carrying on revenue-producing operations is an inflexible temporal prerequisite for the application of I.R.C. § 162(a)."¹⁹⁶ Instead, the Court of Claims would have turned current deductibility on general capitalization theories, i.e., whether the expenditures were intended to provide benefits extending beyond the tax year in question or were in the nature of start-up costs.¹⁹⁷ Thus, *Blitzer*

¹⁹² See *infra* notes 225-43 and accompanying text.

¹⁹³ 684 F.2d 874 (Ct. Cl. 1982). See generally Jones & Fowler, Pre-Operating Expenses: Sec. 195 Does Not Resolve Conflicting Judicial Views, 14 Tax Adviser 471, 473-74 (1983); Warner, *supra* note 87, at 3-4.

¹⁹⁴ See 684 F.2d at 879-81.

¹⁹⁵ The court's discussion of whether the partnership was carrying on a trade or business in the tax year in question constituted dictum in that the expenditures at issue were actually capital expenditures (e.g., payments for services in connection with the acquisition and construction of capital assets, services in connection with obtaining a 42-year loan, and a front-end fee for services rendered throughout the life of the partnership). 684 F.2d at 893-94. The *Blitzer* court stated that the taxpayer might well have been able to prove that some portion of fees paid to the administrative general partner were "of a non-capital nature, for performing overhead, recordkeeping and normal housekeeping duties" during the tax year in question, but the taxpayer waived any right to a remand since the amount involved was too small. 684 F.2d at 895.

¹⁹⁶ 684 F.2d at 880 (footnote omitted). In *Blitzer* the government relied upon *Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965) (on remand), and on the Tax Court decisions in *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980), *Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977), and *Goodwin v. Commissioner*, 75 T.C. 424 (1980). See *Blitzer*, 684 F.2d at 880. The court distinguished *Richmond Television* and *Madison Gas & Electric* from the case before it on the basis that they involved costs treated as capital expenses under the application of tests which were apart from the "carrying on a trade or business" requirement, i.e., staff costs that provided future benefits. *Id.* Additionally, the *Blitzer* court dismissed *Francis* and *Goodwin* as being "without critical analysis." *Id.*; see also, Bradley, *supra* note 183. For further discussion of *Richmond Television*, see *supra* notes 180-82 and accompanying text; of *Madison Gas & Electric*, *Francis*, and *Goodwin*, see *supra* note 112 and accompanying text.

¹⁹⁷ The court in *Blitzer* stated:

Defendant [the government] has supplied no good reason why normal recurring expenses to maintain any business enterprise, and which are not in the nature of start-up costs nor intended to provide benefits extending beyond the year in question, should not be deductible as ordinary expenses of such business irrespective of

left open the possibility of capitalizing start-up costs on some ground other than the preparatory doctrine.¹⁹⁸ It would, nevertheless, allow new corporations and new partnerships a current deduction for recurring expenditures producing short-term benefits.¹⁹⁹ Such expenditures fall within the classic definition of pre-operating or pre-opening expenses;²⁰⁰ however, investigatory costs would not be included. The Court of Claims previously had held that investigatory costs as to the acquisition of an *investment*, even though recurring, had to be capitalized and added to the basis of the assets.²⁰¹

Blitzer, in a step long advocated by commentators,²⁰² functionally limited "trade or business" in section 162(a) to requiring only regular, continuous conduct distinguishing the activity from non-deductible "personal" or "family" expenses.²⁰³ Ample support exists in the "hobby loss" area for this interpretation of "trade or business."²⁰⁴ However, something more than continuity is needed to distinguish investment activities from business activities. "The 'regular, extensive and continuous' test is not in itself the correct test for determining whether a taxpayer is engaged in the trade or

whether or not the business has yet completed construction or acquisition of its income-producing asset.

684 F.2d at 880.

¹⁹⁸ The Claims Court subsequently approved an "amassing of assets" capitalization rationale as undergirding the start-up cost doctrine. See *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228 (1985). But see *supra* notes 120 & 131 and accompanying texts (criticizing the Claims Court's approach).

¹⁹⁹ 684 F.2d at 880 (dictum). Such deductions could be allowed "for amortization of organization and loan costs, for payment of telephone and other utility bills, rent, stationery, and salaries and wages of corporate officers, secretaries and even for those who sweep the floor . . . [although] the business enterprise is not yet in a position to earn income." *Id.*; accord *Brotherman v. United States*, 6 Cl. Ct. 407 (1984).

²⁰⁰ See *infra* note 315. Other decisions have treated similar costs as nondeductible preparatory costs. E.g., *Goodwin v. Commissioner*, 75 T.C. 424, 434 (1980), *aff'd mem.*, 691 F.2d 490 (3d Cir. 1982); *Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977). The Court of Claims viewed these decisions as mechanical. *Blitzer*, 684 F.2d at 880; accord *Bradley*, *supra* note 183.

²⁰¹ See *Weinstein v. United States*, 420 F.2d 700 (Ct. Cl. 1970). Recurring acquisition costs of capital assets also must be capitalized. See *Union Mutual Life Ins. Co. v. United States*, 570 F.2d 382, 390-91 (1st Cir. 1978).

²⁰² E.g., *Buell*, *supra* note 2, at 280; *Roth*, *supra* note 2, at 48; see *Erbacher*, *supra* note 2, at 491, 493, 495.

²⁰³ 684 F.2d at 879-80; accord *Brotherman v. United States*, 6 Cl. Ct. 407 (1984).

²⁰⁴ 1 B. Bittker, *supra* note 5, ¶ 22.5.1 to .2, at 22-44 to -49; *Lee*, *supra* note 122, at 390-97.

business of managing his own investments.”²⁰⁵ At the same time, there is no need to use the term “trade or business” to separate currently deductible expenses from capital expenditures; this separation is the primary function of the “ordinary” requirement under both sections 162 and 212.²⁰⁶

Rejecting revenue-producing operations as an “inflexible temporal prerequisite” for the application of section 162(a),²⁰⁷ the court in *Blitzer* held that a taxpayer had begun business, for purposes of this provision, as soon as the taxpayer “had actually begun, . . . a regular, continuous course of conduct,”²⁰⁸ in this instance “to engage in, and carry on, its ‘trade or business’ of developing, constructing, owning and operating an apartment project with a bona fide expectation of profit.”²⁰⁹ The taxpayer’s activities reached trade or business status under this definition on the date on which it “had acquired the land, had arranged for the financing of the project, had executed its building loan agreement and given a note therefor, had received substantial funds, and had prepared plans for actual construction of its apartments (which began shortly thereafter [and was completed in the following tax year]).”²¹⁰ While couched in traditional commencement of a trade or business format and perhaps supported by regulations under section 248,²¹¹

²⁰⁵ *Moller v. United States*, 721 F.2d 810, 814 (D.C. Cir. 1983).

²⁰⁶ See *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966); *Raymond Bertolini Trucking Co. v. Commissioner*, 736 F.2d 1120, 1123 (6th Cir. 1984).

²⁰⁷ *Blitzer*, 684 F.2d at 880.

²⁰⁸ *Id.* For a discussion of the “continuity” doctrine, see Lee, *supra* note 122, at 449-51.

²⁰⁹ 684 F.2d at 880-81; Warner, *supra* note 87, at 3. See generally Lee, *supra* note 2, at 387 (trade or business requirement connotes profit motive and continuity). For a discussion of the “profit” prerequisite, see Lee, *supra* note 122, at 380-90.

²¹⁰ 684 F.2d at 880.

²¹¹ See Treas. Reg. §§ 1.248-1(a)(3), 1.1372-4(b)(5)(ii)(b). The regulations peg “deemed commencement of a business” (or “active conduct” in the latter instance) to whether the activities of the (corporate) taxpayer advance to the extent necessary to identify the nature of its business operations, e.g., the acquisition of necessary “operating assets.” The Tax Court explicitly rejected this model in the context of preparatory expenses. See *infra* note 428.

With increasing sophistication, or at least experience, the drafters of the regulations under § 709 added, in 1983, a definition of “operating assets” providing that such assets are “assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.” Treas. Reg. § 1.709-2(c). This definition was implicitly based on the model of § 248. See S. Rep. No. 938, 94th Cong., 2d Sess. pt. 1, 94, reprinted in 1976 U.S. Code Cong. & Admin. News 3439, 3530. It provides for 60-month amortization of partnership organization fees “beginning with the month in which the partnership begins business.” See I.R.C. § 709(b)(1). Not surprisingly, a decision following the start-up cost doctrine

this approach, also long called for by commentators,²¹² pinpoints commencement of business activities substantially prior to the first carrying on of revenue-producing operations. The government and the Tax Court preferred the later starting point as the commencement of a business for start-up costs purposes.²¹³

Blitzer and other cases attacking the "holding oneself out as providing goods or services" definition of trade or business status²¹⁴ undermine the noncapital aspects of the preparatory doctrine, thus opening the way for a functional analysis of the deductibility of start-up and business expansion costs, as well. The practical effect of *Blitzer* probably lay, however, more in its determination of when a business commences, than in its effect on the definitional underpinnings of the traditional start-up cost doctrine. For instance, under *Blitzer*, at least as soon as the typical real estate tax shelter venture acquired land and executed a construction loan agreement, it could currently deduct classic recurring start-up costs prior to completion or even commencement of construction.²¹⁵ Investigatory costs, therefore, would not be currently deductible under the *Blitzer* approach because (1) they would still fail the "ordinary" expense requirement previously viewed by the Court of Claims as a capitalizable acquisition cost,²¹⁶ and (2) gen-

approved these regulations. *Aboussie v. United States*, 779 F.2d 424, 430 (8th Cir. 1985).

²¹² See, e.g., Galvin, *Investigation and Start-Up Costs: Consequences and Considerations for New Business*, 56 *Taxes* 413, 418 (1978); Roth, *supra* note 2, at 39-40.

²¹³ See *infra* notes 415 & 420. Notwithstanding its usual hard-line tack as to when a business commences, the Tax Court on occasion has pinpointed commencement not on the first purchase or sale (in a commodities trading business) but on when "planning for the business was completed." *Louismet v. Commissioner*, 43 T.C.M. (CCH) 1496 (1982). For examples of typical Tax Court opinions, see cases cited *infra* note 415.

²¹⁴ The author elsewhere has criticized the use of the "holding one's self out as providing goods or services" definition of "trade or business" as support for the classic start-up cost doctrine. See Lee, *supra* note 122, at 452-54; Lee, *supra* note 2, at 398-400. The issue of whether meeting the "goods or services" standard is a prerequisite for "trade or business" status is presently before the Supreme Court. See *Commissioner v. Groetzinger*, 721 F.2d 269 (7th Cir. 1985), cert. granted, 106 S. Ct. 1456 (1986). See generally, Boyle, *What is a Trade or Business?*, 39 *Tax Law.* 737 (1986); Note, *Trade or Business Issue: Can a Gambling Loss Properly Be Considered a Business Loss?*, 19 *Suffolk U.L. Rev.* 907 (1985); Comment, *Defining "Trade or Business" Under the Internal Revenue Code: A Survey of Relevant Cases*, 11 *Fla. St. U.L. Rev.* 949 (1984).

²¹⁵ See Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, at 296 (Comm. Print 1985) [hereinafter *General Explanation*].

²¹⁶ See *Weinstein v. United States*, 420 F.2d 700 (Ct. Cl. 1970).

erally they would be incurred prior to the *Blitzer* identification of the business starting point for trade or business status.

Under a deep structure analysis, *Blitzer's* rejection of the "functioning as a going concern" gloss on section 162 is correct. Following this analysis, the "carrying on a trade or business" requirement should be limited to distinguishing between section 162 activities and non-profit-motivated activities or investments.²¹⁷ A trade or business should be viewed as commencing as soon as the activity can be determined to be profit-motivated and not merely an investment, i.e., usually when the business character of the activity can be identified. An expenditure incurred prior to such point, e.g., investigatory costs incurred prior to a firm decision to enter the activity, should be set up under the model as a separate asset and currently deducted in the tax year in which the business commences, but only if the expenditure produces sufficiently short-term, variable-term, or insubstantial benefits. Otherwise, the period benefited by such a capitalized cost should be estimated, even if in a rough guess, and the expenditure then amortized over that useful life. Under the model, most, if not all, pre-opening expenses would be currently deductible in the year incurred unless otherwise prohibited under the distortion of income doctrine. However, as a practical matter probably only investigatory costs would be set up as a separate asset and then expensed or amortized once the business commences, because only they would be likely to be nonrecurring.²¹⁸

Even if the taxpayer's trade or business were determined not to commence until the business begins to function as a going concern, substantial distortion of income could be avoided by treating limited-life investigatory and pre-opening costs as creating free-standing assets, amortizable in full in the first tax year of operation.²¹⁹

²¹⁷ *Blitzer*, 684 F.2d at 879; see Buell, *supra* note 2, at 280.

²¹⁸ See Note, *supra* note 87, at 453.

²¹⁹ The Tax Court has obliquely indicated its receptiveness to such an approach. *Goodwin v. Commissioner*, 75 T.C. 424, 433-34 n.9 (1980), *aff'd mem.*, 691 F.2d 490 (3d Cir. 1982). The *Goodwin* Court indicated approval of the result, but not the reasoning, in *United States v. Manor Care, Inc.*, 490 F. Supp. 355 (D. Md. 1980). The *Manor Care* court allowed a current deduction in the tax year the business began to function as a going concern for expenditures paid earlier in the same year, but prior to the taxpayer's both obtaining a license to operate and operating the business. *Id.* at 362. In *Goodwin*, the Tax Court disagreed with the reasoning in *Manor Care* that the expenditures were deductible under § 162, on the ground they "were clearly pre-operating in nature." 75 T.C. at 433-34 n.8.

In the case of the investigatory expenses and rare pre-opening expenses that benefit an extended period, amortization would begin when the business commences and would be available through the benefited period. In the case of pre-opening expenses which are sufficiently recurring so that if they are incurred after the business commences they will be currently deductible, a reasonable allowance under this approach for amortization in the year the business commences of such expenditures would be equal to the entire amount of the expense.

The suggested approach would bring symmetry and less distortion of income to the start-up and business expansion costs area. Unfortunately, its conflict with contrary definitional precedents and the necessity of case-by-case determination of useful life or distortion of income would pose substantial problems in tax administration. Moreover, at least since the 1984 amendments in response to *Blitzer*,²²⁰ courts arguably are not free to develop case-law solutions as to start-up costs under provisions other than section 195.²²¹

B. Antithesis: Definitional Separate, Saleable Asset Doctrine

The distortion of income caused by capitalization without amortization under the classic preparatory doctrine generated a host of definitional refinements to the doctrine. Examples of such refinements are: the preparatory doctrine does not apply to recurring-type expenditures incurred in the same tax year that the business later commences,²²² and conceptually unsound attribution of business status²²³ and deductions²²⁴ across corporate lines. The major

Instead, the *Goodwin* court indicated the identical result of a current deduction could be reached by capitalizing the expenditures and then providing—*once* the business began—amortization deductions over the period benefited. *Id.* Further, the Tax Court reasoned, implicitly, that the period benefited by such recurring pre-operating costs was a year or less; therefore, the “reasonable allowance” in the year the business commenced for depreciation of such capitalized pre-operating costs was the entire cost. See Schuster, *Pre-Opening Costs—Recent Legislative and Judicial Attention*, Tax. Mgmt. Mem. No. 81-8 (BNA) 3, 5-6 (1981).

²²⁰ See *infra* note 446 and accompanying text.

²²¹ See *infra* note 441 and accompanying text.

²²² *United States v. Manor Care, Inc.*, 490 F. Supp. 355 (D. Md. 1980). See generally Schuster, *supra* note 219.

²²³ *Duffy v. United States*, 690 F.2d 889 (Ct. Cl. 1982). Notwithstanding the Supreme Court’s pronouncement in *Whipple v. Commissioner*, 373 U.S. 193 (1963) (relying on a long

development in response to the inequities of the preparatory doctrine is the "separate, saleable asset" doctrine, fashioned to allow current deduction of start-up-like expenditures with present and future benefits incurred in expanding an existing business.

*Briarcliff Candy Corp. v. Commissioner*²²⁵ and most of its bank credit card case progeny, establishing the "separate, saleable property right" bright-line test for current deductibility of certain business expansion costs,²²⁶ contained common elements. The expenses

line of its earlier decisions that a shareholder was not engaged in the business of the corporation in which he owned stock), in *Duffy* the Court of Claims, in the context of whether sales of property by a shareholder to his controlled corporation were made in the ordinary course of the shareholder's business, imputed the corporation's trade or business activities to the shareholder under an agency theory. 690 F.2d at 895-96; see also *Tibbals v. United States*, 362 F.2d 266, 272 (Ct. Cl. 1966).

²²⁴ *Baltimore Aircoil Co. v. United States*, 333 F. Supp. 705 (D. Md. 1971) (although parent and subsidiary were separate entities, they filed consolidated returns and the subsidiary was merely a branch or division of parent); see also *Playboy Clubs Int'l, Inc., v. United States*, 76-2 U.S. Tax Cas. (CCH) ¶ 9560 (N.D. Ill. 1976), *aff'd in part, vacated in part, and remanded in part*, in unpublished order, (7th Cir. May 16, 1977). The Tax Court refused to take this approach, at least where the parent and subsidiary were not in the same business. *Bennett Paper Corp. v. Commissioner*, 78 T.C. 458, 464-65 (1982), *aff'd per curiam*, 699 F.2d 450 (8th Cir. 1983); accord *Priv. Ltr. Rul.* 8,423,005 (Feb. 8, 1984).

²²⁵ 475 F.2d 775 (2d Cir. 1973); Case Note, *supra* note 90.

²²⁶ *Briarcliff Candy*, and its progeny, have been described as involving new ways of, not new geographic branches for, operating an existing business. See *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1185 (5th Cir. 1984). In fact, however, *Briarcliff Candy* promoted sales through new retail, franchise outlets in drug stores in areas of geographic expansion (the suburbs).

In *Briarcliff Candy*, recurring (and generally increasing) expenditures were involved, which was also true in the first bank credit card decision. See *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974). In *First Sec. Bank v. Commissioner*, 592 F.2d 1050 (9th Cir. 1979) (permitting a current deduction under the separate, saleable asset test for the cost of a computer program having a five-year useful period), however, the Ninth Circuit majority was unable to distinguish the computer costs in *Colorado Springs National Bank*. See *id.* at 1053 (Duniway, J., dissenting). This inability stemmed from misfocusing on the separate, saleable asset test. In *Colorado Springs National Bank*, the deductible computer costs consisted almost entirely of data entry charges, clearly recurring costs probably with short-term benefits, and hence were currently deductible without distortion of income. See 505 F.2d at 1187-88. In contrast, in *First Security Bank* the computer costs largely consisted of the cost of a computer program, used for five years, which under a distortion of income analysis should have been capitalized and amortized, probably over that period. 592 F.2d at 1053 n.1 (Duniway, J., dissenting in part).

Indeed, the best-reasoned bank credit card opinion did not even consider the lack of transferability, the focal point of *Colorado Springs National Bank* and *Briarcliff Candy*. See *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433 (8th Cir. 1979). The court in *Iowa-Des Moines National Bank* rested on the facts that: (1) the acquired credit information was short-lived and subject to sudden change; (2) the information obtained could only have been used to issue credit cards and did not create goodwill; and (3) equivalent credit

were recurring (and in *Briarcliff Candy* increased annually in amount over a long period),²²⁷ and thus were similar to many pre-opening expenses. Moreover, "[t]he distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can be feasibly capitalized and those that cannot be."²²⁸ These cases universally viewed the expansion costs as new ways of carrying on an existing business, rather than starting a new business in a new location.²²⁹

The most important common factor, however, was the view that a current deduction of a recurring expense with some future benefits was preferable to its capitalization without amortization—"rough justice."²³⁰ The Second Circuit in *Briarcliff Candy* merely charged the government "to furnish clear standards and guidelines as to what intangible assets are deductible under § 162 and what are not."²³¹ The leading bank credit card decision, *Colorado Springs National Bank v. United States*, however, sharpened the thrust:

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 ap-*

screening, clearly an ordinary and necessary part of banking, could have been internally performed and currently deducted. *Id.* at 436. Therefore, in an interesting twist on *Idaho Power's* tax parity mandate, the court in *Iowa-Des Moines National Bank* held that purchased credit screening was currently deductible. *Id.* The model works the same way; thus, in practical effect a distortion of income analysis (although not expressly so articulated) would not change the result in *most* of the bank credit card cases, but would produce capitalization and amortization in *First Security Bank*.

²²⁷ Over an eight-year period (1963-70) the franchise division's expenses annually ranged from \$580,702 to \$808,965. 475 F.2d at 780.

²²⁸ *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982); see *supra* notes 73-78 and accompanying text.

²²⁹ *Colorado Springs Nat'l Bank*, 505 F.2d at 1190. The court held that "[t]he credit card system enables a bank to carry on an old business in a new way. A new method is distinguishable from a new business." *Id.*; accord *First Nat'l Bank v. United States*, 558 F.2d 721 (4th Cir. 1977) (*per curiam*); *First Sec. Bank v. Commissioner*, 63 T.C. 644, 649 (1975), *aff'd*, 592 F.2d 1050 (9th Cir. 1979); see *Briarcliff Candy*, 475 F.2d at 781, 787.

²³⁰ See Warner, *supra* note 87, at 8; Note, *supra* note 4, at 332-33.

²³¹ 475 F.2d at 783. The recurring costs in question consisted of compensation paid to added salespersons, extensive advertising, and costs of soliciting drug stores and others to act as sales agents. See *id.*

proach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.²³²

Briarcliff Candy and its progeny read the Supreme Court in *Commissioner v. Lincoln Savings & Loan Association* as having shifted the emphasis radically: ensuing future benefit was thought no longer controlling. Rather, the court in *Briarcliff Candy* held that the inquiry should be whether the expenditure created or enhanced essentially a separate and distinct asset.²³³ "Asset" was de-

²³² 505 F.2d at 1192 (emphasis added).

²³³ 475 F. 2d at 786. In *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345 (1971), the taxpayer currently deducted compulsory payments to the Federal Savings and Loan Insurance Corporation's ("FSLIC") Secondary Reserve, in which Lincoln Savings & Loan had a transferable pro rata share that could also be refunded or applied to FSLIC's concededly deductible primary reserve. The Commissioner argued that because the Secondary Reserve provided future benefits it should be capitalized. *Id.* at 354. In response, the Court stated 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.

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

Id. This passage illustrates well one of the dangers of dictum. Although the passage showed that the Court in *Lincoln Savings & Loan* focused on the presence of a separate asset, several decisions and commentators have read it as merely indicating that the presence of a separate asset is a "condition sufficient" for capitalization. See, e.g., *Florida Publishing Co. v. Commissioner*, 64 T.C. 269, 272, (1975), *aff'd* in unpublished opinion, (5th Cir. April 26, 1977); see also *NCNB Corp v. United States*, 651 F.2d 942, 957-58 (4th Cir. 1981), vacated *en banc*, 684 F.2d 285 (4th Cir. 1982); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 225 (1985); 1 B. Bittker, *supra* note 5, ¶ 20.4.4, at 20-80 n.54; *Gunn*, *supra* note 5, at 444; *Lee & Murphy*, *supra* note 5, at 476; *Warner*, *supra* note 87, at 5, 8 (stating that a separate property interest rule was hard to justify); *Note*, *supra* note 5, at 622; *Note*, *supra* note 4, at 332 (stating that the separate asset standard was not sound tax policy, and therefore should be interpreted merely as a condition sufficient for capitalization). Implicit support for this reading can be found in the Court's subsequent capital expenditure cases, which adopted other capitalization tests. See, e.g., *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1973); *United States v. Mississippi Chem. Corp.*, 405 U.S. 298 (1972); see also *Note*, *supra* note 4, at 320 & n.56.

Other cases and many student commentators have read *Lincoln Savings & Loan* as requiring creation or enhancement of a separate transferable asset as a condition precedent for capitalization. See cases and sources cited *infra* note 234. The author would reconcile *Lincoln Savings & Loan* with the clear reflection of income doctrine by treating the deferred charge, required where current deduction of the cost would produce a distortion of

financed in its business sense as "items of ownership of a permanent or fixed nature which are convertible into cash."²³⁴ *Briarcliff Candy*'s unarticulated premise may have been that such "assets" (apart from increase in value of the business) usually would be depreciable or amortizable; hence, no distortion of income would result from capitalization.²³⁵ While *Briarcliff Candy*, with its pronouncements on the one-year rule, called into question the production of future benefits rationale for capitalizing pre-opening expenses,²³⁶ its progeny tended to explain the preparatory doctrine in relation to the "carrying on a trade or business" leg of *Rich-*

income, as a separate, free-standing, and usually amortizable asset, thus satisfying the *Lincoln Savings & Loan* test. See *supra* notes 42-45 and accompanying text; cf. *Central Texas Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1185 (5th Cir. 1984).

²³⁴ *Briarcliff Candy*, 475 F.2d at 786. *Briarcliff Candy* and its bank credit card progeny read *Lincoln Savings & Loan* as requiring a separate, saleable asset and the standard set forth in *NCNB II*, 684 F.2d at 289, as preconditions for capitalization. See *supra* note 227. Specifically, *Briarcliff Candy* and its progeny held that the "ensuing benefit" language in *Lincoln Savings & Loan* overruled the one-year standard for distinguishing between capital and current costs. Most student commentators have erroneously favored the separate, saleable property rule. E.g., Note, *supra* note 87, at 463, 465; Note, *supra* note 115, at 1138, 1142; Note, *Deductibility of Bank Branching Expenditures: Central Texas Savings & Loan Association v. United States*, A Weak Rebuttal to *NCNB Corp. v. United States*, 19 U. Richmond L. Rev. 147 (1984). But see Note, *supra* note 4, at 330, 332. Unfortunately, congressional staff also seem to have read *Lincoln Savings & Loan* as establishing such a separate and distinct asset precondition to capitalization. See S. Rep. No. 313, 99th Cong., 2d Sess. 141 (1986); Staff of Joint Comm. on Tax'n, 99th Cong., 1st Sess., *Tax Reform Accounting Issues* 50 (Sept. 13, 1985).

²³⁵ As one commentator noted

the property interest test drawn from *Lincoln Savings & Loan* is difficult to justify in theory. However, it may serve as a means of imposing rough justice by requiring capitalization only with respect to those assets and benefits—tangible assets and intangible property interests—most likely to have ascertainable useful lives that will support amortization deductions.

Warner, *supra* note 87, at 3. *Colorado Springs National Bank* appears to have been greatly influenced by such considerations. See *supra* note 228 and accompanying text. On the other hand, the Second Circuit historically has displayed a predilection for importing property law concepts into this and related areas of taxation. See *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *Van Iderstine Co. v. Commissioner*, 261 F.2d 211, 213 (2d Cir. 1958) (a capital expenditure must result in the acquisition of "capital," i.e., an addition to the taxpayer's taxable wealth).

²³⁶ If the future benefits/capitalization basis for the preparatory doctrine is removed, and the definitional preparatory basis is undercut by *Blitzer*, then recurring pre-opening costs should be currently deductible. See Erbacher, *supra* note 2, at 495; Lee, *supra* note 2, at 30 n.53; Note, *supra* note 5, at 624 n.34; see also *supra* notes 193-214 and accompanying text. The business expansion decisions, however, were not so forthright. See *infra* notes 292-300 and accompanying text.

mond Television.²³⁷

The "separate, saleable asset" precondition for capitalization is overinclusive, permitting a current deduction for (1) substantial expenditures benefiting an extended period of time although creating no transferable asset, e.g., a computer program expected to last five years,²³⁸ and (2) acquisition costs of a license with an indefinite life.²³⁹ A current deduction in such instances produces more distortion of income than capitalization as a free-standing asset *amortizable* over the benefited period. In addition to its functional weaknesses, the separate, saleable asset test is conceptually weak, based upon a limited, and oft-criticized,²⁴⁰ reading of *Lincoln Savings & Loan*. As the Claims Court pointed out in *Cleveland Electric Illuminating Co. v. United States*,²⁴¹ the "separate and distinct asset" referent in *Lincoln Savings & Loan* only meant that in the particular case before the Court the taxpayer's acquisition of such an asset was decisive. "It does not state . . . that if the separate and distinct asset test is not met the payment is a necessary and ordinary expense."²⁴² A host of examples may be found where capital treatment is required although no such separate and distinct asset is created or enhanced.²⁴³

In summary, the first application of the separate, saleable asset doctrine worked well (steady-state recurring expenditures).²⁴⁴

²³⁷ See, e.g., *Colorado Springs Nat'l Bank*, 505 F.2d at 1190; see also *First Nat'l Bank v. United States*, 41 F. Supp. 1107, 1111 (D.S.C. 1976), *aff'd per curiam*, 558 F.2d 721 (4th Cir. 1977); *First Sec. Bank v. Commissioner*, 63 T.C. 644, 649 (1975), *aff'd*, 592 F.2d 1050 (9th Cir. 1979). See generally Note, *supra* note 115, at 1134 & n.57. *Central Texas Savings & Loan* (which applied the origin-of-the-claim doctrine to expansion costs) agreed that "if a taxpayer were to start a new business, the pre-operational or start-up expenses would not be deductible under section 162(a)." 731 F.2d at 1183.

All three definitional doctrines (preparatory doctrine, separate, saleable asset, and acquisition cost), however, fail the acid clear reflection of income test. Distinguishing (and hence, approving in dictum) the preparatory doctrine was undoubtedly motivated by "the desire to permit the taxpayer to deduct its expenses without directly challenging the well-entrenched rule prohibiting the deduction of pre-operating costs." Note, *supra* note 5, at 627; see *infra* notes 310-18 and accompanying text.

²³⁸ *First Sec. Bank*, 592 F.2d at 1053 (Duniway, J., dissenting).

²³⁹ *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982) (*en banc*). *Contra Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181 (5th Cir. 1984).

²⁴⁰ *Gunn*, *supra* note 5, at 452; Note, *supra* note 4, at 330.

²⁴¹ 7 Cl. Ct. 220 (1985).

²⁴² *Id.* at 225.

²⁴³ *Id.*; *Gunn*, *supra* note 5, at 446, 447 n.20; Lee & Murphy, *supra* note 5, at 544-46.

²⁴⁴ See *supra* note 227 and accompanying text.

When mechanically extended, however, as is the nature of a bright-line test, the doctrine itself produced distortion of income and, in time, countervailing authorities.

C. Failed Synthesis: Amortization of Free-Standing Deferred Charge

The majority panel decision in *NCNB I* (vacated on en banc review), paralleling an approach called for by some commentators²⁴⁵ and the inspiration for the model, attempted to chart a middle ground or "golden mean"²⁴⁶ between the *Richmond Television* "one-year rule"²⁴⁷ and the *Briarcliff Candy* "separate, saleable interest" rule. The panel favored untying the "Gordian knot" of these two talismanic rules by: (1) capitalizing business expansion costs (and start-up costs as well) to the extent that their current deduction would distort the taxpayer's income because future years would be benefited (while recognizing exceptions for certain nondistorting, currently deductible costs that would benefit future years);²⁴⁸ but then, (2) treating the expansion costs as separate,

²⁴⁵ Erbacher, *supra* note 2, at 500; Seago, *supra* note 2, at 421; Note, *supra* note 5, at 619, 633; Case Note, *supra* note 90, at 916-17. These commentators, however, meant different things by "clear reflection of income," usually adopting either the incorporation of financial accounting rules or judicial policy. See *supra* notes 81-95 and accompanying text; *infra* notes 254-67 and accompanying text.

²⁴⁶ *NCNB II*, 684 F.2d at 294-95 (Murnaghan, J., dissenting). In his vacated majority opinion in *NCNB I*, Judge Murnaghan saw his device of amortization as avoiding "the Catch-22 from which the Tenth Circuit believed that it had to rescue Colorado Springs National Bank." 651 F.2d at 959. For a discussion of the technical difficulties of the *NCNB I* panel majority's view of amortization, see *infra* notes 254-67 and accompanying text.

²⁴⁷ The court in *Richmond Television* alternatively denied a current deduction for the contested start-up costs (principally pre-opening broadcasting staff training) on the ground that the costs benefited future tax years and, hence, were capital. See *supra* notes 156-57 and accompanying text. The court stated: "Our system of income taxation attempts to match income and expenses so as to tax only net income. A taxpayer may, therefore, not deduct as a current business expense the full cost of acquiring an asset, tangible or intangible, which benefits the taxpayer for more than one year." 345 F.2d at 907. Where an expenditure benefits future years, automatic capitalization can lead to distortion of income. See *supra* notes 36-38 and accompanying text.

²⁴⁸ The *NCNB I* majority read the reference to currently deductible future benefit expenditures in *Lincoln Savings & Loan* as speaking to "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 probable future benefit." *NCNB I*, 651 F.2d at 961. The panel pointed to the allowance of current deductions (1) for repair and educational expenditures benefiting a taxpayer during subsequent tax years and (2) for expenditures that, as a practical matter, could not be associated with

free-standing assets and allowing amortization in both the current and future tax years in proportion to the extent the costs were used in such years.²⁴⁹

1. *NCNB I Panel: Amortization of Deferred Charge*

The panel's treatment of the cost itself as a free-standing, amortizable, separate asset, rather than looking for a saleable asset produced or purchased by the expenditure, constituted one of the opinion's two most significant holdings:

In order more accurately to reflect income, both in the present period and in the future accounting periods, the carried-forward "assets" of an enterprise include, without regard to whether they are tangible or intangible, certain expenditures for benefits whose cost has already been incurred but the outlay for which is nevertheless most properly matched against some future period's revenues which the benefits will help produce. This matching is without regard to whether the benefits are tangible or intangible and also without regard to their realizability, through sale or otherwise. The critical factor is the accounting period in which the associated revenues are to be recognized, not the nature of the benefits which help produce those revenues. Whether the deferred charge has some separate identifiable worth is irrelevant to the accounting process as it is applied.²⁵⁰

either current or future tax years. *Id.* at 961-62. The panel also categorized other minor current deductible expenditures, which conceptually were capital, as "'more-trouble-than-it's-worth exceptions,'" e.g., expenditures with a useful life of no more than a year that in fact overlapped two tax years. *Id.* at 953 & n.21; see Note, *supra* note 4, at 332-33. For discussion of the proper future benefit exceptions to capitalization under the model, see *supra* notes 53-78 and accompanying text.

²⁴⁹ *NCNB I*, 651 F.2d at 962-63. For discussion of the flaw in this view of amortization, see *infra* notes 253-61 and accompanying text.

²⁵⁰ 651 F.2d at 949. For a hypothetical (strikingly prophetic of the *Wolfsen Land & Cattle* approach) involving recurring landscaping costs, see Gunn, *supra* note 5, at 446 & n.19. Professor Gunn advocated that the "cost" be treated as the amortizable asset itself, rather than what was purchased with the cost. *Id.*

The taxpayer in *Central Texas Savings & Loan* argued in the alternative that the market survey and permit application "expenditures should have been amortized over the life of the 'work product,' presumably the period of time prior to approval of the permit during which the studies and applications were used." *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1181 (5th Cir. 1984). The Fifth Circuit artlessly held that § 195 was not yet applicable to the year in question, so that the court did not have to decide whether the contested (survey and permit) costs could meet the § 195 proviso that amortizable start-up costs "would be deductible if they were paid in connection with expansion of an existing

This approach, which the panel would have applied to both business expansion and start-up costs,²⁵¹ was fundamentally sound and is close to the model suggested.²⁵²

However, through overreliance on Generally Accepted Accounting Principles ("GAAP"),²⁵³ the panel opinion in *NCNB I* was unclear on tax technicalities, and its distortion of income analysis perhaps failed to account adequately for recurring investigatory costs. The *NCNB I* panel majority thus fell into two major technical errors in its approach to amortization of the capitalized market survey and branch permit application costs at issue in the case. The first error was that amortization was determined year-by-year on the basis of actual *use* of the intangible created by the contested expenditures in current operations in that year rather than by estimating useful life. The second error was that amortization of the capitalized acquisition costs of nonwasting assets, such as branch permits, was permitted.

These technical errors resulted from the panel's opinion that the determination of annual *net* income for a given tax year was an accounting question, calling for the matching, in the appropriate period, of the gross revenues for the year and the cost of producing

business." *Id.* at 1186. The Fifth Circuit, as a further non sequitur, concluded that "[i]n the future, however, Section 195(a) should encourage formation of new businesses without the attendant controversy and litigation to determine the proper tax classification of the start-up expenditures." *Id.* at 1186. The judicial pattern of deliberating the backstopping of § 195 while espousing a capitalization theory that logically would emasculate the provision has become commonplace. See *Johnsen v. Commissioner*, 794 F.2d 1157 (6th Cir. 1986); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985). See generally *infra* notes 309-17 and accompanying text.

²⁵¹ 651 F.2d at 956-57; accord *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1187 (10th Cir. 1974).

²⁵² The model also would set up many, if not most, expenditures benefiting future years as a deferred charge, but would amortize the "asset" over a useful life determined by approximation. See *supra* notes 42-43 and accompanying text. Moreover, if the period benefited were short, say up to three years, the model would allow a current deduction. See *supra* note 45 and accompanying text. Thus, under the model the market survey costs might be currently deductible, while the permit costs would be amortizable.

²⁵³ 651 F.2d 954, 961-63. Some commentators have advocated identification of financial accounting with clear reflection of income in the start-up cost area. See, e.g., Lee, *supra* note 5; Case Note, *supra* note 90. A thesis of this article, however, is that only broad financial accounting concepts, e.g., amortization of start-up costs as a deferred charge, and not financial accounting principles themselves, should govern. See *supra* notes 81-95 and accompanying text. See generally, Comment, *Tax Treatment of the Costs of Internally Developed Intangible Assets*, 57 S. Cal. L. Rev. 767, 787 (1984).

those revenues.²⁵⁴ Therefore, the Fourth Circuit panel looked to the GAAP “hierarchy” of expense recognition principles for the proper “matching”²⁵⁵ rules: (1) association of expense with revenue “on the basis of cause and effect”; (2) if not possible, systematic and rational allocation; and, (3) if neither possible, recognition of costs as expenses in the period incurred or in which a loss is sustained.²⁵⁶ Based on these rules the panel majority believed that

when there are discernible future benefits from an expenditure, there very often will be a cause and effect relation between the expenditure and revenues to be received during future periods. . . . Even when there is no direct means of associating the expenditure and later revenues as cause and effect, there will almost always be a way systematically and rationally to allocate the cost among the periods in which benefits are provided.²⁵⁷

Consequently, relying upon a melange of clear reflection of income, GAAP, and *Cohan* approximation,²⁵⁸ the panel remanded the case to the district court to determine the extent to which (“even if no better than a rough guess”)²⁵⁹ the internal and external business expansion costs (market surveys and permit costs) were used in the production of current revenue during the years before the trial court. The panel also held that the remaining amount of the costs were similarly to be allocated in subsequent tax years between use in production of future income and use, if any, in the production of current revenue.²⁶⁰ The panel viewed such allocation (or amortization) according to use in the tax year as constituting a “systematic and rational allocation” of the cost, e.g., of the market survey, among the accounting periods during which it was economically valuable to the taxpayer. Such allocation was appropriate even if it was not possible to associate, according to cause and effect, the use of such a survey and some sub-

²⁵⁴ 651 F.2d at 948, 952, 961-962.

²⁵⁵ Id. at 952.

²⁵⁶ Id. For the text of these principles, see *supra* note 84.

²⁵⁷ 651 F.2d at 961.

²⁵⁸ *Cohan v. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930). For a discussion of *Cohan* approximations and their proper use in depreciation/amortization questions, see *supra* notes 166-74 and accompanying text.

²⁵⁹ 651 F.2d at 962.

²⁶⁰ Id. at 963.

sequent revenues.²⁶¹

Seeking "rough justice," the *NCNB I* panel carried the financial accounting principle of matching expenditures with associated revenues too far. It failed to appreciate that tax accounting, unlike financial accounting, does not match costs and revenues on a cause-and-effect basis year-by-year. Rather, under tax accounting principles the period to be benefited, i.e., the useful life, generally is estimated in the year the expenditure is made and its cost is then deducted over that period, ratably in the case of intangibles.²⁶² Thus, under tax amortization "rough justice" is obtained by estimating useful life through a "rough guess."²⁶³

The *NCNB I* panel, taking matching of costs and revenue for financial accounting to its logical extreme, called for amortization of the direct and indirect *permit* application costs in the same manner as the survey costs.²⁶⁴ The branch banking permit, however, had an indefinite life²⁶⁵ and hence, under traditional doctrine, could not be amortized.²⁶⁶ In addition, traditionally, useful life could not be estimated under *Cohan*, since the permit was not wasting, i.e., had an indefinite life.²⁶⁷ Betrayed by its desire to clearly reflect income and the purported ease of systematically and rationally allocating costs among the tax years of use, the *NCNB I* panel failed to address both the acquisition cost doctrine (treatment of the application costs as a separate asset would be of no avail)²⁶⁸ and the inability to estimate with reasonable accuracy the

²⁶¹ Id. at 962. These, of course, are the standards of GAAP allocation. See *supra* note 84. In effect the panel applied a "transactional approach," matching expenses and revenue (through use rather than income generated) on year-by-year basis. Such a transactional or "open" approach is contrary in this context to the annual accounting principle under which the transaction is closed in year one, i.e., determine the useful life and then prorate the cost over that period. See Warner, *supra* note 87, at 6. Interestingly, the Fourth Circuit took an open-transaction approach (for lease-option transactions) once before and then reversed itself en banc, adopting a closed transaction approach. See *Kitchin v. Commissioner*, 340 F.2d 895 (4th Cir.), vacated en banc, 353 F.2d 13 (4th Cir. 1965).

²⁶² Several narrow exceptions to ratable amortization of intangibles are permitted. See 1 B. Bittker, *supra* note 5, ¶ 23.5.6, at 23-70 to -72; see also *supra* notes 34-35 and accompanying text.

²⁶³ See *supra* notes 170-71 and accompanying text.

²⁶⁴ 651 F.2d at 963.

²⁶⁵ See 12 U.S.C. § 36 (1982).

²⁶⁶ See Treas. Reg. § 1.167(a)-3.

²⁶⁷ See *supra* note 167 and accompanying text.

²⁶⁸ The capitalized cost would still have an indefinite life.

useful life of the branch banking permits. As one commentator noted:

Where a cost, such as that of a license, does not provide benefits that decrease with time, *Lincoln Savings & Loan* clearly bars a deduction, even though the result may be more or less (depending on the actual duration of the business) unfortunate as a matter of taxation of only net income.²⁶⁹

2. NCNB I Panel: Capitalization and Distortion of Income

The second significant holding of the *NCNB I* majority was its deep structure analysis of the basis for capitalization. The presence of "future benefits" did not automatically require capitalization; rather, wherever current deduction of expenditures providing future benefits would substantially distort the taxpayer's income, capitalization *and* amortization were in order. Thus the panel's approach (whether the current deduction of expenditures benefiting current and future years would distort the taxpayer's income) was sound,²⁷⁰ a long-needed application of basics. The non-income-distorting exceptions, however, were drawn too narrowly due to overreliance on the financial accounting rules implementing the matching of revenues and costs in the appropriate period.²⁷¹ Many of the non-income-distorting exceptions noted by the *NCNB I* panel majority fell within the de minimis exception described by commentators, e.g., minor expenditures for books of a professional or tools of a craftsman.²⁷² However, the *NCNB I* panel majority's understanding²⁷³ of the current tax treatment of certain advanced or practical education costs, currently deductible by a taxpayer employed in the same field but automatically capitalizable (without amortization) by a taxpayer not yet so employed, was contrary to a clear reflection of income analysis and rested largely on a talismanic existing/new business dichotomy, strikingly similar to the definitional preparatory and separate, saleable asset tests.²⁷⁴

²⁶⁹ Gunn, *supra* note 5, at 494 n.230.

²⁷⁰ See *supra* note 24 and accompanying text.

²⁷¹ See 651 F.2d at 948 & n.11. For discussion of the proper relationship of GAAP and tax accounting, see *supra* notes 81-95 and accompanying text.

²⁷² See *supra* note 62 and accompanying text; see also *supra* note 248.

²⁷³ See 651 F.2d at 961.

²⁷⁴ See Lee, *Command Performance: The Tax Treatment of Employer Mandated Expenses*, 7 U. Rich. L. Rev. 1, 33-36 (1972). Employee job-seeking costs also can be fit into an

More significantly, the *NCNB I* panel overlooked perhaps the major conceptual exception to the clear reflection of income principle permitting the current deduction of an expenditure benefiting future, as well as current, tax years: regularly recurring expenditures. If a taxpayer annually makes similar expenditures in relatively uniform amounts benefiting both present and future years, the taxpayer's income in any given year is not distorted by deducting the entire amount of the expenditure made in that year, so long as expenditures made in other years benefiting that year are not also amortized in that year.²⁷⁵ Similarly, distortion usually will not arise when currently deducting, in their entirety, regularly increasing or steady-state expenditures.²⁷⁶ Such a rationale supports the current deduction of advertising expenditures and goes a long way towards justifying the results, albeit not the rationale, of many of the business expansion cases in this area.

As a practical matter, the choice between amortization and current deduction of recurring expenditures, without distortion of income, should turn more on whether the benefits created are so short-term and whether useful life is so difficult to estimate that amortization is more trouble than it is worth and unlikely to produce a clearer reflection of income than expensing.²⁷⁷ This may be the case with the market surveys in *NCNB*, which the *NCNB I* panel sought to capitalize and then amortize.

In summary, the *NCNB I* panel majority correctly looked to one of the deep structure principles of capitalization versus current expense, i.e., the clear reflection of income, in determining the proper treatment of the business expansion costs. It correctly viewed the use of the financial accounting concept of a deferred charge as the resolution of the prior all-or-nothing rules. However, it erroneously treated the internal and external permit costs as a separate, amortizable asset apart from the branch banking privilege acquired with

old-business/new-business mold. See Halperin, Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem, 122 U. Pa. L. Rev. 859, 905-08 (1974). To the extent § 195 works at all, it should apply to *new* job-advancement educational and job-seeking expenses of employees, since such status constitutes a trade or business. See Lee, *supra* note 2, at 396; see *infra* note 468 and accompanying text.

²⁷⁵ See *supra* notes 67-75 and accompanying text.

²⁷⁶ See *id.*

²⁷⁷ See *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979); *Southland Royalty Co. v. United States*, 582 F.2d 604, 618 (Ct. Cl. 1978).

such permits. Such permit costs should be amortizable only if the branch itself has a determinable life or if the absence of a wasting asset is expressly acknowledged as not being a barrier to a *Cohan* "rough guess" approach to achieving a clearer reflection of income. Moreover, the *NCNB I* panel's method of amortizing the survey costs presents difficulties: allocation year-by-year according to current revenue and future revenue use, determining or estimating useful life, and difficulties of *Cohan* approximation.

The model approach of current deduction of a recurring expenditure appears preferable to capitalization and amortization because the model would not distort income where the expenditure produces future benefits but has a short and very uncertain useful life. However, the model, also based on avoiding distortion of income, is a far cry from the "separate, saleable asset" test of the *NCNB II* en banc majority and would not, like it, allow current deduction of the permit costs.

3. *NCNB II En Banc: Adoption of Separate, Saleable Asset Doctrine*

On rehearing en banc, the majority in *NCNB II* vacated the panel decision below and extended the *Briarcliff Candy* "separate, saleable asset" reading of *Lincoln Savings & Loan* to investigatory (market survey) costs and permit costs incurred in establishing branch operations in new locations. The court stated that:

The money spent or obligated for metro studies, feasibility studies, and applications to the Comptroller of the Currency, it seems to us, adds nothing to the value of a bank's assets which can be so definitely ascertained that it must be capitalized. Certainly no "separate and distinct additional asset" is created. While the benefit of all these classes of expenses may or may not endure for more than one year, that is but one factor to be considered. The branch has no existence separate and apart from the parent bank; as a branch bank, it is not readily saleable and has no market value other than the real estate which it occupies and the tangible equipment therein.²⁷⁸

The *NCNB II* en banc majority, however, failed to address the clear reflection of income and amortization aspects of the panel

²⁷⁸ 684 F.2d at 293.

opinion. Instead, it set up a "strawman," erroneously treating the panel opinion as merely a "future benefits" decision resting on the one-year rule articulated in *Richmond Television*, which the majority then knocked down by reading *Lincoln Savings & Loan* as overturning the parts of *Richmond Television* "establishing a one-year standard for distinguishing between capital and current costs."²⁷⁹ Just as in *Briarcliff Candy* and its progeny, upon which it relied heavily, the *NCNB II* majority emphasized the recurring nature of the contested expenses, both as to the frequency of the taxpayer's evaluations of its market position and as to the regularity of actions based upon such evaluations, i.e., opening and closing branches.²⁸⁰ However, the opinion failed to discuss the frequency of restudy of the same market or the rapidity of change in the environment; rather, the majority focused on the constant use of such studies in the bank's decision-making process. Significantly, over eighty percent of the contested expenditures were for internal costs (salaries, supplies, and depreciation) regularly incurred in preparing market studies (together with outside consultants) and preparation of applications to open branch offices,²⁸¹ but neither

²⁷⁹ Id. at 289 & n.4.

²⁸⁰ Id. at 294; see *NCNB I*, 651 F.2d at 963, 970 (Widener, J., dissenting) (author of en banc opinion).

²⁸¹ 684 F.2d at 286 n.1. The en banc majority's focus unfortunately appears solely to have been on the recurring use of the market surveys, for which it made a good case for current deduction along the lines of *Iowa-Des Moines Nat'l Bank*, 592 F.2d at 436, and *Southland Royalty*, 582 F.2d at 618 (discussed supra at notes 67-72 and accompanying text). In his *NCNB I* dissent, Judge Widener consistently ignored the direct and indirect permit costs:

We deal only with intangibles which in proper perspective are used as a part of the decision making process of the bank. The taxpayer is in the regular day to day business of branch banking. This is nothing new. It must compete or die. To this end, it employs consultants to prepare Metro Studies, and itself prepares feasibility and other more precise studies of prospective locations to open or close branch banks. The money spent on the Metro Studies and the money spent on the salaries, etc., involved in the decision making process of the bank, as well as carrying out that process until the physical facility is obtained, is nothing more nor less than the expenses any merchant or manufacturer must bear if it is to stay in day to day competition with its competitors. The principal future benefit that such intangibles can be said to produce is that the bank has become wiser after spending the money, and this by its acquisition of additional knowledge. The additional knowledge is then used in its decision making process. Whatever benefit the bank has gained from these studies is not salable, and this is acknowledged by the government, and it has no intrinsic ascertainable value.

651 F.2d at 970 (Widener, J., dissenting).

The *NCNB I* panel majority also focused primarily on amortization of the survey costs,

the *NCNB I* nor the *NCNB II* opinion broke down costs between direct and indirect market survey costs and direct and indirect permit application costs.

The *NCNB II* opinion focused on the recurring *use* of the intangibles created by the expenditures in the decision-making process of the bank holding company, namely, "all of these expenses were connected with NCNB's developing and operating a statewide network of branch banking facilities."²⁸² The majority's separate, saleable asset test may have reached the correct result (current deduction) as to the recurring market *survey* costs, but talismanic application produced the wrong result as to the direct and indirect *permit* costs because their value would continue undiminished as long as the branch continued.²⁸³ The mere fact that the permit costs were recurring did not render them currently deductible. The costs were not recurring in the sense of creating short-term benefits or replacement of similar prior assets; rather, they were recurring because the taxpayer acquired additional permits. However, recurring acquisitions of long-lived or nonwasting assets are not currently deductible. Otherwise, a taxpayer who constantly expands by building or buying new plants could currently deduct the cost of each plant.²⁸⁴ The answer to nonamortizable permit costs lies in remedial legislation or equitable approximation of useful life.²⁸⁵

Part of the result reached by the Fourth Circuit en banc in *NCNB II* (deduction of the market survey fees) may be justifiable if the survey costs were sufficiently recurring so that a current de-

apparently intending that the same principles would apply to the permit costs. 651 F.2d at 963. Conversely, the Fifth Circuit focused solely on the permit costs to the exclusion of market survey costs. *Central Tex. Sav. & Loan v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984). These decisions appear to have been straining for universal rules rather than resolutions of the particular facts—a failing shared by commentators, as well. See, e.g., sources cited *supra* note 234.

²⁸² 684 F.2d at 290. See generally, Note, *supra* note 4, at 327 n.138.

²⁸³ As Professor Gunn has pointed out:

Briarcliff does not support the deductibility of the cost of licenses. Where a cost, such as that of a license, does not provide benefits that decrease with time, *Lincoln Savings & Loan* clearly bars a deduction, even though that result may be more or less (depending on the actual duration of the business) unfortunate as a matter of taxation of only net income.

Gunn, *supra* note 5, at 494 n.230.

²⁸⁴ See Warner, *supra* note 87, at 5.

²⁸⁵ See *supra* notes 131-38 and accompanying text.

duction would not distort the taxpayer's income. Justification may also be based on the ground that amortization was not feasible due to inability to separate present and future benefits. Nevertheless, allowing current deduction of permit fees with an indefinite life would distort the taxpayer's income.

4. Acquisition Cost Doctrine Response to NCNB II *En Banc*

In direct response to the Fourth Circuit's talismanic application of the separate, saleable asset test to business expansion costs, two other circuits subsequently applied the acquisition cost doctrine to bank expansion costs. First, in *Ellis Banking Corp. v. United States*²⁸⁶ the Eleventh Circuit easily applied the doctrine to classic acquisition costs (costs of determining through independent audit the purchase price of target's stock acquired in geographic expansion through acquisition).²⁸⁷ Second, in *Central Texas Savings & Loan Association v. United States*²⁸⁸ the Fifth Circuit broadly applied the acquisition cost doctrine to expenses seemingly indistinguishable from those incurred in *NCNB*.²⁸⁹ The Fifth Circuit viewed the state permits required for each bank branch as satisfying the separate and distinct asset test of *Lincoln Savings & Loan*.²⁹⁰

Tested against a distortion of income analysis, the result in *Central Texas Savings & Loan* was partly right and partly wrong. The

²⁸⁶ 688 F.2d 1376 (11th Cir. 1982), cert. denied, 463 U.S. 1207 (1983).

²⁸⁷ *Id.* at 1380-81. The major function of examining the target's books was to determine the appropriateness of the exchange ratio, or acquisition price—the quintessential acquisition cost under the origin-of-the-claim doctrine. The Eleventh Circuit apparently would permit capitalization and amortization as a separate asset of the costs of market surveys used in connection with a capital acquisition if the survey continued to be used in ongoing operations. 688 F.2d at 1381-82 n.11 (citing the vacated *NCNB I* decision). The author also would treat as a separate amortizable asset survey costs used solely in an acquisition if the value of the survey is temporally limited and less than the life of the asset acquired, such as a branch license. See *supra* notes 131-38 and accompanying text. Interestingly, the Eleventh Circuit expressly acknowledged the conflict between its decision and the *NCNB II* majority. 688 F.2d at 1380 n.7.

²⁸⁸ 731 F.2d 1181 (5th Cir. 1984).

²⁸⁹ *Id.* at 1185. While not expressly acknowledging the conflict, the *Central Texas Savings & Loan* court distinguished *Briarcliff Candy* and its credit card progeny (upon which the *NCNB II* majority relied heavily). 731 F.2d at 1184-85. Moreover, the Fifth Circuit disagreed with the proposition that the compulsory accounting rule of bank regulators (also relied upon in *NCNB II*) determined the tax consequences of the expenditures. *Id.* at 1185.

²⁹⁰ *Id.* at 1185.

permit application costs were properly capitalized and added to the cost of the nonamortizable permit or branch, but the survey costs should then have been treated as a separate asset and currently deducted or amortized. Instead, the Fifth Circuit: (1) talismanically applied the acquisition cost doctrine derived from *Richmond Television* and its progeny to the (presumably recurring) limited-life market survey costs; (2) mechanically associated them with an indeterminable-life asset (the permits); and thereby, (3) precluded amortization.²⁹¹ Thus, under this view recurring, short-term benefit expenditures incurred in expansion to a new location could neither be currently deducted nor amortized, thereby distorting the taxpayer's income—the same distortion that provoked the separate, saleable asset test.

In *Cleveland Electric Illuminating Co. v. United States*²⁹² the Claims Court completed the circle, reaffirming the start-up cost doctrine of *Richmond Television*. The court reaffirmed the doctrine this time on its future benefits leg, the preparatory leg not being available due to the binding precedent of *Blitzer v. United States*.²⁹³ *Cleveland Electric Illuminating* read *Richmond Television* and its Tax Court progeny as accepting or assuming the “not fully articulated” rationale that

where a business requires substantial start-up expenditures before it can begin operations, which are not directly for the purchase of tangible assets and which will not ordinarily be recovered out of revenues for the same year, the capital investment is in the business as a whole rather than merely in the intangibles, and it includes the start-up costs.²⁹⁴

The Claims Court accepted this rationale and thus rested on a pure future benefits theory. Precisely this aspect of *Richmond Tel-*

²⁹¹ The Fifth Circuit was led astray by the future benefits aspects of both the survey and permit costs. “While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item.” 731 F.2d at 1183 (citing Judge Murnaghan’s *dissent* in *NCNB II*).

²⁹² 7 Cl. Ct. 220 (1985). The Claims Court here followed the future benefits leg of *Richmond Television*; thus, start-up expenditures that will not ordinarily be recovered out of revenues for the year constitute a capital investment in the business as a whole. *Id.* at 228-29; accord *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986).

²⁹³ 684 F.2d 874 (Ct. Cl. 1982). In *Blitzer*, the Court of Claims held that *Richmond Television* expenditures constituted “capital expenditures under tax law standards even apart from the ‘trade or business’ phrase in I.R.C. § 162.” *Id.* at 880.

²⁹⁴ 7 Cl. Ct. at 228.

evision was overturned by the *NCNB II* en banc majority.²⁹⁵ Not surprisingly, the Claims Court, like the Fifth Circuit before it in *Central Texas Savings & Loan*,²⁹⁶ also specifically rejected the Fourth Circuit's separate, saleable asset test on the basis of the clear reflection of income principle. The Claims Court noted that "capital treatment of expenditures connected with the acquisition of an asset having an extended life is an important facet of matching revenues and expenditures in determining net income."²⁹⁷

Yet the approach adopted by the Fifth Circuit and the Claims Court itself produces distortion of income when recurring expenditures, e.g., market surveys or staff training, are added to a nonamortizable asset, e.g., an indefinite-life operating permit. Moreover, the courts' rejection of the separate, saleable asset test creates a conceptual quandary—how to justify the current deduction of start-up-type costs. An example of this problem is allowing current deduction of staff training costs for a new branch in expanding the *same* business, while requiring capitalization of start-up costs for staff training for a new branch in a *different* or new business. *Cleveland Electric Illuminating* attempted to do so on the basis that the new business (nuclear power generating plant) start-up costs for new employee training were substantial, provided future benefits, and constituted a one-time expenditure. The court distinguished this "new" business from a "same" business expansion because the same business (fossil fuel power generating plant) expansion costs for new employee training were not so substantial, replacement employees would receive similar training, and the employee turnover rate was projected as ten percent per year. In addition, the court found that no new operating permit was required for the new plant in the same business, an immediate benefit was present, and any division of the cost according to immediate and future years was thought impractical.²⁹⁸

Other litigation discloses that in fact start-up employee training in a nuclear power plant is not a one-time expenditure, because the employee turnover rate is quite high and extensive retraining is

²⁹⁵ 684 F.2d at 289.

²⁹⁶ 731 F.2d at 1184-85.

²⁹⁷ *Cleveland Elec. Illuminating*, 7 Cl. Ct. at 224 (stating the Claim Court's reading of the Eleventh Circuit's holding in *Ellis Banking*).

²⁹⁸ *Id.* at 234-35.

required on an ongoing basis.²⁹⁹ Thus, all the Claims Court's purported differentiating factors, except "substantiality" and the requirement of an operating permit, would appear to apply equally to the nuclear and coal-fired generating plants. Additionally, the court's rationale in *Cleveland Electric Illuminating* for the "investment in the business as a whole" approach did not distinguish the costs of the two plants. In the context of both start-up and expansion costs the value created or acquired in excess of the cost of the tangible assets is (increased) earnings power.³⁰⁰ The Claims Court should have set up the new business employee training costs (or perhaps only the excess over the amount of recurring costs) as a free-standing asset amortizable over a period based upon projected employee turnover and retraining rates. The fossil fuel generating plant training costs similarly should have been set up as a separate asset amortizable, probably, over ten years.

The basic question, therefore, is why did the Claims Court in *Cleveland Electric Illuminating* and the Fifth Circuit in *Central Texas Savings & Loan* ignore the *NCNB I* panel's "golden mean" of amortization of substantial recurring expansion costs as a free-standing asset? A number of possible answers suggest themselves. The *NCNB I* panel's approach was not articulated fully and was confused by overreliance on GAAP as to the mechanics of amortization. Precedents³⁰¹ and commentary,³⁰² however, suggested the proper analysis. Additionally, the taxpayers' counsels apparently adopted an all-or-nothing (current deduction or capitalization) litigating stance or artlessly presented any amortization arguments.³⁰³ Nevertheless, the panel's discussion in *NCNB I* was there to be read. The decisive factor for not using the "golden mean" of amor-

²⁹⁹ *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 543-44 (1979) (turnover was high due to an extremely competitive job market and to physical and psychological problems developing from stress; therefore, new operators had to be trained and current ones retrained continuously), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

³⁰⁰ See *supra* note 233.

³⁰¹ See *supra* notes 139-40 and accompanying text.

³⁰² See *Erbacher*, *supra* note 2, at 500 (start-up costs should be currently deductible and, if not, amortized over a short period); *Gunn*, *supra* note 5, at 446 (capitalized costs should be amortized as a free-standing asset); *Seago*, *supra* note 2, at 416 (recurring steady-state start-up costs should be currently deductible).

³⁰³ See, e.g., *Central Tex. Sav. & Loan*, 731 F.2d at 1185-86 (court discussed taxpayer's amortization claim only in the context of then-not-yet applicable § 195); *Cleveland Elec. Illuminating*, 7 Cl. Ct. at 223-24 (taxpayer relied on separate and distinct asset as precondition to capitalization).

tization approach in subsequent cases undoubtedly was the enactment of section 195 after counsel argued *NCNB I* but before issuance of the panel's decision.³⁰⁴

D. Fatal Intersection of Section 195 and Case-Law Development

Had some of the post-1980 case-law developments (*Blitzer* and *NCNB I*) occurred earlier, section 195 would not be needed for start-up, as contrasted with investigatory, costs. A functional approach to the "carrying on of a trade or business" proviso of section 162(a), coupled with both (1) capitalization as a free-standing *amortizable*, "asset" of substantial not regularly recurring costs and (2) current deduction of less substantial or regularly recurring unequal amounts would have resolved the start-up cost controversy. Ironically, however, with the enactment of section 195 some of these same developments (*NCNB I* and *Central Texas Savings & Loan*) logically would render a large part of section 195 a nullity.

Section 195, as enacted in 1980, provided an elective sixty-month amortization, commencing with the beginning of the taxpayer's trade or business, of the start-up costs of an active trade or business, if identical expenses would have been currently deductible in the event paid or incurred in connection with the expansion of an existing trade or business in the same field.³⁰⁵ This provision rested on the following explicit assumptions, contained in the Committee Reports, as to the then-existing case law: (1) start-up and investigatory costs incurred prior to the commencement of business were not currently deductible (under the preparatory doctrine) because they were not incurred in carrying on a trade or business;³⁰⁶ (2) often such start-up or pre-opening costs could not be amortized because no ascertainable useful life could be established;³⁰⁷ and, (3) similar costs incurred in expanding an existing

³⁰⁴ The panel decided *NCNB I* on June 18, 1981; arguments in the case took place on Dec. 3, 1979. See 651 F.2d at 942. Section 195 was originally enacted on Dec. 28, 1980. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 102, 94 Stat. 3521, 3522 (codified at I.R.C. § 195 (1980)).

³⁰⁵ I.R.C. § 195(b)(2) (1980). For the corresponding current provision, see I.R.C. § 195(c)(1)(B) (1984).

³⁰⁶ H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9 (1980); S. Rep. No. 1036, *supra* note 9, at 10, reprinted in 1980 U.S. Code Cong. & Admin. News at 7300.

³⁰⁷ H.R. Rep. No. 1278, *supra* note 306, at 10. The 1980 Committee Reports stated that

business were currently deductible³⁰⁸ under the separate, saleable asset test.³⁰⁹ Thus, capitalization of substantial, but not frequently recurring business expansion costs, under the *NCNB I* panel and the *Central Texas Savings & Loan* decisions, logically would render the sixty-month amortization pursuant to the original section 195 unavailable for comparable costs incurred before a new business began. Under the *NCNB I* approach, but not *Central Texas Savings & Loan*, "case-law" amortization would be available. This combination of the need to preserve the statutory reference point (deductible in expansion) and the legislative history's definitional view of the (then) case law infected subsequent case-law development.

This double impact of section 195 is probably the principal cause of the Fourth Circuit's en banc decision to vacate the *NCNB I* opinion. In *NCNB II* the court held that:

Congress is . . . under the impression that expenditures for market studies and feasibility studies, as at issue here, are fully deductible if incurred by an existing business undergoing expansion. An interpretation by us to the contrary would render § 195 meaningless for it would obliterate the reference point in the statute—"the expansion of an existing trade or business."³¹⁰

The Claims Court in *Cleveland Electric Illuminating* similarly tried to maintain section 195, remaining true to Congress' view of the prior law,³¹¹ while at the same time rejecting the talismanic separate, saleable asset test³¹² and the preparatory doctrine.³¹³

The next question is whether courts are compelled to follow the

"they [certain start-up costs] relate to a business with an indeterminate life." *Id.*; S. Rep. No. 1036, *supra* note 9, at 11, reprinted in 1980 U.S. Code Cong. & Admin. News at 7301.

³⁰⁸ H.R. Rep. No. 1278, *supra* note 306, at 11. The 1980 Committee Reports provided that "[i]n 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. As under present law, these expenses will continue to be currently deductible." *Id.*; S. Rep. No. 1036, *supra* note 9, at 12, reprinted in 1980 U.S. Code Cong. & Admin. News at 7302.

³⁰⁹ See *supra* notes 226-35 and accompanying text.

³¹⁰ 684 F.2d at 291 (quoting I.R.C. § 195(b)(2) (1980)).

³¹¹ 7 Cl. Ct. 220, 228 (1985); accord *Johnsen v. United States*, 794 F.2d 1157, 1163 (6th Cir. 1986).

³¹² 7 Cl. Ct. 224-25.

³¹³ The Court of Claims (predecessor to the Federal Circuit, which reviews Claims Court decisions) previously rejected the preparatory doctrine in *Blitzer*. See *supra* notes 196-204 and accompanying text.

section 195 drafters' view of the deductibility of start-up and business expansion costs. The Claims Court accurately observed in *Cleveland Electric Illuminating* that under traditional rules of statutory construction "while the views of a later Congress are not controlling as to the meaning and application of preexisting law, they are entitled to consideration as a secondary authoritative expression of expert opinion as to such law."³¹⁴ In fact, the expert opinion of Congress, i.e., its statement of prior case law in the 1980 legislative history, has turned out to be erroneous. Congressional opinion, apparently based upon commentary that described the preparatory or pre-operating doctrine as applying to start-up costs³¹⁵ and the contradictory separate, saleable asset test as apply-

³¹⁴ 7 Cl. Ct. at 228; accord *Johnsen*, 794 F.2d at 1163.

³¹⁵ Neither the original nor amended statute adopted the definitions of "start-up" and "investigatory" costs included in the 1980 Committee Reports. Compare I.R.C. § 195(b) (1980) and I.R.C. § 195(c)(1) (1984) with H.R. Rep. No. 1278, supra note 306, at 9-11 and S. Rep. No. 1036, supra note 9, at 10-12, reprinted in 1980 U.S. Code Cong. & Admin. News at 7300-02. The Committee Reports paraphrased the definitions of these costs suggested in Lee, supra note 2, at 384-85. Thus, according to the Reports:

Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business

. . . .

Startup or preopening expenses are costs which are incurred subsequent to a decision to acquire or establish a particular business and prior to its actual operation. Generally, the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of the particular business operation to which they relate

Startup costs may include expenses relating to advertising, employee training, lining-up distributors, suppliers, or potential customers, and professional services in setting up books and records

. . . .

Under the provision, eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. Eligible expenses also include startup costs which are incurred subsequent to a decision to establish a particular business and prior to the time when the business begins. For example, startup costs include advertising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred in lining up prospective distributors, suppliers or customers, and salaries or fees paid or incurred for executives, consultants, and for similar professional services.

H.R. Rep. No. 1278, supra note 306, at 9-11; S. Rep. No. 1036, supra note 9, at 10-12, reprinted in 1980 U.S. Code Cong. & Admin. News at 7300-02. These definitions are similar to those recommended in the author's earlier article:

Business investigation expenses consist of costs incurred in investigation of a prospective business prior to reaching a firm decision whether to acquire it. These expendi-

ing to similar costs in business expansion,³¹⁶ did not consider a deep structure distortion of income basis for capitalization and amortization.³¹⁷ With both talismanic doctrines conceptually discredited,³¹⁸ Congress' "view" of the law similarly erodes conceptually. Thus, the results reached by the Claims Court in *Cleveland Electric Illuminating* and by the Fourth Circuit in *NCNB II* were not mandated by the legislative history of section 195.

Under distortion of income principles, only recurring or insubstantial business expansion costs would be currently deductible; less frequently recurring (say, more than every three years) or more substantial expenditures should be capitalized and then amortized as a free-standing deferred charge. Therefore, typical business expansion investigatory expenditures probably do not produce benefits which diminish over the life of the business and, hence, would not be treated as separate, amortizable assets. Most market survey costs do produce benefits which diminish, but last longer than a year and, hence, generally should be set up as separate, amortizable assets unless repeated every two to three years. Advertising, salaries paid to employees overseeing the expansion, etc., should be currently deductible since they recur and produce short-term benefits. Employee training as to the expanded facilities should be either capitalized and amortized or currently deducted, depending on the degree of regular retraining and employee turnover. The treatment of costs for obtaining distributors, customers,

tures are commonly distinguished from pre-operating expenses (also called start-up or pre-opening costs), which are paid during the time between the decision to establish or acquire a new business and the beginning of actual business operations. The term usually refers to expenses which would be currently deductible if they had been incurred after business operations had begun in full flower. Typical examples of pre-operating expenses are costs of advertising and promotion, training of employees, lining up suppliers and potential customers or distributors, and legal and accounting services in setting up books and records. Expenditures for R & D, although capital, are pre-operating and not investigatory expenditures. Distinctions analogous to investigatory, pre-operating, and operating expenses also exist in the areas of farming and mining.

Lee, *supra* note 2, at 384-85 (footnotes omitted).

³¹⁶ See Lee, *supra* note 2, at 391-95 (preparatory doctrine), 390 n.53, 411-13 (separate and distinct asset doctrine).

³¹⁷ The author's previous article mentioned the distortion of income. See Lee, *supra* note 2, at 412, 415. Nevertheless, setting up the start-up costs as a separate amortizable asset in order to prevent distortion of income was not considered.

³¹⁸ See *supra* notes 175-243 and accompanying text.

and supplies in expansion should similarly depend on the degree to which they are recurring and the turnover rate of such contracts.

Since substantial and less frequently incurred expenditures would not be currently deductible under a distortion of income analysis, whether expended in operation or expansion of an existing business, conceptual consistency would rule out section 195 amortization of similar substantial, but not frequently recurring, expenditures in a new business. (Such non-covered start-up costs in many instances should, however, be amortizable under section 167, at least once the business commenced.)³¹⁹ Under this approach, longer-term, substantial expenditures would not be covered by section 195, while recurring lesser expenditures, which can be currently deductible without distortion of income, would be covered by the provision and thus, absurdly, only amortizable over sixty months.

The ideal legislative solution to the business expansion and remaining start-up controversies would be expansion of section 195 to encompass business expansion costs and creation of a three-tier system of deduction. First, recurring (in the sense of replacement, not expansion) costs in creating a new business or expanding an existing business that produce short- or highly variable-term benefits should be currently deductible. Second, expenditures so incurred producing longer- but not indefinite-lived benefits should be amortized over sixty months. Third, expenditures producing indefinite-lived intangibles, e.g., permit costs, should be amortized over a longer period, e.g., eighteen to twenty years.

If such an ideal legislative solution is not soon achieved, courts will face three major options in dealing with business expansion costs and start-up costs. The first option is for courts to "bow to the will of Congress"³²⁰ in codifying past judicial error and to preserve section 195, denying current deduction of start-up costs

³¹⁹ See *supra* note 219 and accompanying text.

³²⁰ *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 380 n.10 (1983) (holding that courts must follow § 111, the codification of the judicially created tax benefit doctrine.) Instead of correcting past judicial errors, the courts are yielding increasingly to the congressional codification or enactment of new provisions based upon such errors. The same holds true regarding the judicial attitude toward administrative positions. An example of this trend can be seen in the Supreme Court's recent revisit to the *Crane* doctrine. See *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983) (O'Connor, J., concurring).

(under the preparatory or some similar doctrine)³²¹ while permitting a current deduction of all business expansion costs (to the extent they do not create a separate, saleable asset).³²² The second option is to apply the "same business" standard broadly and at the same time utilize the distortion of income concept (capitalization and then amortization of substantial, long-term benefit expenditures) as to such business expansion costs, thus narrowing the category of start-up costs subject to section 195 while expanding the start-up costs subject to capitalization and amortization outside the statute. The final judicial option is to apply a distortion of income analysis to business expansion costs (regardless of whether "same business" is construed narrowly), but apply section 195 broadly to all start-up costs other than those creating or enhancing a separate, saleable asset.

The two options preserving section 195 (the first and third approaches) will possess the most surface appeal³²³ due to the potential ultimate lessening of controversy under the statutory regime and to the quagmire of existing conflicting start-up and business expansion precedents. These options, however, require eschewing a distortion of income analysis, or at the least will produce conceptual inconsistency. Even such conceptual defects may not constitute the most serious problem with section 195.³²⁴ Indeed, once the full panoply of glitches in section 195, and particularly in the Committee Reports certain to be the model for future regulations, is appreciated, the option of eviscerating section 195 through strict adherence to distortion of income principles takes on an added appeal.³²⁵

³²¹ See *supra* notes 175-87 and accompanying text.

³²² See *supra* notes 225-35 and accompanying text.

³²³ In *Cleveland Elec. Illuminating*, the Claims Court allowed a current deduction of employee training costs of the "same" business branch (fossil fueled electric generating plant), but required capitalization of virtually the same expenditures associated with the "new" business branch (nuclear fueled electric generating plant). Clearly the preservation of § 195 was a motivating factor. 7 Cl. Ct. at 229.

³²⁴ See *infra* notes 326-56 and accompanying text.

³²⁵ Such strict adherence includes, e.g., capitalization and then amortization of substantial, long-term benefit business expansion and operation costs in an existing business, as well as similar treatment by the courts of comparable new business start-up costs (excluded from § 195 because not currently deductible in operation by an existing business).

IV. SECTION 195: PLUS ÇA CHANGE, PLUS LA MÊME CHOSE: THE OTHER FAILED SYNTHESIS

A. *Introduction: "Those who cannot remember the past are condemned to fulfill it."*³²⁶

As the calls for federal tax simplification gained momentum in the late 1970s, reform proponents studied start-up costs, among many other areas.³²⁷ To effectuate the goals of clarity and comprehensibility of the statutory requirements, ease of taxpayer compliance, and ease of administration, reformers suggested that the "entire area could be simplified and the controversy greatly reduced by adopting a compromise akin to that adopted for corporate organizational expenses. There, the law prescribes a 60-month fixed amortization."³²⁸ By eliminating the all-or-nothing consequences created by adopting either the separate, saleable asset or the preparatory rule doctrines, "the necessity for carrying the controversy to conclusion is greatly reduced and one would expect in the long run that most of the controversies would be easily settled."³²⁹

In 1979 Representative Barber Conable introduced a "simple," bare-bones bill, H.R. 5729,³³⁰ which would have granted taxpayers an election to amortize, over at least a sixty-month period commencing with the month the trade or business starts functioning as a going concern, "ordinary and necessary" start-up expenditures. Under the bill, such expenditures must have been incurred incident to the investigation, formation, and creation of a trade or business entered into, but prior to its functioning as a going concern. Eligible expenditures must also have been "chargeable to capital account," i.e., presumably not creating an asset with a useful life of its own other than the business itself,³³¹ and been of a character

³²⁶ 1 G. Santayana, *Life of Reason* ch. xii (1905-06), reprinted in *Oxford Dictionary of Quotations* 414 (3d ed. 1979).

³²⁷ See Krane, *supra* note 10, at 310; see also McDaniel, *supra* note 10; N.Y. Bar Report, *supra* note 10.

³²⁸ Krane, *supra* note 10, at 310 (referring to what is now § 248(a)); see I.R.C. § 248(a).

³²⁹ Krane, *supra* note 10, at 311 n.25.

³³⁰ H.R. 5729, 96th Cong., 1st Sess., 125 Cong. Rec. 29,857 (1979), reprinted in 1980 Hearings, *supra* note 2, at 181.

³³¹ The Brief Summary of H.R. 5729 explained that:

The amortization election would apply only to [1] ordinary and necessary start-up costs [2] which do not create an asset which has a useful life of its own and [3] which

which, if the business had a determinable life, would be amortizable over that life. This proposal closely paralleled section 248, which provides for sixty-month amortization of organizational expenditures.³³² Congress held hearings on this and other reform bills in 1980.³³³

The Department of the Treasury supported H.R. 5729 because it would reduce "the disparity in tax treatment between ordinary and necessary preopening expenses and similar expenses incurred by an existing business."³³⁴ Treasury's main concern, however, was to "induce taxpayers with existing businesses to elect to amortize the start-up costs of a marginally related business, thereby reducing the number of controversies in this area."³³⁵ Treasury wanted the provision to require an unconditional election to amortize start-up expenditures no later than the time for filing the return, including extensions, for the year the expenses were paid or incurred.

At the Hearings on H.R. 5729 ("1980 Hearings"), witnesses urged three principal points. First, the drafters should *not* adopt as the commencement point for the sixty-month amortization period the *Richmond Television* test of functioning as a going concern, but instead should use the starting point employed in various regulations interpreting other Code provisions (including section 248). These provisions deem a business to commence as soon as its activities advance to the extent necessary to establish the nature of the business.³³⁶ Second, taxpayers incurring start-up or "expansion" costs in an *existing* business prior to the effective date of the

are of a character which would allow the taxpayer to amortize them if they were expended incident to the investigation, formation, and creation of a trade or business having a determinable useful life.

Brief Summary—H.R. 5729, reprinted in 1980 Hearings, *supra* note 2, 181, 182. The original proposed statutory definition (contained in § 193(b) as proposed by H.R. 5729) paralleled [1] and [3] above, with "chargeable to capital account" corresponding to requirement [2]. See H.R. 5729, reprinted in 1980 Hearings, *supra* note 2, at 181 (proposed § 193(b)).

³³² I.R.C. § 248(a).

³³³ 1980 Hearings, *supra* note 2.

³³⁴ *Id.* at 14 (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation).

³³⁵ *Id.*

³³⁶ *Id.* at 46, 102, 113, 114 (statements of Charles M. Walker, Chairman, Section of Taxation, A.B.A.; Samuel M. Chase, Jr., Chairman, Legislative Ad Hoc Subcommittee of Real Estate Securities, Nat'l Ass'n of Realtors; Paul Clevenger, Vice President, Taxes, UAL, Inc.; supplemental statement of Gerald W. Padwe, Associate National Director, Tax Services, Touche Ross & Co., respectively).

proposed legislation should not be precluded from using the bank credit card business expansion cost precedents³³⁷ to obtain a current deduction under section 162. Third, the proposed statute should be available "to an existing business investigating a new product or service line, or preparing to open a new branch."³³⁸ One prophetic, but ignored, voice called for postponing consideration of H.R. 5729 until the Court of Claims decided *Blitzer*, because it might "clarify the definition of a beginning of business,"³³⁹ thereby rendering section 195 unneeded as to start-up costs.

Congress held no further hearings, and the drafters of the provision enacted as section 195 responded to all of the above points (save *Blitzer*) by minor changes in the still bare-bones statute, accompanied, however, by extensive additions to the explanatory Committee Reports.³⁴⁰ Additionally, the final statute required that the trade or business be "active"³⁴¹ in order to preclude amortization of start-up costs of investments.³⁴² To prevent amortization of capital expenditures, the drafters in 1980 substituted for the "ordinary and necessary" requirement of the draft bill the language in section 195 as enacted providing that amortizable start-up costs must be (currently) deductible in the year paid if incurred instead in expanding an existing business.³⁴³

Thus section 195, as enacted in 1980, provided an "election in" under which a taxpayer could elect to treat start-up expenditures as deferred expenses amortizable ratably over a sixty-month or longer period commencing with the month in which the business began.³⁴⁴ Eligible start-up expenditures included any amount paid

³³⁷ Id. at 110 (statement of Gerald W. Padwe). In general, the industry witnesses feared that the Service would argue that, since proposed § 193 would permit amortization of certain types of expenditures prospectively, such expenditures should not be deductible or amortizable prior to the effective date of the proposed new statute.

³³⁸ Id. at 115 (supplemental statement of Gerald W. Padwe).

³³⁹ Id. at 106 (statement of Samuel M. Chase, Jr.).

³⁴⁰ H.R. Rep. No. 1278, *supra* note 306, at 9-13; S. Rep. No. 1036, *supra* note 9, at 10-14, reprinted in 1980 U.S. Code Cong. & Admin. News at 7300-04.

³⁴¹ I.R.C. § 195(a) (1980); I.R.C. § 195(b)(1) (1984). See generally Shapiro & Shaw, Start-Up Expenditures—Section 195: Clarification or More Confusion?, 34 Major Tax Plan. 11-1 (1982).

³⁴² H.R. Rep. No. 1278, *supra* note 306, at 11; S. Rep. No. 1036, *supra* note 9, at 12, reprinted in 1980 U.S. Code Cong. & Admin. News at 7302.

³⁴³ I.R.C. § 195(b)(2) (1980); see H.R. Rep. No. 1278, *supra* note 306, at 11; S. Rep. No. 1036, *supra* note 9, at 12, reprinted in 1980 U.S. Code Cong. & Admin. News at 7302.

³⁴⁴ I.R.C. § 195(a) (1980); I.R.C. § 195(b) (1984).

or incurred in connection with (1) investigating the creation or acquisition of an active trade or business or (2) creating an active trade or business, which in either case would be currently deductible if paid or incurred in connection with the expansion of an existing trade or business in the same field.³⁴⁵ Predictably, the section 195 election had to be made by the due date (including extensions) of the return for the year in which the business began.³⁴⁶

The Tax Reform Act of 1984 (the "Act")³⁴⁷ amended section 195 to make it exclusive as to targeted start-up costs; "start-up cost" deductions under sections 162 or 212 were precluded,³⁴⁸ and eligible start-up costs were expanded to cover *Hoopengartner* "pre-business" activities.³⁴⁹ The Act also changed the 1980 statutory requirements for amortization under section 195 from a comparison with expenses currently deductible in "expansion" of an active trade or business to a comparison with expenses deductible in the year of payment if the start-up costs had been paid in connection with the *operation* of an active business.³⁵⁰ Even in 1984, however, the drafters continued to ignore the deep structure conflict between the premise articulated in the 1984 legislative history to the section 195 changes (that start-up expenditures "generally result in the creation of an asset which has a useful life that extends substantially beyond the year in which incurred,"³⁵¹ presumably the business itself)³⁵² and the statutory requirement that the expendi-

³⁴⁵ I.R.C. § 195(b) (1980). The bare-bones statute left to the Committee Reports the task of defining start-up and investigatory costs. See *supra* note 315.

³⁴⁶ I.R.C. § 195(c)(1) (1980); I.R.C. § 195(d)(1) (1984).

³⁴⁷ Pub. L. No. 98-369, § 94(a), 98 Stat. 494, 614-15 (codified at I.R.C. § 195).

³⁴⁸ I.R.C. § 195(a) (1984); Senate Comm. on Finance, Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, 1 S. Print No. 169, 98th Cong., 2d Sess. 283 (1984), reprinted as 71 Stand. Fed. Tax Rep. (CCH) No. 16.

³⁴⁹ S. Print No. 169, *supra* note 348, at 283 (stating the Finance Committee's intent that § 195 reach expenses of the sort involved in *Hoopengartner v. Commissioner*, 80 T.C. 538 (1983)); see *supra* note 175.

³⁵⁰ Compare I.R.C. § 195(b)(2) (1980) with I.R.C. § 195(c)(1)(B) (1984). See *infra* notes 391-96 and accompanying text.

³⁵¹ S. Print No. 169, *supra* note 348, at 282. Increasingly, the courts also have begun to adopt such future benefits capitalization as the basis for the start-up cost doctrine. See *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228 (1985). But see *Aboussie v. United States*, 779 F.2d 424, 428 (8th Cir. 1985).

³⁵² See *supra* note 112.

ture be (entirely) deductible in the year paid in an existing business under general expense-capitalization rules.³⁵³ For an expenditure to be deducted entirely in the year paid, either in expansion or operation, it must not distort the taxpayer's income. Yet the current deduction of an expenditure with a useful life extending substantially beyond the year in which paid will distort the taxpayer's income (unless it is *de minimis* or steady-state recurring),³⁵⁴ whether expended in operation or expansion.

The legislative history shows that Congress believed that section 195 would "encourage formation of new businesses and decrease controversy and litigation arising under . . . [prior] law with respect to the proper income tax classification of startup expenditures."³⁵⁵ Attempts at simplicity through the adoption of legislation by Committee Reports flawed by both the adoption of case-law reference points, where there is a splintering of authorities, and the utter failure of the drafters to consider the deep structure of capital expenditures, set the stage for complete confusion and uncertainty as to the current rules—clearly a "disgrace"³⁵⁶ given the goal of simplification. Additionally, this tacked-on legislation does not work in many instances, especially if the more recent business expansion cases and deep structure concepts are taken seriously. The 1984 remedial legislation still missed the mark.

³⁵³ I.R.C. § 195(c)(1)(B) (1984); I.R.C. § 195(b)(2) (1980).

³⁵⁴ See *supra* notes 35-38 and accompanying text.

³⁵⁵ H.R. Rep. No. 1278, *supra* note 306, at 9; S. Rep. No. 1036, *supra* note 9, at 11, reprinted in 1980 U.S. Code Cong. & Admin. News at 7301; see 1980 Hearings, *supra* note 2, at 14 (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation). Halperin suggested that:

In the unclear cases, of which there are many, taxpayers should elect to amortize; if they fail to elect and the Internal Revenue Service successfully maintains that the costs must be capitalized, the election would not be available and the costs would not be recoverable through amortization. Electing to amortize these expenses over five years would appear for most taxpayers to be a more prudent decision.

Id. (footnote omitted); see Krane, *supra* note 10, at 311 n. 25.

³⁵⁶ Cf. *NCNB II*, 684 F.2d at 296 (Murnaghan, J., dissenting) Judge Murnaghan concluded: "The benefit heaped upon them [taxpayers, preeminently banks, by the separate, saleable asset rule] further contributes to the deserved description of our income tax system as a disgrace." *Id.*

B. Efficacy of Section 195: The "Shot in the Foot"—The Deductible Expansion/Operation Costs Reference Point

1. Introduction

H.R. 5729, closely paralleling the section 248(b) definition of "organizational expenditures,"³⁵⁷ defined start-up costs as any expenditure that is

- (1) an ordinary and necessary expense incident to the investigation, formation, and creation of the trade or business;
- (2) chargeable to capital account; and
- (3) of a character which, if expended incident to the investigation, formation, and creation of the trade or business having a determinable life, would be amortizable over such life.³⁵⁸

Due to the absence of any deep structure analysis, the irreconcilable conflict between the "ordinary" requirement and the capital expenditure aspects apparently was not perceived. Seemingly, "chargeable to capital account" only referred to expenses which would qualify but for the fact they are incurred prior to going concern status.³⁵⁹ However, the third requirement for amortization, i.e., that the business has a determinable life, clearly rested on the assumption that start-up expenditures are capitalizable as an acquisition cost, which would absolutely preclude "ordinary" status.³⁶⁰ This conceptual schizophrenia has continued through every subsequent version of the provision: the "shot in the foot."

Section 195, as enacted in 1980, defined start-up expenditures as any amount

- (1) paid or incurred in connection with—
 - (A) investigating the creation or acquisition of an active trade or business, or

³⁵⁷ Section 248(b) defines 60-month amortizable "organizational expenditures" as "any expenditure which—(1) is incident to the creation of the corporation; (2) is chargeable to capital account; and (3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life." I.R.C. § 248(b).

³⁵⁸ H.R. 5729, 96th Cong., 1st Sess. (1979), reprinted in 1980 Hearings, *supra* note 2, at 181.

³⁵⁹ See 1980 Hearings, *supra* note 2, at 109 (statement of Gerald W. Padwe, Associate National Director, Tax Services, Touche Ross & Co.). According to Padwe: "Expenses which would qualify but for the fact they are incurred prior to going concern status, become—in tax terms—'chargeable to capital account' and not currently deductible; or, in accounting terms, a deferred charge in the nature of an intangible asset." *Id.*

³⁶⁰ See *supra* note 19.

(B) creating an active trade or business, and

(2) which, if paid or incurred in connection with the expansion of an existing trade or business (in the same field as the trade or business referred to in paragraph (1)), would be allowable as a deduction for the taxable year in which paid or incurred.³⁶¹

Congress left to the unpromulgated regulations the role of defining eligible start-up expenditures. However, the 1980 Committee Reports provided extensive definitions and illustrations of investigatory and start-up costs. Thus, investigatory costs were said to consist of the cost of seeking and reviewing a prospective business prior to reaching a final decision to acquire or enter that business.³⁶² The Reports illustrated investigatory costs as "expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc."³⁶³ The requirement that the taxpayer actually enter into the active business was intended to prevent abuses,³⁶⁴ such as in the reported cases where taxpayers deducted travel costs for a prospective business that manifested a strong personal component.³⁶⁵ While such an approach was easier to administer, a substantiation requirement would have been more precise and equitable.

The drafters of the 1980 Committee Reports defined the second category of targeted costs—start-up or pre-opening expenses—as costs incurred subsequent to a decision to establish a particular business, but prior to the time when the business began, and which would have been deductible currently if they were incurred after commencement of the particular business operation to which they relate.³⁶⁶ These Reports also illustrated start-up costs with "adver-

³⁶¹ I.R.C. § 195(b)(2) (1981). The drafters explained that the second paragraph was intended to bar amortization of syndication costs, the acquisition cost of the business, and the cost of investing in depreciable property. H.R. Rep. No. 1278, *supra* note 306, at 11; S. Rep. No. 1036, *supra* note 9, at 12, reprinted in 1980 U.S. Code Cong. & Admin. News at 7302.

[The texts of the House and Senate 1980 Committee Reports regarding the intent of § 195 are virtually identical. For the sole significant difference between the two, see *infra* notes 510-11 and accompanying text. Hereinafter, only the Senate Finance Committee Report will be cited. In addition, since the 1980 U.S. Code Cong. & Admin News reprint includes the original Senate Report's pagination, parallel citations will be omitted.]

³⁶² S. Rep. No. 1036, *supra* note 9, at 10, 11.

³⁶³ *Id.* at 11.

³⁶⁴ See *infra* notes 410-12 and accompanying text.

³⁶⁵ See *supra* note 179 and accompanying text.

³⁶⁶ S. Rep. No. 1036, *supra* note 9, at 11; see *supra* note 315.

tising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred in lining up prospective distributors, suppliers or customers, and salaries or fees paid or incurred for executives, consultants, and for similar professional services."³⁶⁷

The drafters of the Reports pointed out that costs may be incurred during the start-up stage which would be nondeductible and nonamortizable even if incurred subsequent to commencement of business operations, either because the expenses were of a purely capital nature or related to a business with an indeterminable life.³⁶⁸ The "ordinary and necessary" deductible expense of an existing business in expansion (or now operation) standard of original section 195 was intended to deny amortization to such nonordinary and necessary business expenses.³⁶⁹ The 1980 Committee Reports provided the following examples of such nonamortizable expenses:

[A]mounts paid or incurred in connection with the sale of stock, securities, or partnership interests are not within the definition of startup expenditures, e.g., securities registration expenses, underwriters' commissions, etc., are not startup expenditures. In addition, the amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, startup expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life, including expenses incident to a lease and leasehold improvements.³⁷⁰

Although syndication costs cannot fit into the capital expenditure mold as easily as the acquisition cost of a trade or business, of depreciable or amortizable property, or of leasehold improvements, all three categories are not currently deductible under a distortion of income analysis. To provide a deduction for syndication or registration costs, where the monies raised in the undertaking are excluded from income³⁷¹ by the business raising the funds, would dis-

³⁶⁷ S. Rep. No. 1036, *supra* note 9, at 11-12.

³⁶⁸ *Id.* at 11.

³⁶⁹ *Id.* at 12.

³⁷⁰ *Id.*

³⁷¹ See I.R.C. §§ 721, 1032.

tort the taxpayer's income.³⁷² Additionally, current deduction of the other listed capital expenditures would produce a distortion of income since benefits are produced over a number of years and none of the exceptions discussed in the model apply.³⁷³

2. Source of the Problem

The cause of the potential "shot in the foot" was the absence of any deep structure or distortion of income analysis by the drafters, courts, or commentators, prior to 1980, as to why start-up costs of a new business should or should not be deductible currently.³⁷⁴ Rather, the drafters of the Committee Reports and the statute accepted the new business preparatory doctrine and the existing business separate, saleable asset test as their conceptual framework.³⁷⁵ The 1980 Committee Reports explained that "business investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code."³⁷⁶ The drafters believed that the latter definitional rationale applied to start-up or pre-opening expenses as well, since they are incurred prior to the actual operation of the business,³⁷⁷ although some pre-opening expenses would not be deductible even if incurred after business operations commence because they "either may be of a purely cap-

³⁷² See *Missouri Pac. Corp. v. United States*, 5 Cl. Ct. 296, 309 (1984) (since year-one stock issuance transaction gave rise to no taxable income to recipient corporation, year-two adjustment gives rise to no deduction under the doctrine adopted in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952)); *Gunn*, supra note 5, at 447 n.20; *Lee & Murphy*, supra note 5, at 524-25.

³⁷³ See supra notes 37-38 & 53-78 and accompanying texts.

³⁷⁴ See cases and sources cited supra notes 2, 168 & 171.

³⁷⁵ S. Rep. No. 1036, supra note 9, at 12. Quoting the Senate Report's definition of investigatory costs, the *NCNB II* court concluded that: "Congress is thus under the impression that expenditures for market studies and feasibility studies, as at issue here, are fully deductible if incurred by an existing business undergoing expansion." 684 F.2d at 291. In *Johnsen*, the Tax Court similarly quoted the House Report's definition of start-up costs as manifesting that "Congress has recognized that section 162 precludes deduction of preopening expenses." *Johnsen v. Commissioner*, 83 T.C. 103, 116-17 (1984), rev'd on other grounds, 794 F.2d 1157 (6th Cir. 1986); see also *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985). Thus, courts have relied upon the drafters' mechanical reading of § 162 to apply definitional rules that distort the taxpayer's income. See supra notes 305-17 and accompanying text.

³⁷⁶ S. Rep. No. 1036, supra note 9, at 10.

³⁷⁷ *Id.* at 11.

ital nature, or may be capitalizable simply because they relate to a business with an indeterminate life.”³⁷⁸ The drafters correctly read then-current law (*Briarcliff Candy* and its bank credit card progeny) as allowing, under the definitional “separate property interest test,” current deduction of the “ordinary and necessary” costs of an existing business expanding in the same field,³⁷⁹ at least as to new ways of conducting an existing business. To preclude amortization of start-up costs that would be nondeductible and nonamortizable, even if they were incurred subsequent to commencement,³⁸⁰ the drafters of section 195 provided that amortizable start-up costs did not include any amount that would *not* be currently deductible “if paid or incurred in connection with the expansion of an existing trade or business (in the same field . . .).”³⁸¹

By tying amortization of new business start-up costs to whether identical expenditures would be deductible by an existing business in expanding, however, the drafters left the door open for subsequent business expansion cases to rule that expenditures identical to the start-up costs, intended to be covered by section 195, were not currently deductible under section 162, and hence, identical targeted start-up costs would not be amortizable under section 195. The *NCNB I* panel did just that in treating recurring market survey costs incurred in expanding to new branches as constituting separate, but amortizable assets.³⁸² Similarly, the *Central Texas Savings & Loan Association v. United States*³⁸³ treatment of

³⁷⁸ *Id.*

³⁷⁹ *Id.* at 12.

³⁸⁰ *Id.* The Committee Reports explained:

Thus, amounts paid or incurred in connection with the sale of stock, securities, or partnership interests are not within the definition of startup expenditures In addition, the amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, startup expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life, including expenses incident to a lease and leasehold improvements.

Id.

³⁸¹ I.R.C. § 195(b)(2) (1980) (predecessor to I.R.C. § 195(c)(1)(B) (1984)).

³⁸² 651 F.2d at 956-57, 962. The court held that the test is not whether the business is old or new, but instead is whether the nature of the matching income represents current or future income; expansion costs are usually related to anticipated future income, and hence must be capitalized where a current deduction would distort income. See generally *supra* notes 245-69 and accompanying text.

³⁸³ 731 F.2d 1181, 1185 (5th Cir. 1984).

branch expansion costs, including investigatory costs, as constituting part of the acquisition cost of the branch itself under the "origin-of-the-claim" doctrine denied a current deduction for such costs, although traditionally no case-law amortization of such cost would be available since the branch would have no determinable life.

The Claims Court attempted in *Cleveland Electric Illuminating Co. v. United States*³⁸⁴ to preserve a playing field for section 195 by permitting a current deduction for employee training costs as to a new branch of the same business while requiring capitalization of more substantial employee training costs as to a purportedly new business. Denied the support of the preparatory doctrine by *Blitzer*,³⁸⁵ and itself functionally rejecting the separate, saleable asset avenue,³⁸⁶ however, the Claims Court could not fashion a convincing rationale for its disparate treatment of substantially identical costs.³⁸⁷

In summary, believing that expenditures identical to the targeted investigatory and start-up costs of a new business were currently deductible if made by an existing business expanding in the same field,³⁸⁸ the drafters of section 195 chose the standard of deductibility in expansion in the same field as the barrier to preclude the amortization of the cost of syndication, purchase of a business, or assets when either held for sale or depreciable. Shortly after the enactment of section 195, however, courts applying a distortion of income analysis or the origin-of-the-claim doctrine to business expansion costs properly undercut the separate, saleable asset doctrine.³⁸⁹ Consequently, in some jurisdictions (e.g., the Fifth Circuit and perhaps the Eleventh Circuit) expenditures identical to the targeted investigatory start-up costs *could not* be currently deducted in expansion, and hence, start-up costs of new businesses arguably could not be amortized under section 195. This would have eliminated the disparity between new and existing businesses, albeit not in the direction intended by Congress.

³⁸⁴ 7 Cl. Ct. 220, 228-29, 234-35 (1985).

³⁸⁵ See supra notes 193-213 and accompanying text.

³⁸⁶ 7 Cl. Ct. at 225.

³⁸⁷ See supra notes 298-300 and accompanying text.

³⁸⁸ See supra note 375.

³⁸⁹ See supra notes 287-304 and accompanying text.

3. 1984 Amendments

By 1984, *Blitzer* and *Hoopengartner* forced Congress to repair section 195 by attempting to make it preemptive. The *NCNB* opinions also had exposed the defects in the statutory reference point of deductibility of a comparable expenditure in expansion by an existing business in the same field. Without explanation in either the Senate Finance or Conference Committee Reports, the Tax Reform Act of 1984 amendments to section 195 changed "expansion" to "operation"³⁹⁰ in the section 195 requirement that identical expenses "if paid or incurred in connection with the operation of an existing trade or business . . . , would be allowable as a deduction for the taxable year in which paid or incurred."³⁹¹

Obviously, the change from "expansion" to "operation" was in response to the *NCNB* opinions. Unfortunately, *Central Texas Savings & Loan* was decided after the Senate Committee on Finance approved its version of the legislation but before preparation of the Conference Bill and Report,³⁹² and thus, the impact of its "origin-of-the-claim" analysis was not taken into account by the 1984 amendments.³⁹³ The panel opinion in *NCNB I* viewed an "ordinary" expenditure as one that constituted part of the cost of producing the income for the current year and, conversely, a capital expenditure as one that properly must be matched against some future period's revenues that it would help produce. Therefore, the panel remanded the decision to the district court to make a finding concerning the amount of use of the market surveys in the taxpayer's *current revenue-producing operations* and the amount of use of the surveys in the planning for, or implementation of, new facilities for future use in the taxpayer's revenue-producing

³⁹⁰ Tax Reform Act of 1984, Pub. L. No. 98-369, § 94(a), 98 Stat. 494, 615 (codified at I.R.C. § 195(c)(1)(B)).

³⁹¹ I.R.C. § 195(c)(1)(B) (1984) (identical to I.R.C. § 195(b)(2) (1980) except "operation" substituted for "expansion").

³⁹² *Central Texas Savings & Loan* was decided on May 11, 1984. See 731 F.2d at 1181. The Senate Committee on Finance approved its Report recommending amendments to § 195 on Mar. 21, 1984. See S. Print No. 169, *supra* note 348 (suggested amendments were § 73 of the Committee's proposed Deficit Reduction Tax Act). The Conference Report on the Tax Reform Act of 1984, H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess., was ordered to be printed on June 23, 1984.

³⁹³ In addition, the Claims Court's *Cleveland Electric Illuminating* and Sixth Circuit's *Johnsen* decisions were not issued until 1985 and 1986, respectively. See 7 Cl. Ct. at 200; 794 F.2d at 1157.

operations.³⁹⁴

Possibly, the drafters intended the 1984 change from "expansion" to "operation" to limit section 195 amortization to expenditures that are totally used up in current operations, while at the same time to bolster the section 195 preemption of deductions for start-up costs. Thus, Congress reasoned that such start-up costs "generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred."³⁹⁵ Such expenditures usually would not be deductible in *operation* of an existing business in the year paid, under a distortion of income analysis.³⁹⁶ Consequently, the amendment does not remedy the deep structure conflict between the conceptionalization of start-up costs as creating a long-lived asset and a comparability requirement of current deductibility in operation largely to preclude amortization of long-lived assets.

4. *Suggested Solution*

The ideal solution would be application of the same statutory rules to comparable expenditures by both existing and new businesses, i.e., a current deduction as to recurring and short- or variable-term benefits, a longer amortization for longer-term benefits (say, sixty months), and a still longer amortization period for indefinite-life expenditures such as permit costs (say, eighteen to twenty years).³⁹⁷ If, however, as is more likely, Congress at most merely tinkers with section 195 again, it should eliminate the reference to current deductibility if incurred in operation by an existing business. The provision instead should articulate the criteria for determining which shorter- and longer-term expenditures should be amortized over sixty months by a new business and which should not be amortizable, addressing both the degree of recurrence and the length of useful life necessary. One of the originally proposed requirements for eligible start-up expenditures was whether the expenditure would have been amortizable over the life of the trade or business investigated or acquired if such trade or

³⁹⁴ *NCNB I*, 651 F.2d at 962-63.

³⁹⁵ S. Print No. 169, *supra* note 348, at 282.

³⁹⁶ See *supra* note 354 and accompanying text.

³⁹⁷ See *supra* full paragraph in text following note 319; see also *supra* full paragraph in text following note 172.

business had a determinable life.³⁹⁸ Adoption of this standard in any minor amendment would satisfy *Central Texas Savings & Loan* and its origin-of-the-claim test. However, it would not satisfy the *NCNB I* panel's approach of treating a business expansion or start-up cost as creating a separate, amortizable asset. Consequently, an alternative requirement under such an amendment might be whether the expenditure, if not associated with the basis of the business, would be amortizable as a separate, intangible asset.

If Congress fails to reformulate section 195 along the above lines, courts will have three options: (1) conceptually backstopping section 195 by adopting the definitional preparatory and separate, saleable asset doctrines;³⁹⁹ (2) adopting the functional distortion of income doctrine as to start-up costs incurred in operation or expansion, thus rendering section 195 largely "meaningless";⁴⁰⁰ or, (3) applying a functional test elsewhere, but strong-arming section 195 into a workable tool.⁴⁰¹ The keystone to current section 195's efficacy is the standard of deductible "if paid or incurred in connection with the operation of an existing trade or business."⁴⁰² Those seeking to maintain current section 195 must adopt either the first or third alternative. The statute would be largely "meaningless" if most substantial, less frequently recurring start-up-type costs would not be currently deductible in operation, or expansion, of an existing business under the functional distortion of income analysis of the second choice. However, such a capitalized start-up cost would be amortizable as a free-standing asset under the model. The mechanism for undercutting the statute—the continuing shot-in-the-foot statutory reference point of current deductibility—can now be seen. Whether courts should yield instead to the adminis-

³⁹⁸ See *supra* text accompanying note 331.

³⁹⁹ This is the approach taken by the Fourth Circuit in *NCNB II*, 684 F.2d 285 (4th Cir. 1982) (en banc) and the Tax Court in *Johnsen v. Commissioner*, 83 T.C. 103 (1984), rev'd on other grounds, 794 F.2d 1157 (6th Cir. 1986).

⁴⁰⁰ This is the effect of *NCNB I*, 651 F.2d 942 (4th Cir. 1981), vacated and remanded en banc, 684 F.2d 285 (4th Cir. 1982), notwithstanding Judge Murnaghan's protestations to the contrary. See 684 F.2d at 294-95 (Murnaghan, J., dissenting).

⁴⁰¹ See *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228-29, 234-35 (1985); see also *Johnsen*, 794 F.2d at 1162-63 (adopting capitalization theory for start-up costs, but seeking to preserve § 195); accord *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1185-86 (5th Cir. 1984).

⁴⁰² I.R.C. § 195(c)(1)(B).

trative practicabilities of the third or first alternatives turns on the other defects in section 195, also arising from loosely tacked-on tax reform. Thus, the question to be asked as these further defects are explored is whether section 195 is so seriously flawed that, absent further amendment, courts should fashion a more equitable framework, along the lines of the model, outside of—and largely ignoring—the statutory provision.

C. Exclusivity of Section 195: When Does an Active Business Begin and Confusion End?

1. Introduction

The commencement point of a trade or business, for purposes of section 195 as enacted, had two intended consequences. First, if an activity never reached that point, start-up costs incurred in the activity could not be amortized under section 195. Second, the sixty-month or longer amortization could not commence until this point. Additionally, perhaps as an unintended consequence, expenditures incurred after this point presumably could not be amortized under section 195.⁴⁰³ Current section 195(b)(1) and (d)(1) continue this requirement, adding, however, that amortization begins with the month in which the *active* trade or business begins. Thus, both original and amended section 195 narrowly limit the sixty-month amortization to start-up expenditures that are paid or incurred in connection with an (active) trade or business that the taxpayer *actually* begins.⁴⁰⁴ The result of this provision is that “no deduction is allowed . . . with respect to items incurred incident to a trade or business which actually is not commenced or acquired by the taxpayer.”⁴⁰⁵

While this prerequisite clearly rules out amortization of investigatory or pre-operating expenses of an enterprise that never actually commences business operations, it also might rule out amortization of unsuccessful investigations preceding an investigation of a business ultimately commenced or acquired by the taxpayer. Traditionally, the cost of unsuccessful general investigations is not

⁴⁰³ See Lathen & Lathen, The “Gap Period” Problem in Section 195, 62 Taxes 416, 419-22 (1984).

⁴⁰⁴ See S. Rep. No. 1036, *supra* note 9, at 13-14.

⁴⁰⁵ *Id.* at 13.

added to the cost of a subsequent successful acquisition.⁴⁰⁶ Consequently, the costs of the unsuccessful investigation in the same field probably cannot be added to the cost, amortizable under section 195, incurred as to an active business entered into in that field.⁴⁰⁷

Congress intended that situations not covered by section 195 would be covered by section 165, if at all.⁴⁰⁸ However, only those unsuccessful investigatory expenses going beyond a general search to focus on the acquisition or creation of a specific business or investment that is not consummated are deductible under section 165, as a loss incurred in a transaction entered into for profit.⁴⁰⁹ These rules are harsh ones; they were likely intended as barriers to fictitious claims.⁴¹⁰ This rationale may also be one of the primary reasons for the prior case law generally taking a harsh approach to

⁴⁰⁶ See Rev. Rul. 77-254, 1977-2 C.B. 63, 64 (general investigatory costs incurred prior to focusing on specific acquisition were personal, thus not deductible under § 165); Rev. Rul. 73-421, 1973-2 C.B. 34 (travel expenses in search of a business site were not incurred in carrying on a trade or business). Contrary arguments have been made that unsuccessful acquisition costs should be added to the cost of assets actually acquired. See Wabich, *Expenses Relating to Abandoned Acquisitions and Business Expansion: Capital vs. Ordinary*, 64 *Taxes* 377, 379-80 (1986).

⁴⁰⁷ See Shapiro & Shaw, *supra* note 341, at 11-23 (raising issue whether general investigatory costs may be added to basis of subsequent related acquisitions); see also Solomon & Weintraub, *Business Start-Up Expenses and Section 195: Some Unresolved Problems*, 60 *Taxes* 27, 31 (1982), reprinted in 7 *Rev. Tax'n Individuals* 123, 131 (1983).

⁴⁰⁸ S. Rep. No. 1036, *supra* note 9, at 14, stated that start-up costs of a business with an ascertainable useful life of less than 60 months may not be amortized under § 195. However, the start-up costs will remain subject to pre-§ 195 rules, which will apply to any remaining unamortized amount upon termination of a business prior to the end of the 60-month or longer amortization period. "Therefore, in an appropriate instance, a taxpayer may deduct any unamortized amount as a loss (Code sec. 165) or an unamortized amount might be carried over to the taxpayer's successor in interest" *Id.*; see also S. Print No. 169, *supra* note 348, at 283.

⁴⁰⁹ Section 165 limits an individual's losses, other than trade or business or casualty, etc., losses, to "losses incurred in any transaction entered into for profit, though not connected with a trade or business." I.R.C. § 165(c)(2). After considerable controversy, the Tax Court and the Service agreed that the investigatory costs of a failed acquisition are deductible under this provision once the taxpayer has gone beyond a general search and focused on the acquisition of a specific business or investment, but then failed to consummate the attempted acquisition. *Seed v. Commissioner*, 52 T.C. 880 (1969), *acq.*, 1970-2 C.B. xxi; Rev. Rul. 77-254, 1977-2 C.B. 63. See generally, Seago, *supra* note 2, at 413-14; Wilberding, *supra* note 175, at 232-43; Comment, *Transaction Test for Federal Income Tax Loss Deductions*, 27 *Wash. & Lee L. Rev.* 158 (1970).

⁴¹⁰ See Sharp, *Tax Relief for New Businesses: Equitable Treatment of Start-Up Costs*, 57 *Taxes* 695, 699 (1979).

investigatory expenses.⁴¹¹ However, as commentators have pointed out, "the appropriate remedy for abuse is a skeptical eye, not a rigid rule of law."⁴¹²

2. Source of the Problem

a. Commencement Point of Amortization

H.R. 5729, as originally introduced, pegged commencement of amortization to "the month the trade or business starts functioning as a going concern."⁴¹³ This formulation clearly was modeled on the *Richmond Television*, section 162 test, under which a taxpayer was not yet carrying on a trade or business "until such time as the business has begun to function as a going concern and performed those activities for which it was organized."⁴¹⁴ The Tax Court also has followed this test.⁴¹⁵

However, by 1980 the answer to when a trade or business commences for purposes of section 162 was no longer unanimous. In that year a district court in the Fourth Circuit ruled that recurring payments made by the taxpayer for wages, employee training, utilities, promotion and consumable supplies, and advertising were currently deductible under section 162 for the period from the first of its tax year to the date in the same year that the taxpayer obtained a permit to conduct its business.⁴¹⁶ The district court functionally reasoned that the one-year rule⁴¹⁷ (providing in part that an expenditure producing a benefit that is exhausted completely within the tax year is currently deductible) applied to a new business during the first tax year in which it began operations, there-

⁴¹¹ Note, *supra* note 179, at 88.

⁴¹² 1 B. Bittker, *supra* note 5, ¶ 20.4.4, at 20-77 to 20-78; accord Shapiro & Shaw, *supra* note 341, at 11-21 & n.20.

⁴¹³ H.R. 5729, 96th Cong., 1st Sess. § 1 (proposed § 193(a)), reprinted in 1980 Hearings, *supra* note 2, at 181.

⁴¹⁴ *Richmond Television Corp. v. United States*, 345 F.2d 901, 907 (4th Cir.), vacated and remanded on other grounds, 382 U.S. 68 (1965); see *supra* note 214 and accompanying text.

⁴¹⁵ See, e.g., *Bennett Paper Corp. v. Commissioner*, 78 T.C. 458, 463 (1982), *aff'd*, 699 F.2d 450 (8th Cir. 1983); *Todd v. Commissioner*, 77 T.C. 246, 249 (1981), *aff'd*, 682 F.2d 207 (9th Cir. 1982); *Goodwin v. Commissioner*, 75 T.C. 424, 433 (1980), *aff'd mem.*, 691 F.2d 490 (3d Cir. 1982); see also *Aboussie v. United States*, 779 F.2d 424, 428 (8th Cir. 1985) (court held that "carrying on a business" starts when facts show that taxpayer almost certainly will engage in a profit-seeking activity).

⁴¹⁶ *United States v. Manor Care, Inc.*, 490 F. Supp. 355 (D. Md. 1980); see *supra* note 219.

⁴¹⁷ See *supra* note 247.

fore producing no distortion of income. At the same time, the litigation leading to the *Blitzer* decision had commenced.⁴¹⁸ *Blitzer* applied a functional profit-motivated noninvestment analysis to the section 162 carrying on a trade or business proviso. This analysis in effect pegged practical commencement of a business to activities committing the taxpaying to an identifiable business activity, and it rejected a requirement of carrying on revenue-producing operations as "an inflexible temporal prerequisite for the application of I.R.C. § 162(a)."⁴¹⁹

Moreover, the Service's audit activity in this area had increased by the eve of enactment of section 195, with heavy reliance on *Richmond Television*.⁴²⁰ Viewing the "functioning as a going concern" criterion as erroneous, witnesses argued at the 1980 Hearings on the proposed new section that such a test would leave "open for controversy identification of the point at which a trade or business begins to function as a going concern. Moreover, it [would] depart[] from the formulation already adopted in the Code in closely analogous situations,"⁴²¹ i.e., the regulations under section 248 and 1372(e)(5).⁴²² The witnesses representing industry at the 1980 Hearings apparently feared that the Service would use section 195 and its proposed "functioning as a going concern" standard to backstop the Service's audit and litigating posture that no deduction was allowable under section 162 until the business began to function as a going concern,⁴²³ which in fact proved to be the case.⁴²⁴

Section 195, as enacted, provided that the "not less than 60 months" amortization period commenced with the month in which the business began.⁴²⁵ Other than a reference to when an acquired

⁴¹⁸ *Blitzer v. United States*, 684 F.2d 874, 880 (Ct. Cl. 1982). For a discussion of *Blitzer*, see *supra* notes 193-213 and accompanying text.

⁴¹⁹ 684 F.2d at 880.

⁴²⁰ See 1980 Hearings, *supra* note 2, at 45, 101-02 (statements of Charles M. Walker, Chairman, Section of Taxation, A.B.A., and of Samuel M. Chase, Jr., Chairman, Legislative Ad Hoc Subcommittee on Real Estate Securities, Nat'l Ass'n of Realtors, respectively).

⁴²¹ *Id.* at 45 (statement of Charles M. Walker).

⁴²² Treas. Reg. §§ 1.248-1(a)(3), 1.1372-4(b)(5)(ii)(b).

⁴²³ See 1980 Hearings *supra* note 2, at 102, 113 (statements of Samuel M. Chase, Jr., Chairman, Legislative Ad Hoc Subcommittee on Real Estate Securities, Nat'l Ass'n of Realtors, and of Paul W. Clevenger, Vice President, Taxes, UAL, Inc., respectively).

⁴²⁴ See, e.g., *Johnsen v. Commissioner*, 794 F.2d 1157, 1163 (6th Cir. 1986); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228 (1985).

⁴²⁵ I.R.C. § 195(a) (1980) (parenthetical language).

business began (when acquired),⁴²⁶ the 1980 statute was silent as to when such event actually occurred. The 1980 Committee Reports, however, stated that:

The month of acquisition is to be determined with regard to the economic substance of each situation. Generally it is anticipated that the definition of when a business begins is to be made in reference to the existing provisions for the amortization of organizational expenditures (Code secs. 248 and 709). Generally, if the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.⁴²⁷

Ironically, earlier in *Richmond Television* and in some of its progeny, taxpayers argued to no avail, based upon the section 248 regulations (the section 195 legislative history's reference point), that a business commenced for purposes of section 162 as soon as its activities advanced to the extent necessary to establish the nature of the business operations.⁴²⁸

⁴²⁶ I.R.C. § 195(d) (1980). The month of acquisition was to be determined with regard to the economic substance of each situation. S. Rep. No. 1036, supra note 9, at 14.

⁴²⁷ S. Rep. No. 1036, supra note 9, at 14.

⁴²⁸ In a previous article, the author noted that:

The district court in *Richmond Television Corp. v. United States*, 66-2 U.S.T.C. ¶ 9589 (E.D. Va. 1963), clearly relied upon these regulations [Treas. Reg. § 1.248-1(a)(3)] in giving the jury instructions as to when a business commences. Unfortunately, before the Fourth Circuit the taxpayer merely relied upon the section 248 regulations for the somewhat attenuated argument that since start-up costs were not mentioned in such regulations as chargeable to capital account they were not required to be capitalized. Brief for Appellee at 15, *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965). Ironically, while many commentators have suggested that the [sic] section 248 strongly supports the argument that trade or business status can attach prior to full grown operations, its first explicit presentation to a court after *Richmond Television* was an individual hobby loss case, rather than a preoperating expense case. Justin A. McNamara, 32 T.C.M. 11, 16 (1973). Instead of pointing out that the section 248 regulations speak only to when a business commences and not to whether the requisite profit motive is present, the Tax Court broadly announced: "Our attention has not been called to, nor have we found any case which holds or even implies that the test set forth in section 1.248-1(a)(3) has any applicability to determining whether an enterprise in other than corporate form was [sic] actually entered into a trade or business for purposes of section 162(a)."

Lee, supra note 122, at 460 n.481.

In *Davis v. Commissioner*, the taxpayer similarly relied to no avail upon the § 248 regula-

Some commentators concluded that the above strands created a "gap" under which a business might "begin" for purposes of commencement of amortization under section 195 (starting at the section 248 regulations' standard of when the nature of the business is determined) at a point considerably earlier than under the *Richmond Television* test of when income-producing activities commence (before which time expenditures cannot be deducted under section 162(a)). The commentators claimed that start-up expenses incurred during this "gap" arguably could be neither currently deducted under traditional section 162 definitional authorities nor amortized under section 195. Accordingly, they argued that to achieve the legislative goal of reducing disparity between new and existing businesses recurring "gap" expenses producing short-term benefits should be currently deductible under *Blitzer*.⁴²⁹

The Service chose, probably wisely, to ignore the legislative history,⁴³⁰ as evidenced by Revenue Ruling 81-150.⁴³¹ In subtle reliance on *Richmond Television*, this Ruling held that a limited partnership, organized in 1980 to construct an offshore drilling rig and to engage in contract drilling after its completion in July 1981, did not begin a trade or business for purposes of section 195 until July 1981 and that section 162 amortization also could not begin until that date.⁴³²

tions in a pre-opening context. 45 T.C.M. (CCH) 1070, 1074 n.7 (1983). Moreover, the Tax Court applied the *Richmond Television* actual business operations test to deny current deductibility of pre-opening expenses of a subchapter S corporation. *Scott v. Commissioner*, 46 T.C.M. (CCH) 1324 (1983). The *Scott* court did so despite the taxpayer's reliance on the § 1372 regulations, which provide, for purposes of the passive investment income test, that "a corporation will be deemed to have commenced the active conduct of a trade or business in the taxable year in which it first engages in activities (other than activities merely incidental to the organization of the corporation) designed or intended to enable it to engage in any business operations." Treas. Reg. § 1.1372-4(b)(5)(ii)(b)), quoted in *Scott*, 46 T.C.M. at 1329. The more recently drafted "commencement of business" regulations attempt to push commencement to a later date. See *supra* note 211.

⁴²⁹ E.g., Lathen & Lathen, *supra* note 403, at 419-22.

⁴³⁰ See *id.* at 422 (reporting that one author of unpublished draft § 195 regulations stated that the draft provided that the beginning of business, for purposes of § 195, was when it began for purposes of § 162, presumably under the *Richmond Television* test).

⁴³¹ 1981-1 C.B. 119.

⁴³² *Id.* at 120. The Revenue Ruling held that under *Richmond Television* the partnership was not carrying on a trade or business until July 1981, when completion and operation of the drilling rig took place; therefore, the management fee could not be deducted under § 162. As to § 195, the Ruling flatly stated that the amortization period began July 1981, without mentioning any authority. *Id.* The Service thus ignored the statement in the 1980

b. By-Passing Section 195

More serious problems, at least from the perspective of the Department of the Treasury's main objective of encouraging use of section 195 and decreasing controversies, were the foreseeable⁴³³ *Blitzer* and the unforeseeable *Hoopengartner* developments. After the enactment of section 195, the Court of Claims concluded in *Blitzer*,⁴³⁴ albeit in dictum, that for purposes of section 162 a partnership organized to construct and operate a low-income housing project commenced carrying on its business no later than the date by which it (1) acquired title to the land for the project, (2) executed its building loan agreement, and (3) received substantial funds under the agreement, although construction of the partnership's income-producing asset had not begun. Thus, under *Blitzer* any recurring noncapital expenditures incurred after such events (amounting to a commitment to the identifiable business and the acquisition of an asset to be used in the business, even though not an operating asset) could be currently deducted under section 162(a). The decision by the Court of Claims in *Blitzer* thereby rendered section 195 superfluous as to recurring pre-opening costs (but not as to investigatory costs), as the drafters of the statute should have anticipated. To similar effect, the Tax Court in *Hoopengartner*⁴³⁵ subsequently permitted a current deduction of noncapital expenditures under section 212 to commence upon the acquisition of a property interest in a nonoperating asset, specifically a ground lease on which a building would be constructed to be used in an anticipated active rental business. Not surprisingly, a substantial number of affected taxpayers did not elect to amortize start-up expenditures under section 195, but argued instead, against Service opposition, that the costs were currently deductible

Committee Reports that when a business begins should be defined in light of the definition provided by §§ 248 and 709, i.e., when the partnership's activities "have advanced to the extent necessary to establish the nature of its business operations." S. Rep. No. 1036, *supra* note 9, at 14.

⁴³³ See 1980 Hearings, *supra* note 2, at 102, 106 (statement of Samuel M. Chase, Jr., Chairman, Legislative Ad Hoc Subcommittee on Real Estate Securities, Nat'l Ass'n of Realtors).

⁴³⁴ *Blitzer v. United States*, 684 F.2d 874, 880 (Ct. Cl. 1982).

⁴³⁵ *Hoopengartner v. Commissioner*, 80 T.C. 538 (1983), *aff'd mem.*, 745 F.2d 66 (9th Cir. 1984); see *supra* note 175.

under either section 162 or section 212.⁴³⁶

3. 1984 Amendments

In 1984 Congress amended section 195 to deal with the problem of taxpayers currently deducting pre-opening costs under section 162 or 212. As a "clarification"⁴³⁷ of the original definition of start-up costs, Congress added a third category—costs paid or incurred in connection with "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business."⁴³⁸ This amendment was expressly intended⁴³⁹ to cover the annual ground rent expenses permitted as a current deduction in *Hoopengartner*.⁴⁴⁰ At the same time that Congress broadened the definition of start-up costs in 1984, it preempted any further current deductions under section 162 or 212 as to *targeted* start-up costs by denying any deduction for a start-up expenditure other than as an amortization deduction under section 195, with minor exceptions.⁴⁴¹ The 1984 amendments also provided, without any explanation in the legislative history, that "legislative" regulations would determine when an *active* trade or busi-

⁴³⁶ S. Print No. 169, *supra* note 348, at 282.

⁴³⁷ The Senate Print stated that:

Present law is unclear whether a specific item should be capitalized[,] expensed, or amortized as provided in section 195. For example, some taxpayers who do not elect to amortize start-up expenditures under section 195 have argued that start-up expenditures are currently deductible as ordinary and necessary expenses under section 162, and, in any event, are deductible under section 212 as expenses paid or incurred in connection with property held for the production of income. The Internal Revenue Service disagrees with both these positions.

Id.

⁴³⁸ Tax Reform Act of 1984, Pub. L. No. 98-369, § 94(a), 98 Stat. 494, 615 (codified at I.R.C. § 195(c)(1)(A)(iii)).

⁴³⁹ S. Print No. 169, *supra* note 348, at 282-83.

⁴⁴⁰ See *supra* note 175.

⁴⁴¹ I.R.C. § 195(a) (1984); S. Print No. 169, *supra* note 348, at 283. The Conference Committee properly carved out, from the scope of § 195 capitalization, amounts deductible under §§ 163(a), 164, or 174. I.R.C. § 195(c) (1984) (flush language); H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 896-97, reprinted in 1984 U.S. Code Cong. & Admin. News 1445, 1584-85. The Senate Finance Committee believed that "start-up expenditures generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred. Therefore, such expenditures should not be fully deductible when paid or incurred but rather should be deducted over a longer term." S. Print No. 169, *supra* note 348, at 282-83.

ness begins.⁴⁴²

The linchpin to the section 195 preemption of the current deduction of start-up costs is the determination of when an active trade or business begins. If it begins as soon as the business can be identified, both *Hoopengarner* and *Blitzer* can still come into play as to expenses incurred from that point until revenue-producing operations commence. Thus, as a practical matter, under this approach to determining the commencement of business section 195 "capitalization" and "amortization" would be limited to investigatory expenses.⁴⁴³ Clearly, Congress did not intend this,⁴⁴⁴ and the "legislative" regulations undoubtedly will peg the beginning of an *active* business to some point close to, or identical with, the beginning of revenue-producing operations.⁴⁴⁵ Nevertheless, within the four corners of the 1980 and 1984 legislative histories, the only mention of when a business or active business begins appears in the 1980 reference to the model of "identification of the business" found in sections 248 and 709. To discern the intended scope of the legislative regulations for determining when an active business begins, namely, commencement of revenue-producing operations or functioning as a going concern, (1) the 1984 legislative intent of preempting *Hoopengarner* by section 195, (2) the reference to taxpayer arguments (implicitly based on *Blitzer*) that start-up costs are currently deductible under section 162(a), which the Committees apparently also intended to preempt,⁴⁴⁶ and (3) the rationales

⁴⁴² I.R.C. § 195(c)(2)(A) (1984).

⁴⁴³ Under the *Blitzer* approach, investigatory expenses are usually incurred before the taxpayer acquires assets identifying the business. See 684 F.2d at 880. Moreover, such expenses more easily fall into an acquisition cost mold. See *supra* notes 216 & 218 and accompanying texts. Under a functional analysis, investigatory costs are more likely to be non-recurring than start-up costs.

⁴⁴⁴ The Senate Finance Committee explicitly stated that it intended that the *Hoopengarner* expenses be covered by § 195, i.e., "capitalized" and electively amortized. S. Print No. 169, *supra* note 348, at 283. The Joint Committee on Taxation Staff explicitly cited *Blitzer*, to which the Finance Committee Report only alluded. General Explanation, *supra* note 215, at 296; cf. S. Print No. 169, *supra* note 348, at 283.

⁴⁴⁵ Thus, the circle will close, returning commencement of amortization closer to the original proposal of "the month the trade or business starts functioning as a going concern." See *supra* note 330 and accompanying text. See generally Lathen & Lathen, *supra* note 403, at 422-23.

⁴⁴⁶ The Senate Finance Committee Report referred only to arguments under § 162 and not to *Blitzer* specifically, unlike its references to § 212 and *Hoopengarner*. See S. Print No. 169, *supra* note 348, at 282. This omission may have been due to the *Blitzer* "preemption gap." See *supra* note 429 and accompanying text. In the alternative, it may point out the

of *Blitzer* and *Hoopengartner* must be read together.

Assuming that the regulations provide that an active business begins no earlier than commencement of revenue-producing operations, *Hoopengartner* will have been legislatively overturned. The situation as to *Blitzer* will be far less clear. The Court of Claims, while speaking to the very types of expenditures described in the 1980 legislative history of section 195 as start-up costs when incurred prior to actual operation,⁴⁴⁷ reasoned that normal recurring expenses (utility bills, rent, stationery, and compensation) do not provide benefits beyond the tax year in question and, hence, are currently deductible under section 162(a) once the business commences.⁴⁴⁸ Under *Blitzer*, the new business begins for purposes of section 162 as soon as it is committed to and assets (identifying the business) are acquired. The key to the efficacy of the 1984 changes in this regard is whether such normal recurring expenses incurred after business commences under the *Blitzer* approach, but prior both to completion of construction or acquisition of income-producing assets and to functioning as a going concern under the *Richmond Television* approach, creates an asset with a useful life extending substantially beyond the tax year in which incurred (i.e., the business itself of an increase in earning power). Only if the recurring pre-opening costs can be said to "create" an active business are they covered by the mandatory "capitalization" of new section 195(a). New section 195 applies only to "start-up costs" and the "Congress believed that start-up expenditures generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred";⁴⁴⁹ otherwise, such expenditures will be currently deductible under section 162 under both *Blitzer* and a distortion of income approach to capitalization. Paradoxically, if start-up expenditures do constitute such an acquisition cost, they generally should not be currently de-

embarrassing fact that the drafters of original § 195 should have been on notice as to the potential holding and impact of *Blitzer*. See 1980 Hearings, *supra* note 2, at 102, 106 n.1 (statements of Samuel M. Chase, Jr., Chairman, Legislative Ad Hoc Subcommittee on Real Estate Securities, Nat'l Ass'n of Realtors). In any event, the General Explanation explicitly referred to *Blitzer*. See *supra* note 444.

⁴⁴⁷ See S. Rep. No. 1036, *supra* note 9, at 11; see *supra* note 315.

⁴⁴⁸ *Blitzer*, 684 F.2d at 880; see Fowler, Continuing Saga of Start-Up Costs and Their Identification, 17 Tax Adviser 244, 248 (1986).

⁴⁴⁹ General Explanation, *supra* note 215, at 296.

ductible in "operation" under section 162(a) because a current deduction would produce distortion of income.⁴⁵⁰

Blitzer assumes that such expenses do *not* result in the acquisition of such a long-lived benefit.⁴⁵¹ To the contrary, the legislative history of the 1984 amendments to section 195 (in a *shift* from the rationale underlying the 1980 enactment of section 195, rather than in a "clarification"),⁴⁵² as well as decisions such as *Richmond Television*,⁴⁵³ *Central Texas Savings & Loan*,⁴⁵⁴ *Cleveland Electric Illuminating*,⁴⁵⁵ and *Johnsen*,⁴⁵⁶ assume that they do. Thus, the exclusivity of section 195 as to recurring expenditures producing short-term benefits incurred prior to commencement of revenue-producing operations likely will be established only through additional litigation. A better solution would be to explicitly amend section 162.

4. Suggested Solution

The lesser problem is when a business commences for purposes of section 195. Symmetry undoubtedly mandates that a business begin for purposes of section 195 at the same point that a business is first being carried on for purposes of section 162. From a functional point of view this stage will be as soon as the activity is identifiable as being profit motivated rather than an investment. However, the regulations under section 195 most likely will peg commencement of an active business to when the business begins

⁴⁵⁰ See *supra* notes 35-38 and accompanying text.

⁴⁵¹ 684 F.2d at 880 (recurring expenditures, e.g., utilities, rent, and office expenses, incurred prior to carrying on revenue-producing operations did not provide benefits extending beyond the current tax year).

⁴⁵² Compare *supra* notes 376-77 and accompanying text with *supra* note 395 and accompanying text.

⁴⁵³ *Richmond Television* capitalized pre-opening staff training costs and added them to the basis of a nonamortizable operating permit. See *supra* note 112. In *Francis v. Commissioner*, however, the Tax Court treated recurring pre-operating expenses (insurance, professional fees, office supplies, auto and travel costs, etc.) as acquisition costs of the business entered into. 36 T.C.M. (CCH) 704 (1977). *Blitzer* dismissed *Francis* on the grounds that it was devoid of "critical analysis." 684 F.2d at 880.

⁴⁵⁴ *Central Texas Savings & Loan* involved investigatory survey and permit costs. 731 F.2d at 1182. Such costs were more easily fit into the acquisition cost analysis the opinion espoused than recurring pre-opening costs would be. See *supra* full paragraph in text following note 318; see also *supra* note 443.

⁴⁵⁵ 7 Cl. Ct. at 228.

⁴⁵⁶ 794 F.2d at 1162.

to function as a going concern in order to backstop section 195's new anti-shelter preemption. The section 162 authorities, in time, may also be expected to yield to this standard.

The actual root of the problem in preemption by section 195 is the continued disparity between new businesses and existing businesses; the former are limited to sixty-month amortization of expenditures that the latter can deduct currently. Similar rules should apply to similar expenses incurred by both new and existing businesses. Therefore, the ideal solution is to cover both new business start-up and existing business expansion costs under the same statutory provision, allowing a current deduction or five-year, eighteen-year, or twenty-year amortization, depending upon articulated functional factors.⁴⁶⁷ If such an equitable solution is not enacted, courts will best achieve equity by reading section 195 so as to take substantial long-term benefit pre-operating and business expansion costs out of its penumbra. This position can be based on the ground that such costs, as capital expenditures, will not be currently deductible in operation but instead will be amortizable as free-standing costs by estimating their useful life equitably under *Cohan*. However, this case-by-case approach will generate continued controversy and may lead most courts "to bow to the will of Congress"⁴⁶⁸ in codifying past judicial error, at least as to start-up costs.

D. Exclusion of Business Expansion Costs: Don't Bank on Pyrrhic Victories

1. Source of the Problem

The 1980 Hearings on H.R. 5729 aired two problems regarding the then-proposed new section and expansion costs of existing businesses: whether the new provision would overturn the prior bank credit card "method of business" precedents and whether an existing business expanding through new *branches* would be able to use the proposed section if the new branch start-up costs had to be capitalized. A witness suggested that the first problem should

⁴⁶⁷ See *supra* full paragraph in text following note 172; see also *supra* full paragraph in text following note 319.

⁴⁶⁸ *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 380 n.10 (1983); see *supra* note 320.

be resolved by committee reports providing that the section was "not intended to create any presumptions about the state of the law concerning start-up expenditures in prior taxable years."⁴⁵⁹ The second problem, the witness continued, should be solved by the statute or committee reports clarifying that the section was "not intended to penalize existing businesses if they would otherwise meet the qualifications to amortize expenditures under section [195], and that the new section should be given reasonable interpretation as applicable to existing organizations."⁴⁶⁰

Instead, the 1980 Committee Reports stated that amortizable start-up expenditures did not include ordinary and necessary business expenses incurred in connection with the expansion of an existing trade or business; rather, "[a]s under present law [prior to *NCNB I* and *Central Texas Savings & Loan*], such expenditures will continue to be currently deductible."⁴⁶¹ The determination, however, of whether there has been an expansion of an existing business or an entering into a new trade or business "is to be based on the facts and circumstances of each case as under present law."⁴⁶² In the context of the 1980 "present law" preparatory doctrine, the Tax Court regularly defined the taxpayer's existing business narrowly, particularly in the context of real estate, where it believed that rental holdings in different geographic locations constituted different businesses⁴⁶³ and that development (construction for sale or rental) of residential, commercial, and industrial real estate constituted different businesses.⁴⁶⁴ The Fourth Circuit flatly

⁴⁵⁹ 1980 Hearings, *supra* note 2, at 110 (statement of Gerald W. Padwe, Associate National Director, Tax Services, Touche Ross & Co.).

⁴⁶⁰ *Id.* at 115 (supplemental statement of Gerald W. Padwe).

⁴⁶¹ S. Rep. No. 1036, *supra* note 9, at 12.

⁴⁶² *Id.*

⁴⁶³ *Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977); see *Odom v. Commissioner*, 44 T.C.M. (CCH) 113 (1982) (also looked at substantiality of compared rental activities); *Sheban v. Commissioner*, 29 T.C.M. (CCH) 727 (1970) (similarity of activities not shown); cf. *O'Donnell v. Commissioner*, 62 T.C. 781, 785-86 (1974), (substantiality of activities in the existing business constituting a material factor), *aff'd*, 519 F.2d 1406 (7th Cir. 1975); *Preseault v. Commissioner*, 34 T.C.M. (CCH) 685, 687 (1975). *Contra Malmstedt v. Commissioner*, 578 F.2d 520, 527 & n.13 (4th Cir. 1978). The Tax Court's position as to geographic separation conflicts with the current law concerning conduct of the same or of different active business under § 355(b)(2). See Lee, Proposed Regs. Under 355 Overhaul Device Test and Single Business Divisions, 46 J. Tax'n 194, 198-99 (1977).

⁴⁶⁴ *York v. Commissioner*, 29 T.C. 520, 526-27 (1957) (residential and commercial development not the same as industrial development), *rev'd*, 261 F.2d 421 (4th Cir. 1958); accord

disagreed on both points.⁴⁶⁵ The Tax Court, however, on occasion took a broader approach similar to the new methods/new business line drawn by some of the bank credit card cases,⁴⁶⁶ where neither real estate nor geographic expansion was involved.⁴⁶⁷ It followed a particularly expansive approach as to the business of being an employee.⁴⁶⁸

Subsequently, the Claims Court in *Cleveland Electric Illuminating* added to the confusion as to the "present law" line between expansion of an existing business and entering a new trade or business.⁴⁶⁹ The court found that nuclear generation of electricity was a new and different business than generation of electricity by conventional fossil fuel plants.⁴⁷⁰ Yet, under the bank credit card cases, nuclear generation appears to be merely a new way of carrying on the existing business of generating electricity.⁴⁷¹ It was exceedingly poor drafting, even for congressional committee reports, to specifically incorporate an area in which there was an existing conflict between the Tax Court and other tribunals⁴⁷² (with other conflicts to develop) as to what the "present law" then was regard-

Malmstedt v. Commissioner, 35 T.C.M. (CCH) 199 (1976), rev'd, 578 F.2d 520 (4th Cir. 1978).

⁴⁶⁵ *Malmstedt*, 578 F.2d at 526-27; *York*, 261 F.2d at 422.

⁴⁶⁶ See supra note 229 and accompanying text.

⁴⁶⁷ See *Brown v. Commissioner*, 39 T.C.M. (CCH) 397 (1979) (development of computer monitored learning program was part of existing business of tutoring learning disabled); *Equitable Life Ins. Co. v. Commissioner*, 36 T.C.M. (CCH) 1184 (1977) (costs of registering certain variable annuity contracts with the Securities and Exchange Commission by a company's subsidiary were currently deductible).

⁴⁶⁸ See *Primuth v. Commissioner*, 54 T.C. 374, 377-78 (1970). For its progeny, see, e.g., *Black v. Commissioner*, 60 T.C. 108, 113 (1973) (employment agency fee was deductible although new job in same field obtained independently); *Cremona v. Commissioner*, 58 T.C. 219, 220-22 (1972) (employment agency fee was deductible although taxpayer remained employed at old job); *Kenfield v. Commissioner*, 54 T.C. 1197, 1199-1200 (1970) (employment agency fee was deductible, although taxpayer accepted a new job obtained through an agency, then stayed with his old job because he received a promotion resulting from the new job offer); *Motto v. Commissioner*, 54 T.C. 558, 559 (1970) (employment agency fee was deductible, even when the new job obtained is in the same field). See generally Tucker, *An Individual's Employment-Seeking Expenses: Analyzing the New Judicial Climate*, 34 J. Tax'n 352 (1971); Note, *Federal Income Tax Treatment of Business and Employment Investigatory Expenses*, 56 Minn. L. Rev. 1157 (1972).

⁴⁶⁹ 7 Cl. Ct. 220 (1985).

⁴⁷⁰ *Id.* at 229.

⁴⁷¹ See supra note 229 and accompanying text.

⁴⁷² Compare supra note 464 and accompanying text with supra note 465 and accompanying text.

ing expansion versus new business. This situation represents still another case of tacked-on reform producing the antithesis of simplification, i.e., unpredictability.

Possibly the drafters of the 1980 Committee Reports left open the question of "expansion" so that taxpayers in "marginal cases" would choose amortization under section 195. However, had the drafters drawn a bright line between start-up and expansion costs, some taxpayers would have chosen current deductions under section 162 rather than amortization under section 195. The drafters may have believed that the uncertainty of hanging definitions would force more taxpayers to the certainty of section 195.⁴⁷³ Experience with deductions claimed under *Blitzer* and *Hoopengartner* suggest that this would not have been the case.⁴⁷⁴

Once again, a more fundamental issue than the statutory mechanism for exempting expansion costs of existing businesses from section 195 amortization is the question of why Congress intended preferential treatment for an existing business (current deduction) as contrasted with a new business (only sixty-month amortization). Clearly the sixty-month or longer period for amortization under new section 195(b)(1) was copied from sections 248 and 709,⁴⁷⁵ which provide sixty-month amortization of organizational expenditures by corporations and partnerships, respectively. A major proponent pronounced the sixty-month amortization as more desirable than the immediate deduction for many businesses:

This is because the first few years of a business operation often show low profits so that immediate deductibility might generate a net operating loss. A net operating loss can be complicated for a small businessman to handle. Thus, spreading the deductibility of startup expenses over 5 years may correspond more closely to the earnings growth of a new business.⁴⁷⁶

⁴⁷³ See *supra* note 355 and accompanying text.

⁴⁷⁴ Congress estimated in 1980 that amortization under § 195 would *reduce* fiscal year budget receipts by \$22 million in 1981, \$73 million in 1982, \$121 million in 1983, \$180 million in 1984, and \$254 million in 1985. S. Rep. No. 1036, *supra* note 9, at 14. The 1984 amendments, precluding a current § 162 (*Blitzer*) or § 212 (*Hoopengartner*) deduction, were expected to *increase* fiscal year budget receipts by \$23 million in 1985, \$36 million in 1986, \$31 million in 1987, \$26 million in 1988, and \$19 million in 1989. S. Print No. 169, *supra* note 348, at 283.

⁴⁷⁵ Compare the statements in the 1980 Hearings, *supra* note 2, with S. Rep. No. 1036, *supra* note 9, at 14. See generally Krane, *supra* note 10, at 310-11.

⁴⁷⁶ 126 Cong. Rec. 24,813 (1980) (statement of Rep. Conable, introducer of H.R. 5729).

More likely, however, sixty-month amortization was chosen as a compromise to the all-or-nothing stakes of pre-section 195 case law.⁴⁷⁷

Tax reform, particularly tax simplification, has no substantial natural lobby,⁴⁷⁸ at least prior to President Reagan's efforts in 1985-86. Therefore, simplification projects must tread a narrow path to reach a "collegial" understanding among the tax profession interest groups themselves—Joint Committee, Treasury, and Service staffs and tax section representatives from the professional associations of tax accountants and lawyers⁴⁷⁹—*without* stirring up any opposed special interest groups along the way. During the deliberations over section 195, the banks obviously were concerned that their judicial victories regarding credit card business expansion might be lost in the legislative arena.⁴⁸⁰ Perhaps this led Congress to preclude section 195 from limiting existing businesses to sixty-month amortization of start-up-like costs.

In any event, the compromise sixty-month amortization of new business start-up costs continued the disparity between a new business and an ongoing business; consequently, the seeds of controversy continue to germinate. A more serious consequence to section 195's efficacy arising from the exemption of existing business (through the 1980 "deductible in expansion" standard) was the risk that business expansion costs would *not* "continue to be deductible" when the issue shifted from expansion by new methods to expansion to new geographic locations. Indeed, the House Ways and Means Subcommittee on Select Revenue Measures was warned that costs of such geographic expansion might prove deductible under neither section 195 nor 162.⁴⁸¹ With *Central Texas Savings & Loan* this unheeded warning came true. Under the Fifth Circuit's analysis, "establishment of a new branch office creates a

⁴⁷⁷ See Krane, *supra* note 10, at 310-11 & n. 25.

⁴⁷⁸ See McDaniel, *supra* note 10, at 35-36, 72-75.

⁴⁷⁹ See Hoffman, *Role of the Bar in the Tax Legislative Process*, 37 Tax L. Rev. 413, 499-502 (1982).

⁴⁸⁰ See 1980 Hearings, *supra* note 2, at 110 (statement of Gerald W. Padwe, Associate National Director, Tax Services, Touche Ross & Co.). Referring to the bank credit card victories, Padwe urged the Subcommittee members to adopt reports that "include language that enactment of new Code section 193 [ultimately § 195] is not intended to create any presumptions about the state of the law concerning start-up expenditures in prior taxable years." *Id.*

⁴⁸¹ *Id.* at 114-15 (supplemental statement of Gerald W. Padwe).

separate and distinct additional asset.”⁴⁸² The Fifth Circuit also added the costs capitalized under the “origin-of-the-claim” doctrine to the nonamortizable basis of the indefinite-life permits,⁴⁸³ just as the Claims Court in *Cleveland Electric Illuminating* added the cost of pre-opening staff training to similar permits.⁴⁸⁴ Thus, under their view expansion costs of new branches could not be deducted currently under section 162 and could not be amortized under either current case law (as they could under the separate asset approach adopted by the *NCNB I* panel) or logically under section 195 (due to the Committee Report approach). Here too, of course, the incorporated case law as to expansion costs developed a conflict: *Central Texas Savings & Loan*, *Cleveland Electric Illuminating*, and perhaps *Ellis Banking* versus *NCNB II*.⁴⁸⁵

2. Suggested Solutions

The Department of the Treasury may be expected to apply a strict view to expansion of a business under current section 195, defining the “same business” very narrowly and thus broadening the scope of the preemptive capitalization of the 1984 version of the statute. Treasury may determine, e.g., that a new branch is to be treated as a new business. In essence, this is the consequence of the *Central Texas Savings & Loan* approach. With the section 195 preemption as to targeted start-up costs, this will encourage taxpayers to elect section 195 more frequently as to expansion costs, the original goal of the Treasury. This approach also will have the benefit of providing some deductions to taxpayers expanding to

⁴⁸² 731 F.2d at 1185.

⁴⁸³ The permit costs were recurring, but only as part of the acquisition process; they would end when expansion ended. Market surveys apparently were regularly made independently of acquisitions, but even if made solely for acquisitions such surveys could be a benefit only so long as they were not supplanted by changing market conditions. See *NCNB I*, 651 F.2d at 946 n.5; cf. *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979). In *Iowa-Des Moines National Bank*, although the value of the permits continued undiminished as long as the branch continued—a classic capital expenditure—unfortunately no amortization was available due to the absence of a determinable life. *Id.*; see *Gunn*, supra note 5, at 490-91 & n.219; see also *Nachman v. Commissioner*, 191 F.2d 934, 936 (5th Cir. 1951). Market survey costs and permit costs should, therefore, be treated differently under a distortion of income analysis. The two *NCNB* decisions and *Central Texas Savings & Loan* failed to do so.

⁴⁸⁴ 7 Cl. Ct. at 229.

⁴⁸⁵ See supra notes 287-97 and accompanying text.

new branches in the Fifth Circuit. If Treasury applies a broad reading of the "same business" to encompass expansion to a branch in a different location, then potentially a taxpayer, at least in the Fifth Circuit, will not be entitled to elect section 195. Additionally, under the Fifth Circuit view, such taxpayer will be able neither to deduct these costs currently under section 162 nor to amortize them under section 167. This result should be avoided at all costs.

The ideal solution is statutory "reform" treating identical start-up and expansion costs identically, ranging from immediate deduction to various periods of amortizations depending upon the frequency of the expenditure and its useful life. If this does not occur, then courts choosing the second activist option should apply the exception to section 195 for the expansion of the same business very broadly, carving out many cases from the statute's scope. Each class of expansion costs should therefore be set up as a separate asset currently deductible or amortizable over its "estimated" useful life, equitably determined under *Cohan* if necessary.

*E. Active Business: "When I use a word, . . . it means just what I choose it to mean—neither more nor less."*⁴⁸⁶

1. Source of the Problem

The drafters of the original section 195 did not want the costs of starting-up or investigating an investment to be eligible for section 195's sixty-month amortization.⁴⁸⁷ The statute was meant to "encourage formation of new businesses";⁴⁸⁸ therefore, section 195 requires that amortizable start-up costs relate to the investigation or creation of an *active business*, or to a profit-motivated activity which, it is anticipated, will become an active business. In adopting the term "active business," however, the drafters of section 195 recklessly plunged into one of the true Serbonian Bogs of the tax world.⁴⁸⁹ The term "trade or business" is widely used in the Code,

⁴⁸⁶ L. Carroll, *Through the Looking Glass and What Alice Found There* ch. vi (1871), reprinted in *The Annotated Alice* 269 (M. Gardner ed. 1960) (statement of Humpty Dumpty).

⁴⁸⁷ S. Rep. No. 1036, *supra* note 9, at 12.

⁴⁸⁸ *Id.* at 11.

⁴⁸⁹ See, e.g., Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 Harv. L. Rev. 1194 (1968).

purportedly interchangeably, and while “active conduct of a trade or business” and closely related terms are used less commonly, conflicts abound in connection with the usage of both terms in various regulations and the cases, as has been noted by commentators.⁴⁹⁰ The drafters of the 1980 Committee Reports badly compounded the confusion by referring to “an *active* trade or business (*within the meaning of Code sec. 162*).”⁴⁹¹ Traditionally, section 162 is thought to impose only a “trade or business” requirement, and a rather easy standard to meet at that, while other Code provisions (such as sections 355 and 954(c)(3)(A)) using “active trade or business” or “active conduct of a trade or business” require something more than a mere trade or business, particularly in the context of rental real estate.⁴⁹² The 1984 amendments of section 195 only intensified this confusion.⁴⁹³

2. *Conduct Versus Active Conduct: Overview*

The term “trade or business” appears more frequently in the Code than “active trade or business” and related terms.⁴⁹⁴ Although the lines between investment and trade or business have long been blurred (especially in the Tax Court), for largely historical reasons,⁴⁹⁵ the more recent view is that the distinction between an investment and a trade or business lies in the intensity of the

⁴⁹⁰ See, e.g., Lee, “Active Conduct” Distinguished from “Conduct” of a Rental Real Estate Business, 25 Tax Law. 317 (1972).

⁴⁹¹ S. Rep. No. 1036, *supra* note 9, at 12 (emphasis added).

⁴⁹² Lee, *supra* note 490, at 325-26.

⁴⁹³ See S. Print No. 169, *supra* note 348, at 283.

⁴⁹⁴ Lee, *supra* note 490, at 317.

⁴⁹⁵ Prior to 1942, only property used in a trade or business, unlike investment property, could give rise to deductions for depreciation and operating expenses. 2 B. Bittker, *supra* note 5, ¶ 51.3, at 51-31 n.10. Consequently, the predecessor to the Tax Court essentially espoused the position that renting of real estate was automatically a trade or business. See, e.g., Fackler v. Commissioner, 45 B.T.A. 708, 714 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943). This position was maintained even after the enactment of the predecessors to §§ 167(a)(2) and 212. See Hazard v. Commissioner, 7 T.C. 372, 375-76 (1946); *accord* Elliot v. Commissioner, 32 T.C. 283, 289 (1959); see also Lee, *supra* note 490, at 318-19; Comment, The Single Rental as a Trade or Business Under the Internal Revenue Code, 23 U. Chi. L. Rev. 111, 113-17 (1955). Other tribunals looked instead for regular and continuous management of rental activities. Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943); Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd mem.*, 218 F.2d 603 (2d Cir. 1955); Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958). See generally Rothman, Capital Assets—Sale of a Business or Property Used in a Trade or Business, 447 Tax Mgmt. (BNA) A-18, A-22 (1983).

taxpayer's activities. Thus, a taxpayer can transform almost any section 212 investment activity into a section 162 trade or business by intensifying his participation.⁴⁹⁶ Consequently, rental of a single piece of property, or even of an important project, can constitute an investment activity or a trade or business, or shift back and forth from one status to the other depending upon the intensity of the taxpayer's management or rental activities.⁴⁹⁷ Significantly, under this analysis net leasing property does not qualify as a trade or business.⁴⁹⁸

Active conduct of a trade or business, on the other hand, generally requires a taxpayer to engage in "entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments."⁴⁹⁹ In the context of active conduct of a rental real estate trade or business, the taxpayer generally must perform significant operational management services;⁵⁰⁰ net leasing property alone obviously will not qualify under this standard.⁵⁰¹ A well-known provision in the pre-Subchapter S Revision Act regulations, which is followed in several other regulations, sought to distinguish between passive and active rental businesses based upon whether the taxpayer rendered significant services to the tenant, with maid services qualifying, but not furnishing utilities, cleaning public areas, or collecting trash.⁵⁰²

⁴⁹⁶ *Hoopengartner v. Commissioner*, 80 T.C. 538, 543 n.8 (1983), *aff'd mem.*, 745 F.2d 166 (9th Cir. 1984).

⁴⁹⁷ *Hoopengartner* pinned these otherwise sound conclusions on several cases; unfortunately these cases did not address the issue surrounding the applicability of § 162 versus § 212. Thus, *Hoopengartner*, and not the "precedents" upon which it relied, constitutes the best authority.

⁴⁹⁸ *Union Nat'l Bank v. United States*, 195 F. Supp. 382 (N.D.N.Y. 1961); *Lee*, *supra* note 490, at 320-21. See generally *Lee*, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 Tax L. Rev. 453, 462-66 (1972).

⁴⁹⁹ *Rafferty v. Commissioner*, 452 F.2d 767, 772 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972); see *Rothenberg v. Commissioner*, 48 T.C. 369, 373 (1967); *Treas. Reg. § 1.954-2(d)(1)(ii)(a)(2)*; *Rev. Rul. 79-394*, 1979-2 C.B. 141; *Lee*, *supra* note 463, at 199.

⁵⁰⁰ *Cohen & Conzelmann, Corporate Separations—Active Business Requirement*, 224-3rd Tax Mgmt. (BNA) A-4, A-8 (1981).

⁵⁰¹ *Rafferty*, 452 F.2d at 772-73; see *Gada v. United States*, 460 F. Supp. 849 (D. Conn. 1978); *Prop. Treas. Reg. § 1.355-3(c) (Ex. 5)*. See generally *Cohen & Conzelmann*, *supra* note 500, at A-6; *Lee*, *supra* note 498, at 463. Net leasing coupled, however, with extensive acquisition, financing, and construction activities may constitute active conduct of a rental business. *King v. Commissioner*, 458 F.2d 245 (6th Cir. 1972).

⁵⁰² *Treas. Reg. § 1.1372-4(b)(5)(vi)*. Similar distinctions are drawn in other regulations. See, e.g., *Treas. Reg. §§ 1.167(j)-3(b)*, *1.1402(a)-4(c)(2)*; see also *City Markets, Inc. v. Com-*

Under this rule, payments for use or occupancy of private residences, apartments, offices, and shopping malls constitute "passive" rental income, while the regulations treated similar payments for motel rooms as active income.⁵⁰³ Such degree of activity is not required under most active conduct of a trade or business provisions.⁵⁰⁴

3. *Initial Legislative History of Section 195 as Enacted*

The 1980 Committee Reports explained that the active business requirement was intended to preclude amortization of the investigatory and start-up costs attributable to an investment. "For this purpose, an activity with respect to which expenses are deductible only as itemized deductions for individuals (Code sec. 212) is not considered to be a trade or business."⁵⁰⁵ The Reports also warned that use in a trade or business under section 1231 would not determine whether the activity was a section 195 trade or business.⁵⁰⁶ Significantly, the comparable trade or business status provision of section 1221(2)⁵⁰⁷ is one of the areas where some courts, purporting to use section 162 as their model, stretched the term "trade or business," especially as to rental property, finding such status in a single rental of residential property.⁵⁰⁸

missioner, 433 F.2d 1240, 1242 (6th Cir. 1970); *Bramlette Building Corp. v. Commissioner*, 424 F.2d 751 (5th Cir. 1970); *Feingold v. Commissioner*, 49 T.C. 461 (1968).

⁵⁰³ Treas. Reg. § 1.1372-4(b)(5)(iv).

⁵⁰⁴ See Lee, *supra* note 490, at 326-28; Lee, *supra* note 498, at 464.

⁵⁰⁵ S. Rep. No. 1036, *supra* note 9, at 12.

⁵⁰⁶ *Id.*

⁵⁰⁷ See I.R.C. § 1221(2) (relating to the definition of "capital asset"); 2 B. Bittker, *supra* note 5, ¶ 54.1.3, at 54-8.

⁵⁰⁸ See, e.g., *Crawford v. Commissioner*, 16 T.C. 678 (1951), acq., 1951-2 C.B. 2. Some earlier reported decisions made a distinction between improved and unimproved rental realty, with only the former automatically considered a trade or business. Compare *Hazard v. Commissioner*, 7 T.C. 372 (1946) (improved realty), acq., 1946-2 C.B. 3 with *Emery v. Commissioner*, 17 T.C. 308 (1951) (sale of unimproved realty). But cf. *Curphey v. Commissioner*, 73 T.C. 766 (1980) (relying on factual determination in lieu of dichotomy between improved and unimproved real property). Other decisions, however, also indicated that the rental of even improved real estate did not qualify where the taxpayer's activities were minimal. See, e.g., *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd.*, 182 F.2d 603 (2d Cir. 1955). The Service reversed its earlier position by stating it would apply a facts and circumstances test to all rental real estate. Priv. Ltr. Rul. 8,350,008 (Aug. 23, 1983). Moreover, since the improved real estate in question was net leased, the taxpayer engaging in little or no activity as to the property, the loss on the sale was a capital loss and not a § 1231 loss, i.e., a loss as to real property used in the taxpayer's trade or business. *Id.*

Finally, the 1980 Committee Reports required, in the case of rental activities, "significant furnishing of services incident to the rentals to constitute an active business (within the meaning of Code sec. 162) rather than an investment."⁵⁰⁹ The earlier House Report stopped at this point,⁵¹⁰ thus raising the question whether the more intense level of activity test of the Subchapter S regulations was intended. The drafters of the 1980 legislative history, apparently belatedly realizing the potential impact of their choice of words, added in the subsequent Senate Report that generally "the operation of an apartment complex, an office building, or a shopping center would constitute an active trade or business,"⁵¹¹ thus manifesting that the more rigorous Subchapter S test was not the intention of the Reports.

In summary, the start-up cost bill as introduced used the term "trade or business"⁵¹² and the drafters probably added "active" just to deal with the historical blurring of the line between investment and trade or business rental property. Unfortunately the drafters again chose the format of a bare-bones statutory reference fleshed out by the Committee Reports, attempting to incorporate existing reference points, and again generated confusion based on pre-existing conflicts as to the meaning of the statutory referent.

4. 1984 Amendments

Prior to *Hoopengarner*, Congress' goal was a narrow construction of "active business" so that pre-operating investment costs could not be amortized under section 195, nor deducted currently under then section 212 precedents.⁵¹³ *Hoopengarner* changed the ground rules suddenly, providing the potential for a section 212 deduction for start-up (but not investigatory) costs of a new investment activity. Equipment leasing tax shelters usually involve net leased property, as is also often the case with single tenant real estate and with commercial real estate,⁵¹⁴ so that all of these activities standing alone failed to constitute an active trade or business

⁵⁰⁹ S. Rep. No. 1036, *supra* note 9, at 12.

⁵¹⁰ H.R. Rep. No. 1278, *supra* note 306, at 11.

⁵¹¹ S. Rep. No. 1036, *supra* note 9, at 12.

⁵¹² H.R. 5729, reprinted in 1980 Hearings, *supra* note 2, at 181.

⁵¹³ See *supra* note 176.

⁵¹⁴ Staff of the Joint Comm. on Tax'n, Handbook on Tax Shelters 52-53 (1976).

under traditional authorities. *Hoopengarner* could be used in these situations to obtain current deductions for pre-opening costs under section 212, but not for investigatory costs, as soon as an asset to be used in the activity is acquired, and perhaps even earlier when contractual obligations identifying the activity are assumed. So long as such activities are never "anticipated" to rise to active business status, they would not be caught by the new anti-*Hoopengarner* additional definition of start-up costs.⁵¹⁶ Therefore, such activities would not be capitalized under post-1984 section 195(a). Clearly, the drafters of the Committee Reports accompanying the 1984 version of section 195 wanted a broader definition of "active business" to render the preemptive section 195⁵¹⁶ applicable, denying the current deduction of pre-operating costs of such net leased property under section 212.⁵¹⁷

In 1984 Congress amended section 195, "clarifying" the deduction of start-up expenditures, so "that the rent expenses permitted as a deduction in *Hoopengarner*, and similar expenditures, will be subject to this provision."⁵¹⁸ The drafters added to the two existing 1980 categories of start-up costs (investigation of an active business and creation of an active business) a third category, i.e., "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business."⁵¹⁹ Congress did not change the wording of the 1980 categories. To back up this definition, preempting any deduction of start-up costs under section 212 or section 162, Congress provided in new section 195(a) that all start-up costs had to be "capitalized"⁵²⁰ by denying any deduction except for the sixty-month or more amortization deductions under section 195.⁵²¹ Congress believed that "start-up ex-

⁵¹⁶ See *infra* notes 418-23 and accompanying text.

⁵¹⁸ See *supra* note 348 and accompanying text.

⁵¹⁷ S. Print No. 169, *supra* note 348, at 283.

⁵¹⁸ *Id.*

⁵¹⁹ Tax Reform Act of 1984, Pub. L. No. 98-369, § 94(a), 98 Stat. 494, 615 (codified at I.R.C. § 195(c)(1)(A)(iii)).

⁵²⁰ See I.R.C. § 195(a) (1984). The drafters of the legislative history stated that "the committee believes that it is appropriate to require such expenses to be capitalized unless the taxpayer elects to amortize the start-up expenditures over a period of not less than 60 months." S. Print No. 169, *supra* note 348, at 283. Actually, capitalization is not usually an alternative to amortization, but rather a precondition.

⁵²¹ Exceptions are provided for deductions under §§ 163, 164, and 174. See *supra* note

penditures generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred.”⁵²² Thus, the *Hoopengartner*-type pre-opening ground rent deductions will constitute start-up costs, and therefore cannot be deducted under section 212, but only may be amortized under section 195.

Regarding net leased property, if the net leasing activity never rises to an active business status, the pre-opening stage expenditures of the activity do not constitute capitalizable start-up costs under section 195, and can be deducted currently under the *Hoopengartner* reading of section 212. Congress made no change in section 195 itself regarding net lease property, other than the general anti-*Hoopengartner* amendment in new section 195(c)(1)(A)(iii). Rather, following the now familiar, and disastrous, 1980 model, the congressional staff attempted to change the meaning of “active business” via the Committee Reports to the 1984 amendments:

Active trade or business means that the taxpayer is actively conducting a trade or business. This definition of active trade or business may include a trade or business that is in many respects passive. For example, a business where property is regularly [leased?] based on a net lease basis is an active trade or business for this purpose.⁵²³

Thus, the 1984 legislative history shifted, in the context of rental activities, from a “significant furnishing of services” standard to regularly leasing. The latter, but surely not the former, test would catch net leased property, including equipment leasing tax shelters and leasing of commercial real estate.

Is the 1984 formulation of “active business” as to net leased property consistent with the 1980 test for rental activities? Judged on the basis of established precedent,⁵²⁴ the answer must be no. Active conduct of a rental business requires significant services with respect to the management or operation of the property, or

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⁵²² S. Print No. 169, *supra* note 348, at 282; accord *Johnsen v. Commissioner*, 794 F.2d 1157 (6th Cir. 1986).

⁵²³ S. Print No. 169, *supra* note 348, at 283.

⁵²⁴ See *supra* notes 494-504 and accompanying text.

both.⁵²⁵ Net leasing on a regular basis alone will satisfy neither active conduct aspect. Moreover, such a "regular basis" test comes perilously close to the sections 1221(2) to 1231 precedents,⁵²⁶ explicitly disavowed by the 1980 Committee Reports.⁵²⁷ Additionally, the Federal Circuit recently ruled that regular, extensive, and continuous activities do not in and of themselves establish trade or business status.⁵²⁸

To the extent that the 1980 and 1984 Committee Reports conflict as to the application of the "active business" concept to rental activities, the 1984 version is technically ineffective in changing the meaning of the term enacted in 1980. Should the 1984 version prevail? During the 1984 rearrangement of section 195, the 1980 definition of start-up costs, i.e., costs incurred in investigation or creation of an *active business*, remained unchanged⁵²⁹ except for the addition of the anti-*Hoopengartner* clause covering a section 212 activity that it is anticipated will become an active business. Assuming that "active business" means the same for (1) investigating and creating an active business and (2) holding for profit and the production of income in anticipation of becoming an active business, the 1984 Committee Report in effect technically explained the meaning of the term as used in the 1980 Act. Indeed, the 1984 legislative history explained that the Senate Finance Committee "intends that the definition of start-up expenditures be generally the same as under present law but clarifies the definition to cover certain pre-opening costs."⁵³⁰

Judicial application of and reliance on statutory construction in congressional committee reports, as well as more informal legislative history, has intensified in recent years.⁵³¹ In the process, courts have often discarded old maxims of statutory construction.⁵³² One of these traditional rules is that evidence of later congressional understanding of a previously enacted statute has no in-

⁵²⁵ See *supra* notes 496-504 and accompanying text.

⁵²⁶ See, e.g., *Hazard v. Commissioner*, 7 T.C. 372 (1946), acq., 1946-2 C.B. 3.

⁵²⁷ S. Print No. 169, *supra* note 348, at 283.

⁵²⁸ *Moller v. United States*, 721 F.2d 810, 814 (Fed. Cir. 1983).

⁵²⁹ Compare I.R.C. §§ 195(c)(1)(A)(i), (ii) (1985) with I.R.C. § 195(b)(1)(A), (B) (1981).

⁵³⁰ S. Print No. 169, *supra* note 348, at 283.

⁵³¹ Wald, *Some Observations on the Use of Legislative History in the 1981 Supreme Court Term*, 68 Iowa L. Rev. 195 (1983).

⁵³² *Id.*

terpretive effect as to the intent of the earlier Congress.⁵³³ More recently the prevalent approach with regard to tax law is that the view of a later Congress will not establish definitively the meaning of an earlier enactment, but it is entitled to consideration "as a secondarily authoritative expression of expert opinion."⁵³⁴ However, the maxim is still used that views of a subsequent Congress cannot override the unmistakable intent of the enacting one.⁵³⁵

The discussion in the 1980 Committee Reports of the "significant furnishing of services" test interpreted the active business requirement for start-up and investigatory expenses in the 1980 Act. The 1984 amendments did not change the existing definition of active business for start-up or investigatory expenses, but only added a category of expenses incurred in an activity which is anticipated to become, although it is not yet, an active business. Thus, the 1984 Committee Report's pronouncements on the meaning of active trade or business technically interpreted the definition contained in the 1980 Act, since the definition itself remained unchanged by the 1984 Act. Indeed, the 1984 Report stated that the Senate Finance Committee "intends that the definition of start-up expenditures be generally the same as under present law but clarifies the definition to cover certain pre-opening costs."⁵³⁶ However, since the 1980 and 1984 definitions of "active trade or business" in fact conflict, technically the 1984 Report is ineffective to change the meaning of the term as enacted in 1980. Although the 1980 definition should therefore technically prevail, the reality is that in both 1980 and 1984 Congress chose to "enact" definitions through committee reports rather than through a more detailed statute. In essence, the 1984 Committee Report definition is merely a "techni-

⁵³³ See, e.g., *Waterman Steamship Corp. v. United States*, 381 U.S. 252, 268-69 (1965) (House and Senate Reports accompanying a vetoed attempt to amend the Merchant Ship Sales Act of 1946 had little significance); *United States v. Wise*, 370 U.S. 405, 411 (1962) (subsequent interpretation of the Sherman Act by several Congressmen, unsuccessful in their attempt to amend the statute, had no persuasive significance).

⁵³⁴ *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 228 (1985); accord *Johnsen*, 794 F.2d at 1163 (subsequent congressional views carried some weight and could not be ignored where clearly relevant); cf. *Bobsee Corp. v. United States*, 411 F.2d 231, 237 n.18 (5th Cir. 1969) (subsequent committee reports were not part of legislative history, but should not be disregarded altogether because they constituted secondary expert opinion).

⁵³⁵ *International Bhd. of Teamsters v. United States*, 431 U.S. 324, 354 n.39 (1977) (views of a subsequent Congress were entitled to little, if any, weight).

⁵³⁶ S. Print No. 169, *supra* note 348, at 283.

cal corrections act" amending the 1980 legislation by committee report. The proper question, therefore, is whether this "amendment" of the definition of "active trade or business" by the 1984 Committee Report is prospective only. It is clear, in any event, that the 1984 Report is to be treated in fact as a command and not as an interpretation of the earlier definition.

Regardless of whether the 1984 Committee Report's extension of section 195 to net leased property is upheld by the courts (and it probably will be, the standards of construing statutes notwithstanding, if the obvious trend in recent business expansion cases, i.e., leaving it to Congress,⁵³⁷ is any portent), this problem well illustrates the dangers in following the "simplification" approach of bare-bones statutory language, fleshed out by regulations for which the committee reports are to serve as a blueprint. Congress could have defined "active trade or business" for purposes of section 195 as it desired in 1980 and 1984. The Committee Report approaches of looking to section 162 for the content of "active trade or business" and then abandoning a "substantial services" test for a "regular conduct" test, however, pose the danger of widespread ramifications throughout the Code, since section 195 purports to use a standard term and meaning.

The final question is whether the original function of the section 195 active trade or business test—to preclude amortization of expenditures attributable to an investment—can still be accomplished with the new formulation of "active trade or business," (e.g., regularly leasing on a net lease basis). The essential distinction between an investment and a business is that an investment involves mere collection of income and/or possibly holding for long-term appreciation, while a trade or business requires significant activity beyond collection of income, however regular.⁵³⁸ Just as with the ordinary deduction in the expansion/operation exclusion of capital expenditure costs morass, the drafters of the 1984 Senate Finance Committee Report lost sight of the forest—the exclusion of investment costs.

⁵³⁷ See *supra* notes 310-11 and accompanying text.

⁵³⁸ See *Moller v. United States*, 721 F.2d 810, 814-15 (D.C. Cir. 1983); Rothman, *supra* note 495, at A-22. Trade or business status may differ, however, as to securities (involved in *Moller*) and real estate. See Lee, *supra* note 490, at 323-24.

5. *Suggested Solution*

Ideally, a revised statute ending the disparity in treatment of investigatory and start-up costs between old and new trades or businesses would also end the disparity, if any, between start-up and investigatory costs of old and new investment activities. If Congress intends to continue to limit section 195 amortization to trade or business activities, however, then the statute itself should focus on the functional distinctions between investment activities and trade or business activities. The pertinent factors should include the level of intensity of the taxpayer's activity, the effect of the use of agents, the status of a single rental activity, and the type of rental activities. Moreover, any congressional revision should also expressly consider the applicability of the revised provision to areas analogous to start-up costs where distinctions traditionally have been drawn between identical expenditures incurred prior to obtaining trade or business status as an employee and those incurred after obtaining such status, e.g., costs of seeking a job in a new field versus seeking a new job in the same field and costs of education, beyond the minimum requirements, incurred before and after trade or business status is attained.⁵³⁹

If Congress does not make such changes, the effect of the 1984 definition of active trade or business will remain unsettled. Most likely, courts will accept regulations based on the new definition, at least prospectively. The more difficult task will be drafting the Treasury Regulations, which should adopt functional criteria, as well as fashion a test covering a taxpayer regularly leasing property on a net lease basis but excluding other passive investments.

V. CONCLUSION

The case-law treatment of start-up and business expansion costs illustrates well the dangers of applying definitional approaches in the attempt to distinguish ordinary expenses from capital expenditures and to determine the degree of reasonable accuracy required for estimating the useful life of an intangible for purposes of amortization. A functional clear reflection of income approach would have viewed current deduction, capitalization, amortization, and estimation of useful life as interrelated. The denial of both a cur-

⁵³⁹ See *supra* note 274 and accompanying text.

rent deduction and any amortization of capitalized start-up costs by these definitional rules created distortion of income or inequity. 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. The cases, however, splintered as to when a business began and whether an expansion involved the same business. Some decisions also disregarded the corporate entity to allow current deduction and amortization. Section 195 senselessly perpetuates every one of these conflicts.

Some decisions, however, applied a functional approach to start-up and business expansion expenditures. To avoid the distortion of income that arose from the all-or-nothing approach of both the separate, saleable asset test and the preparatory doctrine, Judge Murnaghan in *NCNB I* turned to an accounting concept. He treated the expenditure benefiting future years as itself creating a separate, amortizable asset. If the expenditure was short-term or fell into other instances in which a current deduction of an expenditure benefiting future years would not distort income, Judge Murnaghan would have permitted a current deduction of start-up and business expansion costs.⁵⁴⁰

The difficulty in this functional approach lies not in its conceptual foundation but rather in practical administration. Treasury has provided no standard for classes of useful lives of intangibles. Consequently, under a capitalization and amortization approach to start-up and business expansion costs, the taxpayer—and the courts—must determine useful life in each case on its own facts. It is unlikely that courts can apply the *Cohan* doctrine to create class lives or even accelerated rates as a reasonable allowance for amortization. Thus, controversies will continue. In order for capitalization and amortization to work in tandem to avoid distortion of income, a liberal approach to estimating useful life of intangibles must be taken. Basically, the view of the *Cohan* rule—that a court *must* approximate if there is some deduction—should be applied to an intangible when it is shown that the intangible is a wasting

⁵⁴⁰ *NCNB I*, 651 F.2d at 956-57, 961-62.

asset or that the present investment at some point can no longer reasonably be matched with income. Unfortunately, the reality is that many opinions, in particular Tax Court decisions, require a reasonable basis for a *Cohan* approximation, including estimation of useful life. Thus, controversy will likely result as to the proper determination of useful life. Furthermore, the basic conflict between those tribunals following the definitional approaches and those adopting the functional approach will continue. Indeed, in *NCNB II* the Fourth Circuit reversed Judge Murnaghan's functional approach by applying the definitional separate, saleable test.

Therefore, most courts following the lead of *NCNB II* may be expected to "bow to the will of Congress" gladly and cede start-up costs to section 195. Unfortunately, section 195 is as deeply flawed as the prior definitional approaches that constitute its conceptual foundation. The lack of deep structure analysis in the statute has resulted in self-contradiction, in light of which the drafters have sought to impose an "ordinary" prerequisite for deducting expenditures they regard as creating benefits lasting substantially beyond the tax year. Section 195 continues the disparity between new and existing businesses, with the former required to amortize expenditures that are currently deductible by the latter. Thus, perversely, tax policy grants a slower, and hence less valuable, deduction to the entrepreneur who is least likely to have access to capital or debt markets because he is in a new business, while giving an immediate, and hence more valuable, deduction to an existing business—"an excellent illustration of a cart-before-horse policy."⁸⁴¹

Section 195 is further flawed by its method of drafting: a bare-bones statute with regulations to supply the details. Even if this concept has merit, the realities are that Congress, through the Joint Committee staff, has attempted to direct the course of the regulations through detailed legislative history. Perhaps due to the absence of the discipline required in drafting a detailed technical statute, these Committee Reports were replete with errors, confusion, and contradiction. Hence, it can be said that the will of Congress was reasonably clear, but—sadly—technically deficient.

Treasury, however, probably will draft regulations that ultimately will work. Courts probably will approve them, by and large.

⁸⁴¹ 1980 Hearings, *supra* note 2, at 107 (statement of Gerald W. Padwe, Associate National Director, Tax Services, Touche Ross & Co.).

Section 195 probably will preempt section 162, as well as section 212, in the start-up area. In the interim, until the regulations are finalized, and depending upon the choices made in those regulations, total confusion will reign. In the end, section 195 has failed utterly at simplification and does not achieve parity. One can only agree with Judge Murnaghan that the failure of the prevalent case law and repeated remedial statutes—ultimately traceable in both instances to the same lack of deep structure analysis—to treat start-up and business expansion costs equitably and similarly “further contributes to the deserved [pre-1986] description of our income tax system as a disgrace.”⁵⁴²

⁵⁴² *NCNB II*, 684 F.2d at 296 (Murnaghan, J. dissenting).