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Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective

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TRANSACTION COSTS RELATING TO ACQUISITION OR ENHANCEMENT OF INTANGIBLE PROPERTY: A POPULIST, POLITICAL, BUT PRACTICAL PERSPECTIVE

*John W. Lee**

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"An outstanding feature of this criterion [of Practicality] is the restraint it imposes on zealous aspirations to achieve near perfect conformity with other criteria. Compromises, often quite crude, are forced frequently because dogged Practicality must be heeded."¹

I. INTRODUCTION

Since the early 1970s, a taxpayer has been required to capitalize costs of, and transaction costs² incurred in connection with, the acquisition of a separate *tangible* asset under the origin of the claim doctrine of *Woodward v. Commissioner*³ and *United States v. Hilton Hotels Corp.*⁴ These cases stand for the proposition that mismatching the character of a claimed *ordinary deduction* when the *related income is tax preferred* by either capital gains treatment or complete nonrecognition distorts the taxpayer's income. Moreover, such mismatching would violate section 446 of the Internal Revenue Code (Code), which requires that a taxpayer's method of tax accounting (which may include the tax treatment of an item's cost as a capital expenditure or a current expense) must clearly reflect the taxpayer's income.⁵ In *Commissioner v. Idaho Power*,⁶ Justice Blackmun

¹ Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 573 (1965).

The two macro-criteria which rank highest are Practicality and Equity. Of the two, Practicality frequently must be granted more weight than Equity. At the second echelon are ranked Free Market Compatibility and concerns subsumed under the heading of Political Order. Between the two the former often outranks the latter. Finally, the criteria of Reduced Economic Inequality and Stability, in that order, appear in the hierarchy.

Id. at 601-02.

² Treasury Regulations 1.197-2(c)(12) (as amended in 2001) and 1.338-6(a)(2)(ii) (as amended in 2001) use the term "transaction costs" in the same context as this article but do not define it. Some use it to mean costs that arise or are incurred "in connection with" a transaction. See, e.g., 1995 FSA LEXIS 395 (Jan. 24, 1995); 1995 FSA LEXIS 233 (Mar. 22, 1995).

³ 397 U.S. 572 (1970) (stating that legal, accounting, and appraisal expenses incurred in purchasing minority stock interest are capital expenditures); see *infra* notes 188-214 and accompanying text. See generally John W. Lee & Nina R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473 (1981).

⁴ 397 U.S. 580 (1970) (stating that consulting, legal, and other professional fees incurred by acquiring firm in minority stock appraisal proceeding are capital expenditures).

⁵ See I.R.C. § 446(c); *infra* notes 185-92, 197-209 and accompanying text.

⁶ 418 U.S. 1 (1974) (stating that equipment depreciation allocable to

extended the capitalization requirement to inside transaction costs of *creating* a tangible with *substantial future benefits* in order to prevent (1) a *timing* of income mismatch in violation of section 446(b), and (2) a violation of the judicial rule of tax parity under which inside and outside transaction costs should be treated the same. For example, the capitalization requirement would avoid providing a tax advantage to inside costs over identical outside costs of constructing or acquiring a tangible asset with future benefits.⁷ Capitalization of transaction costs as to an intangible asset usually yields a far less elegant result, since the intangible asset can be depreciated only under section 167 and only if its useful life can be determined with certainty.⁸ Taxpayers are seldom able to determine the useful life of an intangible asset, particularly with respect to business expansion and start-up costs.⁹ To avoid the distortion of income of capitalization of such costs without depreciation, many, but not all, judicial and administrative authorities from the early 1970s through 1992 allowed a current deduction for expenditures yielding current and future intangible benefits. These expenditures included recurring business expansion costs, based on the erroneous reasoning that such costs were deductible if they did not create a separate asset.¹⁰ This line of reasoning was, in turn, based on

construction of capital facilities is to be capitalized; otherwise, taxpayer constructing own capital assets is tax advantaged over taxpayer purchasing similar assets).

⁷ See *infra* notes 216-20 and accompanying text.

⁸ See *infra* note 197.

⁹ John W. Lee, *Pre-Operating Expenses and Section 174: Will Snow Fall?*, 27 TAX LAW. 381, 411-12 (1974) [hereinafter Lee, *Pre-Operating Expenses*].

¹⁰ John W. Lee, *Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform and a Touch of Basics*, 6 VA. TAX REV. 1, 17-26, 52-7 (1986) [hereinafter Lee, *Start-Up Costs*]. While I can take pride in the fact that my definition of “investigatory” and “start-up costs” was followed in section 195’s legislative history, compare Lee, *Pre-Operating Expenses*, *supra* note 9, at 384-85, with S. REP. NO. 96-1036 (1980), I must also confess that I stated that *Commissioner v. Lincoln Savings & Loan Ass’n*, 403 U.S. 345 (1971), rejected the future benefits test. Lee, *Pre-Operating Expenses*, *supra* note 9, at 390 n.53. I now know that was not so, but in any event came to see that the no separate asset reading was questionable. Lee & Murphy, *supra* note 3, at 477 n.29. Daniel Halperin had it right in a letter to me back then that Lee, *Pre-Operating Expenses*, was too much of a brief. I was trying too hard to get the Supreme Court to reject the start-up gloss on section 162 and, in particular, the holding one’s self out as providing goods or services definition of a trade or business. Of course, I succeeded then only in *Snow v. Commissioner*, 416 U.S. 500 (1974), holding that sections 174 and 162 were different (a Supreme Court clerk and former classmate wrote me at the time asking for a copy of Lee, *Pre-Operating Expenses*), but adopting for section 174 a regular and continuous profit-motivated activities test, which I had advocated. John W. Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 TAX L. REV. 347,

a misreading of *Commissioner v. Lincoln Savings and Loan Ass'n*.¹¹ Underneath this mistaken no separate asset doctrine, however, lay factual patterns which would have supported application of one or another of the rough justice current deduction factors discussed in Part IV of this article.

The Supreme Court granted certiorari in *National Starch and Chemical Corp. v. Commissioner*¹² to resolve the conflict between the two lines of cases. Justice Blackmun, the author of *Lincoln Savings* and *Idaho Power*, explained in *INDOPCO, Inc. v. Commissioner*¹³ that *Lincoln Savings* merely held that the cost of creating or enhancing a separate asset usually had to be capitalized – *not* that the absence of such a tangible asset precluded capitalization notwithstanding more than incidental future benefits.¹⁴ In this sense, future benefits were a strong, but not irrefutable, indicator of a capital expenditure.

Part II recounts how, over the last decade, expensing versus capitalizing of costs with present and future, often intangible benefits became the most significant federal income tax issue in audits of big businesses, which report the bulk of both the corporate sector income and additional tax revenues raised by tax audits and collections.¹⁵ An indicator of this phenomenon was the action of the Internal Revenue Service (Service) in directing team tax auditors of the largest 1500 or so corporations¹⁶ in the aftermath of *INDOPCO* to examine specific expensing/capitalizing issues, particularly those with future benefits flavor. This practice generated a flood of Technical Advice Memoranda (TAM) which often manifested conflicts between the Examination Division of the Service and the Office of Chief Counsel. In addition, this trend produced a few digest, published revenue rulings;¹⁷ and a stream of reported judicial decisions that are

449-51 (1974); Lee, *Pre-Operating Expenses*, *supra* note 9, at 403. In *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the Court adopted this test for section 162 as well. None of these cases cited me but that's my story and I'm sticking to it.

¹¹ 403 U.S. 345 (1971).

¹² 918 F.2d 426 (3d Cir. 1990).

¹³ 503 U.S. 79 (1992). See generally, John W. Lee, *Doping Out the Capitalization Rules after INDOPCO*, 57 TAX NOTES 669 (Nov. 2, 1992) [hereinafter Lee, *Capitalization Rules*].

¹⁴ *INDOPCO*, 503 U.S. at 86-87.

¹⁵ See *infra* notes 71, 77 and accompanying text.

¹⁶ See *infra* notes 73, 94-95 and accompanying text.

¹⁷ John W. Lee et al., *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations* (pt. 1), 23 OHIO N.U. L. REV. 631, 657 n.89 (1997) [hereinafter Lee et al., *Rough Justice I*].

impossible to reconcile.¹⁸

Between 25% and 40% of the audit and litigation resources of the Large and Mid-Size Business unit (LMSB) of the Service are devoted to *INDOPCO* issues.¹⁹ After a wave of initial Service victories in the Tax Court, circuit courts are beginning to reverse these decisions, particularly where everyday or nondepreciable expenditures are at issue.²⁰ At the same time, corporate audit rates have rapidly declined over the past five years,²¹ and widespread abuse of corporate tax shelters has occurred in the pool of the largest businesses in LMSB.²² The media and others have drawn a connection between the decline in corporate audit rates and the use of corporate tax shelters,²³ which are viewed by many in the Treasury Department as the biggest tax problem at this time.²⁴

Against this backdrop, the Service and the Treasury Department have provided in an Advance Notice of Proposed Rulemaking, *Guidance Regarding Deduction and Capitalization of Expenditures*²⁵

¹⁸ *Guidance Regarding Deduction and Capitalization of Expenditures*, 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002).

¹⁹ See *infra* notes 175-77, 182 and accompanying text.

²⁰ See *infra* notes 446-48, 455, 475-78, 529-31 and accompanying text.

²¹ See *infra* notes 103-13 and accompanying text.

²² See *infra* notes 128-33, 154-58 and accompanying text.

²³ See *infra* notes 120, 124-26, 128 and accompanying text.

²⁴ See *infra* notes 132-33 and accompanying text.

²⁵ *Guidance Regarding Deduction and Capitalization of Expenditures*, 67 Fed. Reg. 3461 (Jan. 24, 2002); see *Professor Submits Paper on Capitalization Rules*, TAX NOTES TODAY (May 7, 1996) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1996 TNT 101-20). We then polished and published such a response in a symposium dedicated to Boris Bittker (who early propounded a rule of reason here, see *infra* note 584) in Lee et al., *Rough Justice I*, *supra* note 17, and John W. Lee et al., *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations* (pt. 2), 23 OHIO N.U. L. REV. 1484 (1997) [hereinafter Lee, et al., *Rough Justice II*]. For our recommendations on these points, see Lee et al., *Rough Justice I*, *supra* note 17, at 665 (advising discussion draft), 684 (advising global regulations), and 691 (advising global regulations). For our other recommendations adopted or considered in the Advance Notice, see *infra* notes 244-45 (balancing test), 258 (not more than a twelve-month safe harbor), 266 (de minimis rule), 306 (regularly recurring) and accompanying text. See generally, Thomas L. Evans & Gregory W. Gallagher, *INDOPCO – The Treasury Finally Acts*, 80 TAXES 47, 48-52 (Mar. 2002). I heartily commend the Treasury Department and the Service for the format of an Advance Notice and for the prospect of global regulations, both of which my students and I recommended in response to Service Notice 96-7, 1996-2 C.B. 9 (“invites public comment on approaches the Service should consider to address issues raised under §§ 162 and 263 of the Internal Revenue Code particularly in light of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)”).

(Advance Notice), a conceptual framework for proposing rules with respect to “expenditures that create or enhance intangible assets or benefits.”²⁶ These expenditures include various business capital transactions such as the acquisition, creation, restructuring, or reorganization of a business entity or a business assets acquisition subject to section 1060.²⁷ The Treasury Department and the Service correctly concluded that:

[b]ecause courts focus on particular facts before them, the results reached by the courts are often difficult to reconcile and, particularly in recent years, have contributed to substantial uncertainty and controversy. The IRS and Treasury Department are concerned that the current level of uncertainty and controversy is neither fair to taxpayers nor consistent with sound and efficient tax administration. Recently, much of the uncertainty and controversy in the capitalization area has related to expenditures that create or enhance intangible assets or benefits.²⁸

Accordingly, the Treasury Department and the Service contemplate proposing several rough justice safe harbors permitting current deduction of expenditures with future benefits where the burdens of capitalization outweigh its benefits.²⁹ They also have in mind a proposed rule which would “require a taxpayer to capitalize certain transaction costs that facilitate the taxpayer’s acquisition, creation, or enhancement of intangible assets or benefits.”³⁰ Payments for *outside* services for such facilitating transaction costs would have to be capitalized as in *INDOPCO*, subject to a de minimis, one-year rule for rough justice current deduction exceptions.³¹ In sharp

²⁶ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3462.

²⁷ *Id.* at 3464; I.R.C. § 1060(c).

²⁸ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3462.

²⁹ [T]he forthcoming notice of proposed rulemaking will recognize that many expenditures that create or enhance intangible assets or benefits do not create the type of future benefits for which capitalization under section 263(a) is appropriate, particularly when the administrative and record keeping costs associated with capitalization are weighed against the potential distortion of income.

Id.

³⁰ *Id.* at 3464.

³¹ *Id.* Examples given include payments, subject to the de minimis rule, made to outside attorneys for services in drafting a three-year covenant not to compete or in

contrast, the Advance Notice states that the Treasury Department and the Service expect that the proposed regulations would exclude the following in-house or *inside* transaction costs: (1) “employee compensation” (except for bonuses and commissions that are paid with respect to the transaction), (2) fixed overhead, or (3) de minimis costs not exceeding a specified dollar amount, such as \$5000,³² from the rule calling for capitalization of costs facilitating a transaction. Inside and outside recurring transaction costs incurred in connection with, but *not* facilitating, acquisition, creation, or enhancement of intangible assets, including acquisition of a business, would be currently deductible.³³

These contemplated self-created transaction costs rules will violate the rule of tax parity by favoring inside creation of intangibles over outside purchase.³⁴ The only principled basis for these rules is that administrative burdens of capitalization could outweigh the benefits of a more rigorous matching *and* adherence to tax parity or horizontal equity.³⁵ Accordingly, the proposed regulations should explicitly justify such rules both in the preamble and in the body of the regulations on the basis of a balancing of the burdens and benefits of capitalization.³⁶ Further, burdens to the Service should also be taken into account in such a balancing test,³⁷ due to the hazards of litigating the capitalization issues of customarily deducted everyday expenses even where conceptual rigor would require capitalization, and in order to allow reallocation of compliance resources from capitalization issues to the “immoral and unethical”³⁸ corporate tax

defending a trademark.

³² *Id.*; see *infra* notes 436, 439 and accompanying text.

³³ See *infra* note 434.

³⁴ Fed. Bar Ass’n, *Transcript of Sixth Invitational Biennial Conference on Tax Legislative Process, Day Two*, TAX NOTES TODAY (Aug. 17, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 160-17, ¶¶ 569-79) (comments of Joseph Mikrut) [hereinafter *Transcript of Conference on Tax Legislative Process, Day Two*]. For a discussion of the rule of tax parity, see *infra* notes 219-20 and accompanying text.

³⁵ Lawrence Lokken, *Capitalization: Complexity in Simplicity*, 91 TAX NOTES 1357, 1359, 1364-65, 1369 (May 28, 2001) (currently deduct where administrative burden outweighs more accurate matching); Evans & Gallagher, *supra* note 25, at 55 (administrative burdens of capitalization outweigh lack of tax parity).

³⁶ See *infra* note 609 and accompanying text.

³⁷ See *Miscellaneous Revenue Issues: Hearings Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 103d Cong. 1687 (1993) [hereinafter *1993 House Hearings*] (statement of John W. Lee) (“our real concern is avoiding litigation costs on both sides”).

³⁸ Sydney P. Freedberg, *Now He’s the One Making the Tax Rules*, ST. PETERSBURG TIMES, Mar. 17, 2002, at 1A (quoting ranking Senate Finance

shelter problem.³⁹

The contemplated proposed regulations' limiting of capitalization of transaction costs to those "facilitating" the acquisition, creation, or enhancement of intangibles⁴⁰ appears to be based on various recent appellate decisions, as well as one Tax Court decision. Part IV asserts that these decisions are incorrect in their *reasoning* when measured against (1) the origin of the claim/acquisition cost doctrine of *Woodward v. Commissioner*⁴¹ and *United States v. Hilton Hotels Corp.*,⁴² and (2) the matching of expense and future benefits or income and the rule of tax parity of *Commissioner v. Idaho Power Co.*⁴³ Part VI maintains, however, that most of the *results* reached in these post-*INDOPCO* decisions could be justified under a burdens and benefits of capitalization balancing test for determining minimal distortion of income by the taxpayer's tax accounting method for transaction costs. The proposed regulations should further tie the inside transaction cost rules into these cases but should be explicit in the preamble and body of the proposed regulations to justify the rules on a balancing of burdens and benefits of capitalization. Part IV analyzes such a balancing test, on which the Guidance explicitly based the proposed "safe harbors," allowing current deduction of certain future benefit expenses to intangibles (less than a twelve-month benefit, *de minimis*, and possibly recurring).⁴⁴

The contemplated proposed regulations can be said to have a pro-taxpayer bias favoring self-construction in permitting current deduction of recurring future benefit expenses.⁴⁵ Yet this is precisely what Congress attempted to effect with exceptions in the legislative histories to sections 195, 263A, and 197, for the costs of creating intangibles by an existing business. Congress thus intentionally left simplification of this area of capitalization to existing law,⁴⁶ which

Committee member Sen. Charles Grassley).

³⁹ See *infra* notes 181, 577 and accompanying text.

⁴⁰ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002).

⁴¹ 397 U.S. 572 (1970) (legal, accounting, and appraisal expenses incurred in purchasing minority stock interest are capital expenditures).

⁴² 397 U.S. 580 (1970) (consulting, legal, and other professional fees incurred by acquiring firm in minority stock appraisal proceeding are capital expenditures).

⁴³ 418 U.S. 1 (1974) (equipment depreciation allocable to construction of capital facilities is to be capitalized; otherwise, taxpayer constructing own capital assets is tax advantaged over taxpayer purchasing similar assets).

⁴⁴ 67 Fed. Reg. at 3462.

⁴⁵ See Evans & Gallagher, *supra* note 25, at 54-55.

⁴⁶ See *infra* notes 581-84 and accompanying text.

Congress believed allowed a current deduction.⁴⁷ In fact, Congress once explicitly pointed to *Lincoln Savings*⁴⁸ as the source of such a deduction, (i.e., the no separate asset rule). Due to the paygo Congressional budget rules that require any tax revision reducing *baseline* revenues to be offset by new revenue-raising provisions or by a reduction in spending,⁴⁹ and the peculiarities of revenue scoring rules, Congress cannot explicitly provide a current deduction for such self-created intangibles that most taxpayers apparently deduct without paying for the revenue losses from the hypothetical baseline. In short, the contemplated proposed regulations would take the administrable rough justice approach that Congress would likely have taken but for paygo.⁵⁰ Further, President George W. Bush has approved of the Advance Notice.⁵¹ Consequently, such regulations would seem the ideal candidate for ex post facto Congressional ratification.

⁴⁷ See S. REP. NO. 96-1036, at 10-12 (1990) (“In the case of an existing business, eligible startup 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 expenditures will continue to be currently deductible.”). The Omnibus Budget Reconciliation Act of 1993 legislative history to section 197 simply states that “[i]t is also believed that there is no need at this time to change the Federal income tax treatment of self-created intangible assets, such as goodwill that is created through advertising and other similar expenditures.” H.R. REP. NO. 103-111, at 760 (1993).

⁴⁸ See *infra* note 582.

⁴⁹ See *infra* note 516.

⁵⁰ See *supra* notes 46-48.

⁵¹ See Pam Olson, Remarks Made at the University of Virginia School of Law Tax Study Group Meeting (Mar. 22, 2002); see also Nancy Ognanovich, *President Proposes New Tax Breaks Aimed at Helping Small Business Owners*, 53 BNA DAILY TAX REP., Mar. 19, 2002, at G-10 (“The White House also said Bush has directed Treasury to finalize the proposed rules on the capitalization of intangible assets as soon as possible. The change, it said, will allow small businesses to focus their resources on customers and not the Internal Revenue Service.”); Jo Mannies & Christopher Carey, *In Stop Here, President Pushes Proposals for Small Business; But the Big Issue in Every Speech Is Defeat of Terrorism; He Helps Raise Money for Talent*, ST. LOUIS POST-DISPATCH, Mar. 19, 2002, at A1 (“Bush plans to offer more details today of his program to help small businesses. He wants to reduce taxation and regulation, allow small businesses to take bigger deductions for capital investments and help them hold down the cost of health insurance by pooling risks.”).

II. *INDOPCO* ISSUES AND ADMINISTRATION OF TAX AUDITS OF LARGE AND MID-SIZE BUSINESSES

A. *Service Units of the Internal Revenue Service*

Section 1001 of the Internal Revenue Service Reform and Restructuring Act of 1998⁵² (Reform and Restructuring Act) mandates “reorganization of the Internal Revenue Service,” eliminating or substantially modifying the then-existing three-tiered (nation/region/district) structure of the Service “with an organizational structure that features operating units serving particular groups of taxpayers with similar needs.”⁵³ One reason for this restructuring was to break up perceived “stovepipes” or unconnected functions in the Service.⁵⁴ Accordingly, the Service was reorganized into four taxpayer service units: (1) individual wage and investment only individuals (W&I taxpayers), (2) small businesses and self-employed (SB/SE), (3) large businesses (Large and Mid-Size Business, or LMSB), and (4) the tax-exempt sector (employee plans, exempt organizations and state and local governments).⁵⁵ Although Commissioner Charles O. Rossotti asked his restructuring consultants to consider the appropriateness of the above four service units, his proposed groupings appear to have been carved in stone.⁵⁶

⁵² Pub. L. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 26 U.S.C.).

⁵³ 144 CONG. REC. H5100, H5149 (daily ed. June 24, 1998) (Conf. Explanatory Statement). At least the principal Senate sponsors of this legislation viewed subsection 1001(a)(3) as merely codifying Commissioner Rossotti’s then “current” identification of “four different groups of taxpayers with similar needs.” 144 CONG. REC. S7631 (daily ed. July 8, 1998) (statement of Sen. Kerrey); *id.* at S7644 (statement of Sen. Baucus).

⁵⁴ See *Report of the National Commission on Restructuring the Internal Revenue Service, A Vision for a New IRS*, TAX NOTES TODAY (June 26, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 123-15) (“In a stovepipe operation, functional units such as taxpayer services, exam, collection, appeals, and counsel set and implement their own priorities and objectives, which often are disconnected from the other functions and the organization as a whole.”). The National Commission superficially considered reorganization of the Service along categories of taxpayers lines.

⁵⁵ S. REP. NO. 105-174 (1998); IRS ORG. BLUEPRINT 2000, DOC. NO. 11052, at 1-14 to 1-15 fig.1-4 (revised Apr. 2000) [hereinafter BLUEPRINT 2000].

⁵⁶ See *Hearing before Sen. Fin. Comm. on IRS Restructuring*, 105th Cong. 77 (1998) (colloquy between Sen. Kerrey and former Commissioner Alexander); see also 144 CONG. REC. S4406 (daily ed. May 6, 1998) (remarks of Sen. Minority Floor Manager of H.R. 2676, Sen. Kerrey, Co-Director of the National Commission on Restructuring the Internal Revenue Service); *id.* at S4417; 144 CONG. REC. S7631

Prior to restructuring, the Service concentrated its income tax audits⁵⁷ on (1) large corporations, including those with more than \$250 million in assets and, to a significantly lesser extent, those with \$10 million to \$250 million in assets; (2) small businesses, including small C corporations and sole proprietorships⁵⁸ but largely ignoring S corporations and partnerships; and (3) high income individuals.⁵⁹

(daily ed. July 8, 1998) (remarks of Sen. Kerrey). With an Oversight Board,

whatever plan the IRS comes up with and the Commissioner comes up with . . . the Congress will support that plan . . . taxpayers are going to say that it is an awful lot easier now that the Commissioner has organized the IRS by individual taxpayers, corporate taxpayers small, corporate taxpayers big, and by non-profits.

Id.; S. REP. NO. 105-174 (1998).

⁵⁷ See, e.g., *Hearings Before a House Comm. on Appropriations Subcomm. on Treasury, Postal Serv., and Gen. Gov't Appropriations for Fiscal Year 1992*, 102d Cong. 775-76, 800-02, 833, 918, 968-70 (1991) (statement of Commissioner Fred T. Goldberg, Jr.).

⁵⁸ The audit rate for small business is higher than for taxpayers in general and two-thirds of such audits result in recommended assessments. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: TAX REQUIREMENTS OF SMALL BUSINESSES 2, 14 (1999). The Service's data showed that about 2.3% of the income tax returns filed by small businesses in 1997 were audited (prior to the substantial post-1998 drop off of audits in general), generally through audits conducted by the Service's district offices. *Id.* By contrast, the Service audited 1.3% of all returns filed in 1997. The audit rate for sole proprietors (individuals filing Schedule C) was 3.2%, compared to 1.2% for individuals not filing Schedule C. Small business taxpayers tend to have more compliance problems than other taxpayers, e.g., employment tax compliance due to working capital shortages. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS FACES SEVERAL CHALLENGES AS IT ATTEMPTS TO BETTER SERVE SMALL BUSINESSES 6 (2000). Self-employed persons (sole proprietors and partners) and supplemental income earners (individuals with rental or royalty income) made up almost 40% of individual examination and collections cases. *Id.* Historically, most of the individual audits involved sole proprietors. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS CAN BETTER PURSUE NONCOMPLIANT SOLE PROPRIETORS 2, 5 (1994) (sole proprietors made up just 13% of all individual taxpayers but 40% of individual noncompliance, filed more complex returns, were intentionally noncompliant more often, and tended to be better-off financially than individuals in general. Sole proprietors accounted for 36% of the 1992 estimated tax gap and accounted for 15% of assessed taxes owed by individuals in 1993); accord GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: TAX COMPLIANCE OF NONWAGE EARNERS 1-2, 7, 11 (1996) (74% of taxes owed by individuals was attributable to nonwage income of which self-employment income made up the largest portion).

⁵⁹ Historically, individual audits concentrated on upper-income filers for "they have more to hide from the government and better opportunities for hiding it." William Kates, *IRS Audits Poor More than Rich: Report*, CHI. SUN TIMES, Apr. 16,

Because both *INDOPCO* issue audits and corporate tax shelters are concentrated in the LMSB taxpayers, this article will concentrate on that service unit while briefly noting some parallels and discontinuities with other service units.

B. LMSB Service Unit

As discussed below, audits of *INDOPCO* issues are concentrated in the LMSB service unit which covers firms, C corporations, S corporations, and partnerships, including limited liability companies (LLCs), initially with assets⁶⁰ of \$5 million⁶¹ or more (now \$10 million

2000, at 41 (in the early 1990s, taxpayers with incomes of \$100,000 or more were audited at five times those earning less than \$25,000). In 1999, however, audits of individual taxpayers with less than \$25,000 in income exceeded for the first time ever the audit rate for upper-income taxpayers, generating much media attention. David Cay Johnston, *I.R.S. More Likely to Audit the Poor and Not the Rich*, N.Y. TIMES, Apr. 16, 2000, at A1 (drop in audit rate of corporations and self-employed, although more likely to cheat than the poor; and smallest self-employed more likely to be audited than larger self-employed). This was not the case for face-to-face audits, reflecting that many Earned Income Tax Credit (EITC) audits consisted of inquiries as to identification numbers for children.

⁶⁰ The basis for an asset criterion is that existing corporate and partnership data from the Service are categorized by size of assets. *Preliminary IRS Modernization Conference Transcript: Small Business/Self-Employed*, TAX NOTES TODAY (Feb. 4, 2000) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 24-67, ¶ 33) [hereinafter *SB/SE Hearing Transcript*] (statement of SB/SE TEC Director Songy). This categorization, however, only roughly corresponds with income. John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do"*, 78 TEX. L. REV. 885, 904 nn.115 & 119 (2000) [hereinafter Lee, *Business Tax Entities*]. The Service expects that some business taxpayers with small assets are more like a large multi-national firm, e.g., big service entities, and some with more than \$5 million in assets are really more like small businesses. *SB/SE Hearing Transcript, supra*, ¶ 33 (statement of SB/SE TEC Director Songy).

⁶¹ Prior to restructuring, the Service divided corporations along a \$10-million-in-assets line. GENERAL ACCOUNTING OFFICE, AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 1 (1995). Large corporations were further divided into those 1500 to 1700 largest corporations subject to the Coordinated Examination Program (CEP) and about 40,000 other large corporations. *Id.* The Service established CEP in 1966 to audit corporations with \$250 million in assets and above due to the growth of such corporations in the 1950s and 1960s and to the realization that "one case, one agent" was no longer effective. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 16 (1994). The CEP has been renamed Coordinated Industry Cases (CIC). Sheryl Stratton, *IRS Issues First Report on Prefiling Agreements*, 91 TAX NOTES 198 (2001).

or more).⁶² The LMSB service unit was first estimated to cover approximately 210,000 taxpayers, of which 9300 were large firms and the remaining 200,700 were mid-size firms.⁶³ As of April 2001, the Service had already received 240,000 LMSB returns, return volume running 9% ahead of 2000.⁶⁴ As of 2000, the total income tax liability of filers in the LMSB service unit was \$466 billion and they paid \$712 billion to the Service including employee wage taxes.⁶⁵ The average tax liability per filer was \$2,231,274.⁶⁶

Without fanfare, the Service raised the dividing line between LMSB and SB/SE to \$10 million,⁶⁷ thereby lowering the number of taxpayers in the LMSB service unit to 149,000, of which 60% are corporations.⁶⁸ It is likely that this reduction had little effect on LMSB's share of corporate income taxes and employee wage taxes given the concentration of such items at the \$250 million or more assets level and, to a lesser degree, at the \$100 to \$250 million in assets level as discussed immediately below.⁶⁹ The average tax liability per corporate taxpayer, however, should nearly double since the number of corporations in LMSB has almost halved.

⁶² In the restructuring of the Service after 1997, the floor for the LMSB service unit was lowered to \$5 million in assets, increasing the group to 170,000 taxpayers; by 2001, the group increased to 248,000 taxpayers. *Compare IRS Announces New Headquarters Locations*, TAX NOTES TODAY (Jan. 25, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 99 TNT 15-15), with BLUEPRINT 2000, *supra* note 55, at 4-1 and 4-19 to 4-23; *Preliminary Transcript of Modernization Conference Now Available*, TAX NOTES TODAY (Jan. 14, 2000) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 24-63 at ¶230) (statement of Larry Langdon, LMSB Commissioner).

⁶³ See BLUEPRINT 2000, *supra* note 54, at 4-1, 4-19 to 4-23; *The New IRS Stands Up Transcript*, *supra* note 62, ¶ 230 (statement of Larry Langdon).

⁶⁴ John E. Hembera, *Head of Retailers Industry Segment Reports on Developments*, 91 TAX NOTES 219 (2001).

⁶⁵ BLUEPRINT 2000, *supra* note 55, at 1-13 fig.1-4.

⁶⁶ *Id.* at 1-13 fig.1-4.

⁶⁷ See Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 7 (Jan 7, 2002). Indeed, there was so little publicity that the Joint Committee reporting in May 2002 on the restructuring of the Service still used the \$5 million benchmark. STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 44 (Joint Comm. Print 2002).

⁶⁸ *Unofficial Transcript of Finance Committee Hearing on Tax Shelters*, TAX NOTES TODAY (Mar. 27, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 59-31, ¶ 194) [hereinafter *Transcript of 2002 Senate Hearing on Tax Shelters*] (statement of Larry Langdon, Commissioner of Large and Medium Business Division, Internal Revenue Service).

⁶⁹ See *infra* notes 71-72, 77, 94-95 and accompanying text.

SB/SE Commissioner Joe Kehoe's explanation of the rationale for such change, which he had announced at the Virginia Annual Federal Income Tax Conference held at the University of Virginia on June 8, 2001, was that both LMSB and SB/SE planned to concentrate audit resources on higher income taxpayers in their service units; therefore, the \$5 to \$10 million category of business firms would receive more audit coverage in SB/SE than in LMSB. This is a sound move, given my belief that the appropriate floor on mid-size businesses should be \$50 to \$100 million in assets based on reported earnings.⁷⁰ Generally, more than 80% of corporate sector income is reported by the largest 6000 or so publicly-traded corporations with \$100 million or more in assets *by adjusted basis*, which is usually less than fair market value (75% is reported by the 3000 with such assets over \$250 million, encompassing the CEP corporations).⁷¹ The 40,000 or so mid-size, mostly closely-owned corporations generally reporting average annual income of \$2 million historically reported another 10% or so of corporate sector income.⁷²

C. Historic Audit Patterns of Large Corporations

Historically, the Service selected roughly 1500 corporations for CEP status based on criteria such as size (\$250 million and greater in assets) and complexity.⁷³ The Service conducted CEP audits with teams of more experienced revenue agents and technical specialists.⁷⁴

⁷⁰ John W. Lee, *Sleeper Stigmatism in "A Vision for a New IRS" Reorganized "Along Customer Lines"*, Address Before the William & Mary Law School Alumni 6, 51, 58-62 (April 23, 1999) (copy on file with the Virginia Tax Review).

⁷¹ Lee, *Business Tax Entities*, *supra* note 60, at 904.

⁷² *Id.* at 921-22.

⁷³ GENERAL ACCOUNTING OFFICE, *AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 2* (1995).

⁷⁴ See GENERAL ACCOUNTING OFFICE, *TAX ADMINISTRATION: FACTORS AFFECTING RESULTS FROM AUDITS OF LARGE CORPORATIONS 11, 12* (1997) (eight-and-a-half years versus eighteen years CEP; also move every six years to another industry rule). In contrast to CEP large corporation team audits increasingly directed by Industry Specialization Programs (ISPs), the remaining large corporations (mostly \$10 million to \$250 million in assets) previously were audited by a single revenue agent or "auditor" using his or her judgment to select taxpayers to audit and issues to raise. GENERAL ACCOUNTING OFFICE, *AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 2* (1995). CEP auditors were directed through ISBs as to the issues to raise in audits of CEP corporations. The Service used mathematical formulas (discriminant function, or DIF) for scoring individual returns and small corporation returns on the likelihood of significant noncompliance. See GENERAL ACCOUNTING OFFICE, *FINANCIAL AUDIT: EXAMINATION OF IRS' FISCAL YEAR 1993*

The General Accounting Office reports that “[c]ontrary to IRS testimony, IRS did not audit every CEP taxpayer every year. Using IRS’ method of calculating audit coverage for other groups of taxpayers, we found that CEP audit coverage ranged from 66 percent in 1987 to 77 percent in 1991.”⁷⁵ Part of the discrepancy may be attributable to the fact that the Service generally does not audit CEP returns with little or no revenue potential insofar as they report net operating losses.⁷⁶ CEP audits accounted for 65% of all increases in income taxes *recommended* for all Service audits of individuals *and* corporations in 1992.⁷⁷ Historically, CEP audits used 20% of the Service’s examination resources.⁷⁸ CEP and income tax audits of larger corporations, or those having \$100 million or more in assets, have long been the major component of the Service’s audit program.⁷⁹ The percentage of resources allocated to capitalization issues in

FINANCIAL STATEMENTS, OVERVIEW OF THE FINANCIAL STATEMENTS 15 (1994); *see also* GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS’ RETURN SELECTION PROCESS 1, 2 (1999) (59% of audited tax returns for 1992-94 selected by DIF for which all individual returns are automatically scored). *See generally*, Jim Gallagher, *What Makes Audit Computers Tick*, CHI. TRIB., Mar. 7, 1996, at C-3.

⁷⁵ GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 23 (1994); *see* GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: IRS EFFORTS TO IMPROVE CORPORATE COMPLIANCE 2 (1992) (69% for 1990; 77% for 1991); *Compliance Official’s Statement at IRS Commission Taxpayer Rights Meeting*, TAX NOTES TODAY (Feb. 27, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 39-61) (statement of James E. Donelson, Chief Taxpayer Service/Acting Chief Compliance Officer Internal Revenue Service; audit rate for CEP taxpayers is about 85%). More recently, the number of annual CEP audits has fallen to the 450 to 575 range. *See infra* note 113.

⁷⁶ *See* GENERAL ACCOUNTING OFFICE, CORPORATE TAXES, MANY BENEFITS AND FEW COSTS TO REPORTING NET OPERATING LOSS CARRYOVER 13 (1993) (“IRS generally did not audit CEP returns that had little or no revenue potential, such as those reporting NOLS.”).

⁷⁷ GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 16 (1994); GENERAL ACCOUNTING OFFICE, AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 31 (1995) (\$1,318 million for assets of \$100 million and more versus \$698 million for assets from \$10 million to \$100 million for 1988 through 1994).

⁷⁸ GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 2 (1994); GENERAL ACCOUNTING OFFICE, STATUS OF OPEN RECOMMENDATIONS, IMPROVING OPERATIONS OF FEDERAL DEPARTMENTS AND AGENCIES 124 (1998).

⁷⁹ GENERAL ACCOUNTING OFFICE, TAX POLICY, VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES 123 (1993) (in 1990, the Service allocated 40% of all staff years devoted directly to corporate audits to CEP audits).

LMSB has increased with the overall decrease in corporate audits in 2000 (down 13% from a 1999 record low⁸⁰), while business audit resources remain concentrated on CEP audits.⁸¹ Indeed, a Service official recently stated that capitalization issues alone accounted for as much as 25% of audit resources,⁸² and capitalization is overwhelmingly an LMSB issue.⁸³

The LMSB Commissioner pointed out two major problems with the Service's pre-restructuring large and mid-size corporations compliance activities: (1) audit of CEP corporations "is a flawed process in that both sides basically play Russian roulette with regard to both facts and the law";⁸⁴ and (2) compliance coverage as to the

⁸⁰ David Cay Johnston, *Rate of All I.R.S. Audits Falls; Poor Face Intense Scrutiny*, N.Y. TIMES, Feb. 16, 2001, at A1.

⁸¹ STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998 app. (Joint Comm. Print 2001) (letter from Tax Executives Institute, Inc., to Lindy Paull, Chief of Staff, Joint Committee on Taxation 2 (Apr. 12, 2001)).

⁸² Alison Bennet & Brant Goldwyn, *Olson Calls for Broad Business Cost Rules, Signals Doubt on Future Value of Intangibles*, 152 BNA DAILY TAX REP., Aug. 8, 2001, at G-2; *TEI Urges Careful Consideration of INDOPCO Coalition's Capitalization Proposals*, TAX NOTES TODAY (Nov. 9, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 218-35) ("IRS's Large and Mid-Size Business Division has reported that more than 25 percent of its audit resources are devoted to capitalization issues in some industries."); *Treasury Proposals to Curb Abusive Tax Avoidance Transactions*, TAX NOTES TODAY (Mar. 21, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 55-25) (noting that research and experimental (R&E) credit and capitalization issues account for 40% of audit resources); *Fiscal Year 2003 Budget's Analytical Perspective on Bush Administration's Tax Simplification Proposals*, 25 BNA DAILY TAX REP., Feb. 6, 2002, at L-2 ("The present uncertain legal environment has elevated capitalization to the top of the list of contested audit issues for businesses.").

⁸³ See Lee et al., *Rough Justice I*, *supra* note 17, at 643.

⁸⁴ *Preliminary IRS Modernization Conference Transcript: Afternoon, January 13*, TAX NOTES TODAY (Feb. 4, 2000) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 24-64, ¶ 46) (statement of LMSB Commissioner Langdon).

[T]here [are] a number of years open at the examination cycle, . . . a number of cycles open at the appeals level, and perhaps some cycles in litigation. Sometimes that spans nine, fifteen years.

It's a very costly process for all of us. It's a very frustrating process for us to manage – with our resources – manage all of those open years.

Preliminary IRS Modernization Conference Transcript: Large and Mid-Sized Business (Feb. 4, 2000) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 24-66, ¶ 365-66) [hereinafter *LMSB Hearing Transcript*] (statement of Richard Goelz, Director of Field Operations for Retailers, Food and Pharmaceuticals Industry Group).

nearly 250,000 non-CEP corporations with \$5 million and more in assets, is “not optimal.”⁸⁵ In fact, the audit rate for non-CEP large corporations declined only 50% from 1998 to 2000.⁸⁶

CEP teams generally began auditing returns five to six years after filing and took two to three years to complete them.⁸⁷ Thus, on average, a CEP audit of a given tax year was ten years old,⁸⁸ and any litigation often occurred twelve or more years after the filing year, resulting in an “archeological dig” aspect.⁸⁹ Moreover, the Service devoted 95% of its corporate filer audit resources to post-filing activities.⁹⁰ There were too many layers from auditing agent in field to manager with authority over exam and collections.⁹¹ Additionally, poor coordination between the Office of Chief Counsel and the Examination division resulted in delays in the completion of audits,

⁸⁵ *Id.* ¶ 56 (statement of LMSB Commissioner Langdon).

⁸⁶ *See infra* note 112 and accompanying text.

⁸⁷ GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 2 (1994) (“[T]he 1,700 audit staff years devoted to the program are modest compared to the formidable task of the auditing the 1,700 largest, most complex corporations. Given this task, CEP audits may not start for several years after the return is filed and take several more years to be completed.”).

⁸⁸ *Id.* at 18.

⁸⁹ STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998 app. (Joint Comm. Print 2001) (letter from Tax Executives Institute, Inc., to Lindy Paull, Chief of Staff, Joint Committee on Taxation 2 (April 12, 2001)); GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 39 (noting that as of 1992 one case still in audit since 1961).

⁹⁰ *TEI Asks: Who’s Controlling the Audit in the New IRS?*, TAX NOTES TODAY (Mar. 25, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1999 TNT 57-2).

⁹¹ STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 11-12 n.36 (Joint Comm. Print 1999).

The [IRS] Deputy Commissioner [for modernization] said that a territory manager will have authority over joint collection and exam issues and that the five layers of management will be eliminated. An issue will go from an agent to the group manager to the territory manager, who controls both exam and collection functions.

Id.; accord *ABA Tax Section: New IRS Will Have ‘Territories,’ ‘Areas’*, TAX NOTES TODAY (May 3, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1999 TNT 84-2).

which typically resulted in rejections of capitalization treatment.⁹² Such poor coordination is, of course, a manifestation of the stovepipe phenomenon.⁹³

With respect to 1994 tax returns, the Service's audits of the returns of the 1700 CEP corporations and of 45,000 additional large corporations (those with assets from \$10 to \$250 million in assets) generated about two-thirds of the additional taxes recommended for all income tax audits of that tax year.⁹⁴ In 2000, corporations with \$250 million or more in assets accounted for 64.5% of all additional income taxes and penalties recommended by the Service's agents, while amounting to only 0.5% of audited income tax returns.⁹⁵ CEP large corporations protested almost 80% to 90% of the proposed additional income taxes,⁹⁶ prevailing most of the time,⁹⁷ with the end result that only 20% or so of the proposed increases were sustained in administrative appeals.⁹⁸ As of 1997, almost all (97%) of such assessed taxes for the 1992 tax year had been paid by CEP large

⁹² See Christopher Bergin, *ABA Tax Section Meeting: Rossotti Says Chief Counsel Is Becoming Integral Part of IRS Management*, 91 TAX NOTES 1213 (May 21, 2001) (pointing out that Commissioner Rossotti stated that, traditionally, "Counsel was viewed as an organization that said 'no,' and took too long to say it."). I suspect that this attitude reflects at least in part the conflict between Chief Counsel and Examination on *INDOPCO* issues where a large number of Chief Counsel TAMs reversed Examination's call for capitalization. See also Lee et al., *Rough Justice I*, *supra* note 17, at 657-80, 657 n.90.

⁹³ See *supra* note 54 and accompanying text.

⁹⁴ GENERAL ACCOUNTING OFFICE, *AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 1* (1995).

⁹⁵ Transactional Records Access Clearinghouse at Syracuse Univ., *IRS District, Service Center and International Audits and IRS Auditor Findings of Additional Taxes and Penalties Owed, Federal Income Tax Returns of Individuals and Corporations Fiscal Year 2000*, at <http://trac.syr.edu/tracirs/findings/national/audDollars> (last visited Jan. 20, 2003) (noting that the same 65% portion existed over a decade); GENERAL ACCOUNTING OFFICE, *AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 2*, 16 (65% for 1992); GENERAL ACCOUNTING OFFICE, *TAX ADMINISTRATION: IRS EFFORTS TO IMPROVE CORPORATE COMPLIANCE 23* (1992) (commenting that CEP taxpayers accounted for 90% of all recommended increases in corporate income taxes for 1991).

⁹⁶ GENERAL ACCOUNTING OFFICE, *AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 19*.

⁹⁷ *Id.* at 41-42.

⁹⁸ *Id.* at 42 (citing a 19.72% assessment rate for corporations with \$250 million and more in assets); GENERAL ACCOUNTING OFFICE, *IRS MEASURES COULD PROVIDE A MORE BALANCED PICTURE OF AUDIT RESULTS AND COSTS 10* (1998); *id.* at 3 (noting that "historically, IRS has actually collected 22 percent of the additional taxes that IRS revenue agents have recommended in CEP audits.").

corporations.⁹⁹

On an administrative level, the Service prevailed more often when the adjusted basis assets of business taxpayers tended to be lower, but it was less often able to collect these assessments.¹⁰⁰ In the end, the Service collected from \$1 for every \$5 dollars recommended in audit to \$1 for every \$3 recommended. The Service estimated that in 2000, individuals paid 83% of the income taxes that they owed voluntarily with enforcement bringing in another 3%.¹⁰¹ While this 3% is actually the amount of additional taxes recommended in audit, only 1% was actually collected. Moreover, the estimate of 83% is based on representative, exhaustive audits of classes of taxpayers last permitted by Congress to be conducted in 1988.¹⁰²

⁹⁹ GENERAL ACCOUNTING OFFICE, IRS MEASURES COULD PROVIDE A MORE BALANCED PICTURE OF AUDIT RESULTS AND COSTS 10; GENERAL ACCOUNTING OFFICE, AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 41-42.

¹⁰⁰ GENERAL ACCOUNTING OFFICE, IRS MEASURES COULD PROVIDE A MORE BALANCED PICTURE OF AUDIT RESULTS AND COSTS 10 (commenting that the assessment rate as of 1997 for the non-CEP large corporations (\$10 million or more in assets) was 33%, but only 73% of that was collected, which resulted in a net of 24% of the additional taxes recommended in audit); GENERAL ACCOUNTING OFFICE, AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 43; GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: FACTORS AFFECTING RESULTS FROM AUDITS OF LARGE CORPORATIONS 3 (1997) (noting that for 1988-94, 27% of recommended taxes as to large corporations assessed); GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 5, 29-30 (1994). In contrast to non-CEP large corporations, however, in 2000, small and mid-size corporations accounted for 4% of audits and 10% of additional taxes and penalties recommended by the Service's agents. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPLIANCE MEASURES AND AUDITS OF LARGE CORPORATIONS NEED IMPROVEMENT 25-29, app.2 tbls.II.1-II.5; *see also* GENERAL ACCOUNTING OFFICE, IRS MEASURES COULD PROVIDE A MORE BALANCED PICTURE OF AUDIT RESULTS AND COSTS 25 (noting that collection rates for smaller corporations, those with less than \$10 million in assets, were lower than for CEP and mid-sized corporations, and that the Service assessed 52% of the recommended additional taxes, but collected only 58% of the amounts assessed, resulting in a net collection of 30% of the additional recommended taxes).

¹⁰¹ Janet Novack, *Are You a Chump*, FORBES, Mar. 5, 2001, at 122.

¹⁰² *Id.*; GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: INFORMATION ON IRS' TAXPAYER COMPLIANCE MEASUREMENT PROGRAM 3 n.4 (1995); *see also* *Transcript of Hearing of the Senate Finance Committee on Schemes, Scams and Cons, Part II, the IRS Strikes Back*, FEDERAL NEWS SERVICE (Apr. 11, 2002) (Commissioner Rossotti stating that the Taxpayer Compliance Measurement Program (TCMP) was too intrusive, and that the Service is initiating a far more acceptable "National Research Program"); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 34 (Joint Comm. Print 2002). *See generally*,

D. Decline in Audit Rates of LMSB Corporations

For the 1994 tax year, the Service audited 77% of the 1700 CEP returns¹⁰³ and about 24% of the returns of the other 45,000 large corporations.¹⁰⁴ Declines in audit rates commenced in 1968, but “accelerated in 1995, after Congress, by then controlled by Republicans, cut [the Service’s] spending sharply and required the agency to devote more resources to customer service.”¹⁰⁵ Congress also directed the Service to devote more audit resources to EITC issues largely for political reasons.¹⁰⁶ The audit rates for all taxpayers

O’Neill Statement on National Research Program, TAX NOTES TODAY (Jan. 17, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 12-41); Kathleen David, *Compliance Survey, Retooled Audit Process Focus of SB/SE Efforts, Kehoe Tells Attorneys*, 93 BNA DAILY TAX REP., May 14, 2002, at G-2.

¹⁰³ GENERAL ACCOUNTING OFFICE, AUDIT TRENDS AND TAXES ASSESSED ON LARGE CORPORATIONS 2.

¹⁰⁴ *Id.* at 1 n.4.

¹⁰⁵ David Cay Johnston, *I.R.S. Figures Show Drop in Tax Audits for Big Companies*, N.Y. TIMES, Apr. 12, 1999, at A1.

¹⁰⁶ *Targeting the Poor*, BUFFALO NEWS, Apr. 24, 2000, at B-2 (“Much of the blame lies with a Republican Congress. First, Republicans – miffed that Democrats wouldn’t let them gut the earned income tax credit – mandated that the IRS give greater scrutiny to the program.”); David Cay Johnston, *I.R.S. More Likely to Audit the Poor and Not the Rich*, N.Y. TIMES, Apr. 16, 2000, at A1 (noting a drop in the audit rate of corporations and self-employed, despite the increased propensity with which they cheat on taxes relative to the poor, and citing a negative correlation between the likelihood of a tax audit and the size of a self-employed individual’s business); *A Weakened I.R.S.*, N.Y. TIMES, Apr. 16, 2000, at D-14; *Auditing the Poor*, N.Y. TIMES, Feb. 19, 2001, at A14; Albert B. Crenshaw, *A Kinder IRS Raises New Worries as Audits Plummet*, WASH. POST, Apr. 16, 2000, at H1 (commenting that Newt Gingrich actually proposed in 1995 to gut the EITC program and Clinton countered with a plan to bolster audits); *Misdirected IRS Eyeball*, L.A. TIMES, Apr. 18, 2000, at A14 (pointing out that EITC audits and nonfiler audits account for greater audits of the poor, that EITC noncompliance often involves confusion and misunderstanding rather than criminal intent, and that it often involves disputes over which taxpayer is entitled to the dependency exemption for a child of divorced or separated parents); Liz Pulliam Weston, *Low Incomes More Prone to Audits by IRS*, L.A. TIMES, Apr. 16, 2000, at A1, A42 (noting that 20% to 25% of EITC filings contain errors or are fraudulent); *O’Neill’s Refreshing Candor*, ROCKY MOUNTAIN NEWS (Denver), Apr. 19, 2002, at 49A.

In a fit of pettiness, the Republican Congress ordered the Internal Revenue Service to step up audits of taxpayers claiming the earned income tax credit, a refundable tax credit aimed at helping the working poor. O’Neill’s way of putting it was that the IRS must “examine the devil out of” those receiving the tax credit, which, to be frank, is a form of welfare. The tax has a high error rate, maybe due to fraud, maybe due to confusion. A number of

have continued to decline year after year since 1995. Thus, of the largest 8500 firms, slightly more than one in three were audited in 1998, down from two in three in 1988, and hours spent on corporate audits declined 12% from 1992 levels.¹⁰⁷ This trend continued in 1999 with 35% of the largest asset corporations (those with \$250 million or more in assets) being audited as contrasted with 55% in 1992.¹⁰⁸ In 2000, the audit rate for these largest asset corporations further declined to 31%,¹⁰⁹ while “[t]he number of hours devoted to such audits fell by just 9 percent [from 1992] suggesting that the search for major corporate tax-evasion schemes is consuming a big share of the [Service’s] dwindling . . . capacity to audit such businesses.”¹¹⁰

Republicans suspect fraud. The result has been that one out of 50 low-income taxpayers gets audited by the IRS, three times the rate for taxpayers earning over \$100,000. “You think I like that?” O’Neill asked a House Appropriations subcommittee. “I hate it.”

O’Neill observed correctly that all this auditing firepower recovered very little money for the government because people claiming the tax credit pay little or no income taxes. In any case, most Americans, and all low-income taxpayers, pay more in payroll taxes than they do in income taxes.

While fraud may be widespread in the tax credit, there’s a good argument to be made for confusion. O’Neill said the IRS has 54 pages of instructions for claiming the tax “for the lowest-income people who struggle to make a living. We’ve given them an impossible tax code to interact with and then we ridicule them” for not following it.

Id.

¹⁰⁷ David Cay Johnston, *I.R.S. Figures Show Drop in Tax Audits for Big Companies*, N.Y. TIMES, Apr. 12, 1999, at A1; Transactional Records Access Clearinghouse at Syracuse Univ., *Corporate Federal Income Tax Returns with Assets \$250 Million and More*, at <http://trac.syr.edu/tracirs/findings/national/largeCorp> (last visited May 23, 2001).

¹⁰⁸ Transactional Records Access Clearinghouse at Syracuse Univ., *Corporate Federal Income Tax Returns with Assets \$250 Million and More*, at <http://trac.syr.edu/tracirs/findings/national/largeCorp> (last visited May 23, 2001); see Albert B. Crenshaw & Stephen Barr, *A Kinder IRS Raises New Worries as Audits Plummet*, WASH. POST, Apr. 16, 2000, at H1 (noting that Commissioner Rossotti said that the Service continues to audit the largest 1500 corporations regularly “because that is where the biggest money and legal issues are at stake.”).

¹⁰⁹ Transactional Records Access Clearinghouse at Syracuse Univ., *Corporate Federal Income Tax Returns with Assets \$250 Million and More*, at <http://trac.syr.edu/tracirs/findings/national/audpctcompare-corp> (last visited Apr. 15, 2002) [hereinafter *Tracirs/largeCorp*].

¹¹⁰ David Cay Johnston, *Income-Tax Enforcement Is Broadly Declining, New U.S. Data Indicate*, N.Y. TIMES, Apr. 9, 2001, at C2; *Tracirs/largeCorp*, *supra* note 109; David Cay Johnston, *Rate of All I.R.S. Audits Falls; Poor Face Particular Scrutiny*, N.Y. TIMES, Feb. 16, 2001, at A1.

In summary, the General Accounting Office reported in April 2001 that since 1997, the Service's audits of large corporations decreased by 60%, audits of partnerships decreased by 40%, and audits of individuals decreased by 62%.¹¹¹ Contemporaneously, Commissioner Rossotti expressed concern in a letter to the Chair of the Senate Finance Committee that "[w]hile the IRS continues to audit the 1,100 largest corporations every year, the audit rate for all other corporations has declined from 3.0% in 1992 to 1.1% today."¹¹² In fact, there was less than half the number of CEP audits claimed by Commissioner Rossotti.¹¹³ Interestingly, the amounts of

Audits of corporations also fell, by nearly 13 percent from the record low in 1999. The I.R.S. did not release data on audits of the largest corporations, with more than \$250 million of assets, which pay more than 80 percent of corporate income taxes.

Commissioner Charles O. Rossotti, disclosing the new figures yesterday, attributed the decline in audit rates to the shrinking of the I.R.S. auditing staff even as the number of tax returns grew, and to the diversion of I.R.S. employees to other functions as required by several new laws aimed at protecting taxpayers from abuses.

....

[Rossotti] said the number of auditors, which fell to 12,550 last year from 13,061 in 1999 and nearly 16,000 in 1996, may grow slightly in the coming year.

Id. This, however, proved not to be the case as the number of auditors fell further to 11,598 in 2001. STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 6 (Joint Comm. Print 2002).

¹¹¹ GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: INFORMATION ON SELECTED IRS TAX ENFORCEMENT AND COLLECTION EFFORTS 4, 7 (2001).

¹¹² *Grassley Responds to Rossotti's Letter on IRS Audit*, TAX NOTES TODAY (Mar. 29, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 61-21, ¶ 11). This statistic, however, misleadingly includes small corporations. The audit rate for mid-size corporations is much higher than 1.1%. In 2000, the audit rates were: 6.84% of mid-size corporations with assets from \$5 million to less than \$10 million, down from 18.78% in 1992; 11.57% of mid-size corporations with assets from \$10 million to less than \$50 million, down from 23.20% in 1992; 14.27% of mid-size corporations with assets from \$50 million to less than \$100 million, down from 28.48% in 1992; and 17.20% of mid-size corporations with assets from \$100 million to less than \$250 million were audited, down from 31.31% in 1992. Transactional Records Access Clearinghouse at Syracuse Univ., *IRS District Audits of Federal Income Tax Returns Filed by Corporations*, at <http://trac.syr.edu/tracirs/findings/national/audpctcompare-corp> (last visited May 23, 2001).

¹¹³ *TIGTA Releases Audit Report on Prefiling Agreement Pilot Project*, TAX NOTES TODAY (Sept. 5, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 172-16, ¶ 4) ("The LMSB Division annually examines 20,000 returns, including 450 to

recommended taxes and penalties dropped by about 25% for the largest corporations and by around 50% for mid-size corporations from 1998 to 2000.¹¹⁴ The audit rate for small S corporations and partnerships is 0.39%,¹¹⁵ or virtually nonexistent as practitioners always assumed was the case, except perhaps for traditional individual tax shelter limited partnerships during their heyday. David Cay Johnston, a Pulitzer prize winning journalist for the *New York Times*, reported this 2000 tax year data in the form of the odds of a taxpayer being audited, which varied greatly by market segment: CEP corporation, one in three; small sole proprietor (\$25,000 or less in gross receipts), one in thirty-seven; working poor (EITC applicants), one in forty-seven; smaller corporations (\$1 to \$5 million in assets), one in forty-nine; larger sole proprietorships (\$100,000 or more in gross revenue), one in eighty-three; high income individuals (\$100,000 or more in adjusted gross income (AGI)), one in 145; Subchapter S corporations, one in 233; partnerships, one in 400; middle-income individuals (\$50,000 to \$100,000 AGI), one in 435; and lower-income individuals (\$25,000 to \$50,000 AGI), one in 455.¹¹⁶

E. Decline in Audit Levels and Corporate Tax Shelters

A number of factors contributed to these declines in large and mid-size corporation audits. Returns from corporations with \$250

575 of the nation's largest corporations.").

¹¹⁴ Transactional Records Access Clearinghouse at Syracuse Univ., *IRS District Audits of Federal Income Tax Returns Filed by Corporations*, at <http://trac.syr.edu/tracirs/findings/national/taxpen-corp> (last visited May 23, 2001).

¹¹⁵ STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE 16 (Joint Comm. Print 2001).

A particular source of concern is the growing number of entities, such as partnerships, trusts and S-corporations, which pay no income tax at the business level, but pass on their net income to their shareholders or partners.

In 2000, these "passthrough" entities filed 7.4 million returns, reported \$5 trillion of gross revenues and \$680 billion of income. However, the IRS audited only 29,057 of them, or only one of every 256 returns – the equivalent of .39 percent.

Id. at 16. This 0.39% audit rate for passthrough entities continued in fiscal 2001. STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 6 (Joint Comm. Print 2002).

¹¹⁶ David Cay Johnston, *Affluent Avoid Scrutiny on Taxes Even as I.R.S. Warns of Cheating*, N.Y. TIMES, Apr. 7, 2002, at A1.

million or more in assets doubled from 1988 to 2000 while the permanent Service staff has been cut by almost one-third.¹¹⁷ Moreover, after the Restructuring and Reform Act, the Service shifted the equivalent of approximately 1200 full-time employees from Examination and Collection duties to Customer Service to meet filing season workload peaks in the new customer service Toll-Free Telephone and Walk-In Assistance Programs.¹¹⁸ The Service hopes to “reduce by 50 percent the Customer Service reliance on short-term details of compliance staff. By reducing the diversion of revenue agents, tax auditors and revenue officers from enforcement casework, audit coverage and collection effectiveness are expected to

¹¹⁷ Transactional Records Access Clearinghouse at Syracuse Univ., *TracIRS, New Findings*, at <http://trac.syr.edu/tracirs/findings/aboutIRS/KeyFindings> (last visited May 23, 2001); *Tracirs/largeCorp*, *supra* note 109; Christopher Bergin, *ABA Section Meeting – Rossotti Says Chief Counsel Is Integral Part of IRS Management*, 91 TAX NOTES 1213 (May 21, 2001) (noting that Commissioner Rossotti said the decline in audit rates was attributable to declining resources and Restructuring and Reform Act impediments to appropriate and timely compliance); Albert B. Crenshaw, *Reform Could Prove Overtaxing for IRS*, WASH. POST, Feb. 28, 1999, at H1 (noting the shift of 2400 workers from compliance to customer service; some officials and members of Congress say the pendulum swung too far); David Cay Johnston, *Inquiries Find Little Abuse by Tax Agents*, N.Y. TIMES, Aug. 15 2000, at C1.

Representative Lloyd Doggett, a Texas Democrat who sits on the House Ways and Means Committee, said that while he voted for the law because he heard evidence of I.R.S. abuses, he thinks Congress has gone too far in restricting the agency.

Mr. Doggett said he now thought the 1998 law was “another example of the Republican priority of demonizing the I.R.S. and limiting its resources to fulfill its responsibilities, which I believe is all aimed at trying to end income taxation.”

Id.; David Cay Johnston, *Job Fears Push I.R.S. Workers to Relax Effort*, N.Y. TIMES, May 18, 1999, at A1 (noting that seizures of property are down 98% primarily due to Service workers’ job fears of violating ten “deadly sins”; with Congressional freezes in budget, funds for modernization and retraining come in part from scaling back audits and collections); David Cay Johnston, *Tax Professionals See Pitfalls in New I.R.S.*, N.Y. TIMES, July 18, 1999, at A1; STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 5, 30 (Joint Comm. Print 2002) (commenting that levies tripled in 2001 from 2000, liens increased 50%, and seizures increased from 74 to 274; all are, however, still much lower than their respective levels in 1997 of 19%, 79%, and 2%, respectively).

¹¹⁸ *Rossotti Testimony at House Appropriations Subcommittee Hearing on IRS Budget*, TAX NOTES TODAY (May 3, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 86-74, ¶ 53).

increase.”¹¹⁹

A critical question is whether the decline in corporate audits for CEP and large corporations (i.e., LMSB taxpayers) has resulted in greater noncompliance.¹²⁰ Commissioner Rossotti, seeking to obtain more funding for additional revenue agents and to move corporate tax auditors from deployment to customer service during tax season and then back to corporate audits, testified in May 2001 that while the workforce declined 17% (due to Congressional budget cuts), the number of returns filed increased 13%.¹²¹ Consequently, the number of audits declined.¹²² Commissioner Rossotti further testified:

The IRS is also deeply concerned about the continued drop in audit and collection activity. Clearly, the declines we have witnessed in the past few years must stop or the fairness and effectiveness of our tax system will be undermined. The risks of these declines are not simply the dollar value of the taxes left uncollected. The greatest risk is that the average taxpayer who honestly pays taxes loses confidence if the IRS fails to act effectively and efficiently to collect from those who do not pay what they owe.¹²³

The media widely reported the drop in the tax audit rate for large firms,¹²⁴ growth in use of tax shelters by such firms as audit scrutiny

¹¹⁹ *Id.* ¶ 54.

¹²⁰ David R. Francis, *Audits Drop, Fraud Concern Rises*, CHRISTIAN SCI. MONITOR, Apr. 16, 2001, at 1 (noting that “experts are concerned that the laxer enforcement will increase the ranks of those who don’t [honestly pay their taxes,]” and may induce wealthier and more sophisticated taxpayers to take more risks with respect to paying the proper amount of taxes); see also *The Cost of Ignoring Tax Evasion*, N.Y. TIMES, Apr. 16, 2001, at A18; Amy Feldman, *Please, IRS: Stop Playing Nice Guy*, USA TODAY, Apr. 16, 2001, at A15; Rick Montgomery, *Decline in IRS Audits Tests Taxpayer Honesty; IRS Worries About Integrity of System*, KANSAS CITY STAR, Apr. 15, 2001, at A1; David Cay Johnston, *Wealthiest Pay Declining Share of Their Incomes in Taxes*, N.Y. TIMES, Feb. 26, 2001, at C2 (commenting that the top 1% had a 28.9% effective tax rate in 1996, a 27.9% effective tax rate in 1997, and a 27.1% effective tax rate in 1998).

¹²¹ STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE 14 (Joint Comm. Print 2001).

¹²² *Id.* (Commissioner Rossotti noting other factors include a need to assign compliance staff to customer service).

¹²³ *Id.* at 13, 14.

¹²⁴ *A Weakened I.R.S.*, N.Y. TIMES, Apr. 16, 2000, at D14; David Cay Johnston, *I.R.S. Figures Show a Drop in Tax Audits for Big Companies*, N.Y. TIMES, Apr. 12, 1999, at A1. (“The decline in audit rates began in 1968 but accelerated in 1995, after

faded,¹²⁵ and decline in reported taxable income while book earnings soared.¹²⁶ At the same time, the corporate share of individual and corporate income taxes declined from 21% in 1996 to 14% in 2001.¹²⁷ The General Accounting Office shares concerns “expressed in Congress and by tax practitioners that these declines in audits,

Congress, by then controlled by Republicans, cut I.R.S. spending sharply and required the agency to devote more resources to customer service.”); *see also* Montgomery, *supra* note 120; Amy Feldman & Joan Caplin, *Should You Cheat on Your Taxes?*, MONEY, Apr. 2001, at 108; Novak, *supra* note 101, at 122.

¹²⁵ See David Cay Johnston, *Tax Magicians/A Special Report; Sham Shelters for Business Flourish as Scrutiny Fades*, N.Y. TIMES, Dec. 19, 2000, at A1 [hereinafter Johnston, *Sham Shelters*] (“[T]he recent weakness of I.R.S. because of budget cuts and new restraints imposed by Congress has only emboldened corporations. . . . The Treasury Department has identified corporate tax evasion as the nation’s biggest tax enforcement problem, and . . . shelters are at the core of it.”); *see also* Francis, *supra* note 120, at 1.

¹²⁶ See generally Richard Lavoie, *Deputizing the Gunslingers: Co-Opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43, 45 n.2 (2001); David Cay Johnston, *Corporations’ Taxes are Falling Even as Individuals’ Burden Rises*, N.Y. TIMES, Feb. 20, 2000, at A1 (pointing out that stock options are one factor in drop in corporate effective rate, but the “most troubling factor is the rapid spread of tax shelters, especially among large corporations” and what particularly alarms the Service and the Treasury Department is the “growing willingness by prominent companies . . . to engage in the kind of tax avoidance tactics more characteristic of the most disreputable companies.” It should also be noted that while corporate profits are 252% higher for 1997 than for 1990, tax revenues have increased just 191%. Moreover, less than 70% of profits reported to shareholders are reported as taxable income for 1997 as contrasted with 91% for 1990. “The tax department is viewed more as a profit center and a place that has more of an obligation to more or less aggressively reduce the tax burden.”); Martin A. Sullivan, *News Analysis: Shelter Fallout? Corporate Taxes Down, Profits Up*, 84 TAX NOTES 653 (Aug. 2, 1999) (noting that corporate taxes, as a share of corporate profits, are at their lowest level since President Ronald Reagan’s massive 1981 corporate tax cut indicating “that the efforts of corporate tax advisers to shelter their clients’ profits from tax have had more than a marginal effect”); Martin A. Sullivan, *News Analysis – Despite September Surge, Corporate Tax Receipts Fall Short*, 85 TAX NOTES 565 (Nov. 1, 1999); David Cay Johnston, *Study Finds That Many Large Companies Pay No Taxes*, N.Y. TIMES, Oct. 20, 2000, at C2 (according to Citizens for Tax Justice, “[c]orporate taxes are not rising with profits because companies have found all sorts of ways to get around the [Tax Reform Act of 1986.]” Congress has given a lot of help in gutting the minimum tax rules, “in many cases because of the growing use of stock options, which are an expense for tax purposes but do not count against profits reported to shareholders.”).

¹²⁷ Transactional Records Access Clearinghouse at Syracuse Univ., *Federal Income Tax for Corporations and Individuals, 1910-1000*, at http://trac.syr.edu/tracirs/findings/national/incomeTax1910_presG.html (last visited Oct. 1, 2002); *see also* Robert S. McIntyre, *The Taxonomist*, AM. PROSPECT, Apr. 24, 2000, at 14 (17% in 2000).

enforcement actions, and collections may increase incentives for taxpayers either to not report or to underreport their tax obligations.”¹²⁸ Moreover, tax avoidance at the high-income individual level has also soared.¹²⁹ Leading practitioners have called for tougher penalties to deter corporate tax shelters,¹³⁰ which are of grave concern to both the Treasury Department and the Service.¹³¹

¹²⁸ GENERAL ACCOUNTING OFFICE, IRS MODERNIZATION: CONTINUED IMPROVEMENT IN MANAGEMENT CAPABILITY NEEDED TO SUPPORT LONG-TERM TRANSFORMATION 2 (2001); see also *id.* at 8; GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE: PROGRESS CONTINUES BUT SERIOUS MANAGEMENT CHALLENGES REMAIN 29 (2001).

¹²⁹ See GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE: ENHANCED EFFORTS TO COMBAT ABUSIVE TAX SCHEMES – CHALLENGES REMAIN 1 (2002).

As of February 2002, IRS estimated that in tax year 2000 about 740,000 [individual] taxpayers had used abusive schemes. IRS caught about \$5 billion in improper tax avoidance or tax credit and refund claims, but estimated that another \$20 billion to \$40 billion had not been identified and addressed. Recent developments suggest that the number of individuals involved in one type of abusive tax scheme involving offshore accounts may be greater than what IRS estimated just 2 months ago, and thus, potential lost revenues may be higher.

Id. at 1; *Transcript of Hearing of the Senate Finance Committee on Schemes, Scams and Cons, Part II, the IRS Strikes Back*, FEDERAL NEWS SERVICE (Apr. 11, 2002) (statement of Commissioner Rossotti) (the largest category of promoted schemes is the “use of devices such as trusts and offshore bank accounts to hide income, and these are used mostly by upper income individuals”; offshore schemes may involve as many as 505,000 taxpayers with tax losses ranging from \$20 to \$40 billion); John D. McKinnon, *IRS Data Show More Taxpayers Are Using Scams*, WALL ST. J., Apr. 15, 2002, at A6 (commenting that 700,000 or more individuals are underpaying taxes by tens of billions of dollars); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 29 (Joint Comm. Print 2002) (noting that the “IRS estimates losses in the tens of billions of dollars.”).

¹³⁰ See David Cay Johnston, *Top Tax Expert Calls for Tougher Penalties to Deter Corporate Cheating*, N.Y. TIMES, Mar. 9, 2000, at C2. See generally, Peter C. Canellos, *A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001); *LMSB Hearing Transcript*, *supra* note 84, ¶¶ 259-62 (statement of Sax, Chair of ABA Section of Taxation).

¹³¹ See *LMSB Hearing Transcript*, *supra* note 84, ¶¶ 242-44 (statement of LMSB Commissioner Langdon).

[I]nvestment bankers would come in with the various typical, quite appropriate tax reorganization proposals; and then they would say, “And we also have products whereby you don’t have to pay the capital gains tax

Former Treasury Secretary Lawrence H. Summers is reported to have warned in February 2000 that “illegal corporate tax shelters were costing taxpayers at least \$10 billion a year.” He further said that illegal corporate tax avoidance “may be the most serious compliance issue threatening the American tax system today.”¹³² In 2000, the Treasury Department contended that

a growing number of corporate executives, under intense pressure from shareholders and Wall Street to boost earnings, are using complex tax-evasion schemes to cheat Uncle Sam out of billions of dollars every year As evidence, the Treasury points to a widening gap between profits large companies report to their shareholders and profits subject to taxes that they report to the IRS. The gap in 1997 was \$122 billion, nearly twice as big as in 1995.¹³³

Likewise, Enron appears destined to become a poster child for this phenomenon,¹³⁴ although WorldCom/MCI¹³⁵ more closely

on that transaction, and if your tax department doesn't know about how to avoid capital gains tax, they're out of date.” . . . Of course, they would make these presentations through [tax unsophisticated] corporate development people . . . and so in effect, tax departments are constantly in the mode of dealing with . . . people coming in with proposals . . . that frankly are not sound, that won't be sustained by the courts, and are areas of material concern.

Id. ¶¶ 242-44; accord Johnston, *Sham Shelters*, *supra* note 125.

¹³² David Cay Johnston, *I.R.S. Offers Amnesty to Companies that Admit Tax Indiscretions*, N.Y. TIMES, Dec. 26, 2001, at C1 [hereinafter Johnston, *Amnesty*] (waiver worth as much as \$2.9 billion to the ninety-five companies disclosing for 2001). The amnesty is from penalties for abusive shelters, not the taxes owed, and brought in fifty-two more disclosures in addition to 325 prior disclosures. *See also* Glenn Kessler, *Tax Shelter Disclosure Falls Short, IRS Says; Agency Seeking to Halt Corporate Abuses*, WASH. POST, Mar. 1, 2002, at E1 [hereinafter Kessler, *Tax Shelter Disclosure Falls Short*]; David S. Hilzenrath, *Accountants' Tax Services Draw Fire*, WASH. POST, Feb. 7, 2002, at E1 (“The Internal Revenue Service has estimated that abusive tax shelters cost the U.S. Treasury about \$10 billion a year.”).

¹³³ Owen Ullmann, *IRS Hunts Corporate Schemes*, USA TODAY, Apr. 17, 2000, at A1 (“Despite record profits, corporations paid 2% less in federal taxes last year than in 1998. And the share of all federal taxes paid by corporations has been shrinking since 1997, while individuals have been shouldering a steadily rising burden.”).

¹³⁴ *See* Kessler, *Tax Shelter Disclosure Falls Short*, *supra* note 132.

The burgeoning business of corporate tax shelters has received added scrutiny since the collapse of Enron . . . [which] aggressively used tax shelters peddled by Wall Street and accounting firms . . . [and that t]he

resembles a situation involving capitalization versus expensing.

Section 6111 requires the promoter of a tax shelter to register it with the Secretary of the Treasury.¹³⁶ Professor Michael Graetz, past master of tax administration, policy, and reform, and especially le mot juste, once defined a tax shelter as “a deal done by very smart people that, absent tax considerations, would be very stupid.”¹³⁷ The *Wall*

Senate Finance Committee is nearing an agreement to obtain access to Enron's tax filings to learn more about the transactions.

Id.; David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, N.Y. TIMES, Jan. 17, 2002, at A1; Bill Ghent, *Gimme Shelter*, 34 NAT'L J. 547 (Feb. 23, 2002) (“It is a sin to say it, but ‘thank God for Enron,’ [Senator] Grassley recently told reporters, ‘because we are going to do something about these corporate tax shelters.’”).

¹³⁵ Peter J. Howe, *2 Charged with WorldCom Fraud Former Officials Surrender to FBI in Telecom Scandal*, BOSTON GLOBE, Aug. 2, 2002, at E2 (“An internal WorldCom auditing memo filed with court papers yesterday gave some details of how Sullivan and Myers shifted operating expenses known as ‘line costs’ over to capital accounts where they could be written off over years, improving WorldCom's reported cash flow.”). Glenn Walberg maintains that capitalization for tax purposes is often more concerned about timing issues (when costs are recognized for tax accounting purposes) so that as long as taxpayers are taking legitimate positions on their tax returns, capitalization is not an abusive transaction. In WorldCom, the financial accounting treatment of the line costs does not appear to me to have been legitimate.

¹³⁶ See I.R.C. § 6111. See generally, STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS 2 (Joint Comm. Print 2002).

¹³⁷ STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS 2 n.2. The report provides the following example of a transaction without economic substance:

Both the Tax Court and the Third Circuit Court of Appeals held that the transaction [in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'd* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999)] lacked economic substance. The Third Circuit held that “both the objective analysis of the actual economic consequences of ACM's transactions and the subjective analysis of their intended purposes support the Tax Court's conclusion that ACM's transactions did not have sufficient economic substance to be respected for tax purposes.” The court observed that the economic substance doctrine can apply equally to “shams in substance” as “shams in fact” and that even if the purported activity in the transaction actually occurs, the transaction may be disregarded when (other than tax consequences) the transaction results in “no net change in the taxpayer's economic position.” In other words, as an objective matter, to be respected for tax purposes, a transaction must have practical economic effects other than the creation of tax losses. The court found that there was “a lack of objective economic consequences arising from ACM's offsetting acquisition and virtually immediate disposition of the floating-rate notes. . . . We find that these transactions had only nominal, incidental effects on

Street Journal reported Graetz's definition,¹³⁸ and the Joint Committee Staff¹³⁹ and Senate Finance Committee Chair Max Baucus¹⁴⁰ repeated it, while ranking minority member Senator Charles E. Grassley paraphrased it as the "street" definition.¹⁴¹ Section 6111, on the other hand, provides one definition aimed at traditional tax shelters,¹⁴² and another aimed at corporate tax shelters that have the purpose of avoiding federal income tax plus confidentiality and promoter fees in excess of \$100,000.¹⁴³ Assistant Secretary of Treasury Mark Weinberger testified at the hearing that

[w]hile well-intentioned, you had to trigger two of five criteria to determine whether you had to actually come within the requirements of filing. Then once you triggered those, there were three very subjective exceptions to the rules that you could rely on to get out of having to disclose. So, I think a lot of taxpayers were reading the rules broadly for the exceptions, narrowly for the requirements¹⁴⁴

The Joint Committee Report on Tax Shelters provides both a handy list of Code provisions that may apply to tax shelters and an outstanding glossary of tax doctrines¹⁴⁵ used to battle corporate tax shelters in the courts. This effort initially met with universal victory in that arena, but has recently suffered several circuit court losses¹⁴⁶ that

ACM's net economic position."

Id. at 12.

¹³⁸ Tom Herman, *Tax Report*, WALL ST. J., Feb. 10, 1999, at A1.

¹³⁹ See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS 2 n.2 (Joint Comm. Print 2002).

¹⁴⁰ See *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶ 10.

¹⁴¹ *Id.* ¶ 160 ("Perhaps the most illuminating definition of a shelter comes from the street, as I have tried to indicate. It is a bad deal done by a lot of smart people who would not do it but for the tax benefits.").

¹⁴² A mechanical ceiling of 2:1 "tax shelter ratio," i.e., the ratio that deductions (and translated credits) bear to the investment base cash and adjusted basis (like the "amount at risk" under section 465); substantial investment (at least \$250,000); and at least five investors. I.R.C. § 6111(c)(2); I.R.C. § 6111(d).

¹⁴³ I.R.C. § 6111(d)(1).

¹⁴⁴ *Transcript of Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 199-200 (statement of Assistant Secretary for Tax Policy Mark Weinberger).

¹⁴⁵ See STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS 7-28 (Joint Comm. Print 2002).

¹⁴⁶ *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 418 (Chief Counsel John Williams, former Tax Court judge, stated that generalist judges have more of a sense that tax avoidance is a legitimate business objective than Tax

seem to be in line with the view of the House GOP leadership toward the end of the Clinton Administration, which did “not consider corporate tax shelters a threat to the tax system.”¹⁴⁷ Those GOP leaders, of course, bitterly opposed the “progressive” federal income tax and even expressed the desire “to tear it out by the roots.”¹⁴⁸ Senate Finance Committee Chair Max Baucus and Chief Counsel John Williams discussed in the 2002 Senate Finance Hearings on Tax Shelters the difference in results in the tax shelter cases at the Tax Court Level and in some circuit courts. At the same time, Senator Baucus averred that Tax Court judges had a better understanding of corporate tax shelters than some circuit courts. In response to this comment, Chief Counsel Williams said, “the generalist judges have more of a sense that tax avoidance is a legitimate business objective than tax court judges do.”¹⁴⁹

Court judges). Chair Baucus less diplomatically put it that Tax Court judges tend to understand these cases relatively well while appellate judges do not. *Id.* ¶¶ 410-11.

¹⁴⁷ Ryan J. Donmoyer, *GOP Leadership: Shelter Problem, What Shelter Problem?*, 86 TAX NOTES 1039 (Feb. 21, 2000) (“House Majority Leader Richard K. Armey, R-Texas, made it clear last week that the GOP leadership does not consider corporate tax shelters a threat to the tax system.”); Ryan J. Donmoyer, *TEI Conference – Archer Tells Administration No on Shelters and Be Careful with FSCs*, 86 TAX NOTES 1815, 1816 (Mar. 27, 2000) (Archer “made it final that Congress will not pursue broad legislation anytime soon to crack down on the proliferation of corporate tax shelters He even endorsed the use of low-tax domiciles like Bermuda by insurance companies that want to reduce their tax liability legally. ‘That’s legitimate,’ he said.”).

¹⁴⁸ *International Trade Commission to Endorse Consumption Tax*, TAX NOTES TODAY (July 20, 1998) (LEXIS, FEDTAX lib., TNT file, elec. cit., 98 TNT 138-2) (“Ways and Means Committee Chair Bill Archer, R-Texas, has said he wants to ‘tear the income tax out by its roots’ and replace it with a consumption tax.”); *accord Taxwriters Exchange Pleasantries, Draw Lines on IRS Reform Conference*, TAX NOTES TODAY (June 11, 1998) (LEXIS, FEDTAX lib., TNT file, elec. cit., 98 TNT 112-3); Howard Gleckman, *Tax Reform Is Coming, Sure. But What Kind?*, BUS. WK., June 12, 1995, at 84; *Rostenkowski Criticizes Congress Tax Cut Plan; Ex-Lawmaker Lauds Bush for 1990 Hike*, CHI. TRIB., Jan. 12, 1999, at N5; David Cay Johnston, *A Tax Cut Your Lawyer Will Love*, N.Y. TIMES, Aug. 3, 1997, at A26; *cf. Treasury Secretary O’Neill’s Statement on OECD Tax Haven Initiative*, TAX NOTES TODAY (May 11, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 92-39) (Bush administration would not support an overly broad effort to impose sanctions on tax havens); David Cay Johnston, *Former I.R.S. Chiefs Back Tax Haven Crackdown*, N.Y. TIMES, June 9, 2001, at C1 (“Seven former commissioners of the Internal Revenue Service urged Treasury Secretary Paul H. O’Neill yesterday to withdraw his opposition to a proposed crackdown [by Organization for Economic Cooperation and Development] on Caribbean nations and others that are considered tax havens.”).

¹⁴⁹ *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 410-11, 417-19. See Alexandra M. Walsh, *Formally Legal, Probably Wrong: Corporate Tax*

When the Treasury Department and the Service determine that a transaction has a substantial tax avoidance purpose, the Service issues a "Notice"¹⁵⁰ informing taxpayers of the details of the transaction.¹⁵¹ A series of penalties is applicable to tax shelter users, as well as tax return preparers and promoters who fail to register tax shelters.¹⁵² Compliance with these registration rules, however, is in the words of Senator Baucus, "to put it bluntly, a joke."¹⁵³ Even so, the ninety-nine reporting big corporations revealed staggering revenue losses from such tax shelters, sixty-four of which were "listed" transactions.¹⁵⁴ These transactions generated \$14.7 billion in deductions and losses for 2000.¹⁵⁵ On December 21, 2001, the Service issued Announcement 2002-2,¹⁵⁶ which provides a 120-day opportunity for taxpayers

Shelters, Practical Reason and the New Textualism, 53 STAN. L. REV. 1541 (2001), for an academic discussion of this phenomenon. See also David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent*, 53 TAX LAW. 579 (2000); George K. Yin, *Business Purpose, Economic Substance, and Corporate Tax Shelters: Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001) (considers history of tax shelter activity in the 1970s and 1980s and applies lessons from response to that problem to current corporate tax shelters and argues for a change to an adjusted book income tax base for public corporations).

¹⁵⁰ See Temp. Treas. Reg. § 301.6111-2T(b)(2) (2002).

¹⁵¹ See, e.g., STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS 33 (Joint Comm. Print 2002).

¹⁵² See *id.* at 31-37.

¹⁵³ *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 19, 191 (for 2001, there were 272 disclosures from ninety-nine taxpayers, with sixty-four listed transactions and 208 reportable transactions). These transactions resulted in tax savings, or often tax avoidance, of \$14.9 billion. See *infra* note 155.

¹⁵⁴ Section 6662(d)(2)(D) of the Code authorizes the Treasury Department to list positions for which it believes there is no substantial authority in the Federal Register.

¹⁵⁵ See Kessler, *Tax Shelter Disclosure Falls Short*, *supra* note 132. David Harris, manager of the Service's office of tax shelter analysis, said:

the 272 transactions disclosed by 99 companies in 2001 resulted in total tax savings of \$14.9 billion, while the 52 additional disclosures under the amnesty resulted in more than \$1.2 billion in claimed losses or deductions. Not all the transactions are considered by the IRS to be abusive. But . . . a preliminary analysis of the 2001 filings suggests that 200 of the deals have been listed as abusive tax shelters or appear to raise concerns.

Id. While this article implies that "tax savings" equals the amount of tax reduction, a subsequent announcement by the Service shows that "tax savings" must mean tax deductions and losses. See *infra* note 156 and accompanying text.

¹⁵⁶ See I.R.S. Announcement 2002-2, 2002-2 I.R.B. 304 (Dec. 21, 2001) (Service will waive the accuracy-related penalty under section 6662 for underpayments due to negligence and the penalty for underpayments due to substantial understatements of income tax, and substantial valuation misstatements, provided that the taxpayer

voluntarily to disclose tax shelters and other questionable items reported on their tax returns so they may obtain a waiver of accuracy penalties. As of two weeks before the end of such period, the Service had received disclosures from more than 250 taxpayers involving 458 tax shelter transactions with reported deductions and losses of more than \$8.5 billion.¹⁵⁷ Senator Baucus questioned LMSB Commissioner Langdon as to the size of the pool of potential purchasers at a recent Senate Finance Committee Hearing on Tax Shelters; he responded that there were 90,000 to 100,000 large corporations in LMSB.¹⁵⁸ Thus, the ninety-nine reporting taxpayers are probably just the tip of the iceberg.

For a rough idea of the potential magnitude of the corporate tax shelter problem, this \$14.7 billion in lost revenue may be contrasted with the \$358 billion in taxable income reported for 1998 by the bigger LMSB regular corporation taxpayers. While two million regular corporations reported \$477 billion in taxable income for 1998 (the latest year for which data is available),¹⁵⁹ based on historical trends, more than 75% of this was probably reported by the largest corporations with \$250 million or more in assets,¹⁶⁰ or roughly \$358 billion in total. Thus the ninety-nine reporting large corporations accounted for revenue losses equal to around 4% of the taxable income reported by such large corporations.¹⁶¹ The Treasury Department thought that many more of the large LMSB corporations would report,¹⁶² so the revenue loss could easily approach half of the

discloses tax shelters and other questionable transactions before the earlier of April 23, 2002, or the transaction is raised during an examination); Tim Reason, *Tax Shelters – Of Beans and Carrots*, CFO, Feb. 1, 2002, at 16 (“Companies that spill the beans about a tax shelter . . . can avoid the 20% penalty on any resulting understatement of tax.”).

¹⁵⁷ *IRS Reminds Taxpayers of Deadline for Voluntary Tax Shelter Disclosure*, TAX NOTES TODAY (April 10, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 69-38).

¹⁵⁸ See *Transcript of Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 194-96.

¹⁵⁹ See Patrice Treubert & William P. Jauquet, *Corporation Income Tax Returns, 1998*, 21 STAT. INCOME BULL. 66, 67 (2001).

¹⁶⁰ See *supra* note 71.

¹⁶¹ $\$477 \times 0.75 = \358 , and $\$14.7 / \$358 = 4.1\%$.

¹⁶² See *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 36, 168 (Mark Weinberger, Assistant Secretary for Tax Policy, stated, “The results are in. We have now received and reviewed the first year of filings and disclosures. We are disappointed in the number and types of transactions that have been disclosed.”). The tax shelter penalty waiver initiative, however, exceeded expectations. Brant Goldwyn, *Langdon Says Shelter Disclosures Have Exceeded Service’s Expectations*, 92 BNA DAILY TAX REP., May 13, 2002, at G-2. Most of the 1000 taxpayers so

income reported by large LMSB corporations.¹⁶³ On the other hand, Tax Notes Economic Correspondent Martin A. Sullivan reported that the corporate effective rate has been “remarkably steady,” from 25.4% to 22.4%, over the past fifteen years.¹⁶⁴ Thus, he concluded that there is no evidence from the data “to indicate that the much ballyhooed increase in corporate shelter activity has had a significant impact on corporate tax receipts.”¹⁶⁵ Yet the corporate effective rate after wider swings from 1987 through 1997 has steadily declined from 1998 to 2003, the last five years of this period.¹⁶⁶ Moreover, Sullivan pointed out that in the first quarter of fiscal 2002, the 24% decline in corporate profits from the preceding fiscal year while the decline in corporate tax payments was only 40% from “an already weak year in 2001 is still a dramatic change and well worth keeping an eye on.”¹⁶⁷

In any event, as discussed immediately below, agents have been tied up with capitalization issues instead of examining these troubling, unpatriotic¹⁶⁸ corporate tax shelters, which are also spreading to high-income individuals.¹⁶⁹ The negative effect on taxpayer confidence in the tax system of such shelters has been widely noted.¹⁷⁰ Less obvious

disclosing were individuals (fifty to 100 recent corporate disclosures, *id.*), which may well reflect “IRS’s John Doe summonses on credit card companies for the names of offshore account holders.” Amy Hamilton, *ABA Tax Section Meeting: Has IRS Found Way to Detect Unreported Income?*, TAX NOTES TODAY (May 13, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 92-13); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, at 30 (Joint Comm. Print 2002); *Treasury Statement on Offshore Credit Card Schemes*, TAX NOTES TODAY (Mar. 26, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 58-21).

¹⁶³ 1000 = 10 times the number reporting. $10 \times \$14.4 = \144 billion. $\$144$ billion / $\$358$ billion = 40.2%.

¹⁶⁴ Martin A. Sullivan, *Corporate Tax Revenues: Up, Down, and All Around*, 95 TAX NOTES 25 (Apr. 1, 2002).

¹⁶⁵ *Id.* at 28.

¹⁶⁶ *Id.* at 27 fig.2B.

¹⁶⁷ *Id.* at 28.

¹⁶⁸ Cf. *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶¶ 7-8 (marketer of “inversion deals” said that some companies conclude that “the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat.” This was very troubling to the Chair, “especially now as we all try to pull together, most particularly since September 11, as a Nation and work together to help our people meet the problems that we are facing.”).

¹⁶⁹ See *supra* note 129 and accompanying text.

¹⁷⁰ *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶ 9 (statement of the Chairman, Senator Baucus) (“These tax shelters could do serious harm. They undermine public confidence in the tax system, clearly. They make

may be their effect on baby boomer investors' confidence in the stock market itself.¹⁷¹ Such a lack of confidence could have a strong economic¹⁷² and political fallout.¹⁷³

F. LMSB Audits and Capitalization Issues

Historically for large corporations, an additional recommended income tax "typically [arose] from different interpretations of an ambiguous and complex tax code. Upon audit, IRS auditors may interpret the tax provisions differently and, as a result, recommend adjustments to the corporation's tax liability."¹⁷⁴ *INDOPCO* issues are the poster child of this process. In the wake of *INDOPCO*, expensing versus capitalizing costs with present and future, often intangible, benefits became the most significant federal income tax

average taxpayers feel like chumps; we have to pay more because the big guys are paying less.").

¹⁷¹ A recent article suggested that baby boomers might lose confidence in the market when they became aware of the widespread use of corporate tax shelters (and the back taxes and penalties hopefully triggered by the media publicity fueled by the Enron scandal). See Marcia Vickers et al., *The Betrayed Investor*, FORBES, Feb. 25, 2002, at 104; Steven Pearlstein, *Andersen: One Player in Big Drama*, WASH. POST, Mar. 15, 2002, at E1 (explaining that lack of confidence of baby boomers in stock market and corporate financial statements exemplified by the Enron scandal may exaggerate bust in market); John Lancaster, *Senate Democrats Set an Agenda on Enron*, WASH. POST, Feb. 15, 2002, at A11 ("According to a Senate leadership aide, they were 'trying to give people, both sophisticated and ordinary investors, the confidence that there's going to be corrective action.'").

¹⁷² *Transcript of 2002 Senate Hearing on Tax Shelters*, *supra* note 68, ¶ 11.

Abusive corporate shelters create a tax benefit without any corresponding economic benefit. No new product, no technological innovation, just a tax break. This could have a perverse effect, forcing perfectly honest companies to consider setting up a shelter of their own to avoid being placed at a competitive disadvantage. That, in a nutshell, is the problem.

Id. (statement of the Chairman, Senator Baucus); cf. Kenneth R. Gosselin, *Market Risk Finally Hitting Home; Unfamiliar with Long Downturns, Some Take Financial, Psychological Hits*, HARTFORD COURANT, Mar. 18, 2002, at A1 (explaining that boomers may withdraw from stock market due to recent downturn after eighteen years of growth).

¹⁷³ Vickers et al., *supra* note 171 (new investors, mostly baby boomers, have lost 30% of the value of stock investments in the past two years; "Never before have the politicians faced the wrath of so many disaffected investors."); cf. Marianne Means, *Privatize Social Security? Ha!*, MILWAUKEE J. SENTINEL, Jan. 17, 2002, at 15A.

¹⁷⁴ GENERAL ACCOUNTING OFFICE, TAXPAYER COMPLIANCE: ANALYZING THE NATURE OF INCOME TAX GAP 4 (1997).

issue by far in audits of big businesses.¹⁷⁵ In large part, this phenomenon reflected the Service's directing its CEP auditors, through many Industry Specialization Programs (ISPs),¹⁷⁶ to look in the aftermath of *INDOPCO* for specific deduction versus capitalization issues, particularly with future benefits flavor, in various market segments at the CEP level applicable to the largest 2000 or so corporations.¹⁷⁷ The administrative responses to expensing and capitalization issues often manifested conflicts between the Examination division and the Office of Chief Counsel.¹⁷⁸ Such regulation by audit and litigation contradicts the vaunted shift by the Service to rising voluntary compliance,¹⁷⁹ a goal of its recent restructuring. Moreover, the propensity of the Service's auditing agents and litigators once again to capitalize transaction costs to intangibles with no depreciation, or to tangibles with a longer recovery period than the future benefit of the expenditure, predictably led to courts allowing current deductions under questionable reasoning.¹⁸⁰ At the same time, corporate audit rates have rapidly declined and been disproportionately directed to these

¹⁷⁵ GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: RECURRING ISSUES IN TAX DISPUTES OVER BUSINESS EXPENSE DEDUCTIONS 2 (1995) (reporting that of 117 Service Office of Appeals cases filed by large corporations, capital expenditure issues comprised 42% of the total number and \$1.1 billion of the \$1.9 billion in proposed tax adjustments, or 58%); see also GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: RECURRING TAX ISSUES TRACKED BY IRS' OFFICE OF APPEALS 5-6, 14, 22-23 (1993).

¹⁷⁶ ISP papers provide guidance to the Service's agents auditing large corporate taxpayers in the CEP. See Marion Marshall et al., *The Changing Landscape of IRS Guidance: A Downward Slope*, 90 TAX NOTES 673, 679 (Jan. 29, 2001); *IRS Publishes List of ISP Guidelines, December 31, 1996*, TAX NOTES TODAY (Feb. 7, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 26-32) (citing a number of capitalization/amortization issues, some predating *INDOPCO*). See generally, Lee et al., *Rough Justice I*, *supra* note 17, at 655-56. Glenn Carrington points out that all of the publicity over capitalization versus expensing after *INDOPCO* may have alerted some taxpayers to the possibility of deducting costs that they otherwise might have capitalized.

¹⁷⁷ See *supra* note 176.

¹⁷⁸ Lee et al., *Rough Justice I*, *supra* note 17, at 655-58.

¹⁷⁹ Sheryl Stratton, *Tackling the Tax Gap on Tip Income*, TAX NOTES TODAY (Apr. 18, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 75-3).

¹⁸⁰ Having thought for some time about a world without the no separate asset doctrine and about the tendency of government auditors and litigators to argue for capitalization without depreciation, I cautioned that "the lesson is clear: unjust rules, capitalization without adequate amortization, will cause some (but not all) courts to seek other solutions promoting uncertainty. The Treasury/IRS goal of 'rough justice' is welcome and to be celebrated." Lee, *Capitalization Rules*, *supra* note 13, at 677.

losing capitalization issues¹⁸¹ while widespread abuse of corporate tax shelters has continued unchecked.

“Resolution of issues such as capitalization and the R & E credit, which the IRS has indicated consumes nearly 40% of the audit resources in the IRS Large & Mid-Size Business Division, will free up resources for better use – such as targeting abusive tax avoidance schemes.”¹⁸² As former Chief Counsel and Assistant Secretary for Tax Policy Ken Gideon stated:

If the current level of *INDOPCO* disputes at the audit level continues, we are going to be spending enormous resources on questions of capitalization. It strikes me, given the other problems of the income tax, that that’s a bad call. The much better call would be to write some rough justice rules and say, okay, these are the rules.¹⁸³

The new Chief Counsel, and former Tax Court Judge, B. John Williams, has wisely decided on the course of “using litigation as an enforcement tool rather than to establish novel legal interpretations;

¹⁸¹ Only 20% of the proposed increases in CEP audits are sustained in administrative appeals and assessed as additional taxes. Almost all (97%) of the so-assessed taxes are paid by CEP large corporations. GENERAL ACCOUNTING OFFICE, IRS MEASURES COULD PROVIDE A MORE BALANCED PICTURE OF AUDIT RESULTS AND COSTS 3-4 (1998).

¹⁸² *Treasury Proposals to Curb Abusive Tax Avoidance Transactions*, TAX NOTES TODAY (Mar. 21, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 55-25); *IRS Memo Provides Guidelines for Intangibles*, TAX NOTES TODAY (May 9, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 90-8, ¶ 6) (explaining that the Service’s examination resources are better utilized on other high-risk compliance areas rather than capitalization issues described in the Advance Notice). For the contrary argument that the Service should allocate *more* resources to fixing up the tax accounting rules, see Lee A. Sheppard, *News Analysis: Tax Shelter Opponents Turn Practical*, 95 TAX NOTES 1111, 1112 (May 20, 2002).

Tax accounting is where the rubber meets the road. The tax administrator should reallocate resources to devote the necessary brainpower to fixing up tax accounting rules that affect all taxpayers. That, of course, includes the capitalization rules, where the Bush Treasury is showing an inclination to reverse the presumption of capitalization. At least if businesses emerge not paying tax because they are allowed to deduct all of their costs, they should be incurring those costs for something more productive than tax shelter promoters’ fees.

Id. at 1111-12.

¹⁸³ *Conference on Tax Legislative Process, Day Two*, *supra* note 34, ¶ 586.

and identifying and shutting down tax shelters faster.”¹⁸⁴

III. ACQUISITION COSTS UNDER *WOODWARD/HILTON HOTELS* AND *IDAHO POWER*

An ordinary business or investment expense is currently deductible under section 162 in the tax year incurred or paid. An expenditure capitalized under section 263, in contrast, may be deducted from ordinary income only through (1) amortization or depreciation under section 168 over the statutory “recovery period” (or under section 167, usually ratably, over the useful life of the asset acquired, created, or improved by the expenditure); or (2) upon destruction, other realization, or abandonment prior to the end of such life as a loss under section 165.¹⁸⁵ Thus, sections 162 and 263 are designed to calculate net income more accurately¹⁸⁶ by generally matching expenses with revenue in the taxable periods in which the

¹⁸⁴ Sheryl Stratton, *Federal Bar Association – Williams Sketches Agenda for Office of Chief Counsel*, 94 TAX NOTES 1430, 1430 (Mar. 18, 2002); accord Lee A. Sheppard, *ABA Tax Section Meeting: Chief Counsel Talks About Shelter Litigation*, TAX NOTES TODAY (May 10, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 92-4) (“‘Litigation is not a proper tool for making tax policy. It is an extraordinarily ineffective way to do it,’ he said. ‘Litigation is an enforcement tool.’”); Brant Goldwyn, *Simplification, Improving Guidance Process Are Top Priorities for Treasury, Olson Says*, 47 BNA DAILY TAX REP., Mar. 11, 2002, at G-2 (“Treasury and IRS believe taxpayers should be provided clear guidance through the rulemaking process, Olson said, rather than through litigation.” Litigation should be used to enforce existing guidance).

¹⁸⁵ See Lee, *Start-Up Costs*, *supra* note 10, at 9-10. Most taxpayers, of course, would prefer a current deduction because it is worth more on a present value basis than the same amount capitalized and then amortized or depreciated over the current and a fixed number of future tax years. *Fishman v. Commissioner*, 837 F.2d 309, 312 (7th Cir. 1988) (“Because of the time value of money – real riskless rates are positive – a deduction taken today is worth more than one taken a year from now.”); see also Kevin J. Coenen, Note, *Capital or Ordinary Expense? The Proper Tax Treatment of a Target Corporation’s Expenditures in an Acquisitive Reorganization*, 58 OHIO ST. L.J. 583, 586 (1997).

¹⁸⁶ Taxing net annual income is a fundamental policy of the Code. See 50 CONG. REC. (Part 4) 3849 (Aug. 28, 1913) (remarks of Sen. John S. Williams, D-Miss.). Today the keystone is section 446’s mandate that a taxpayer’s method of income tax accounting must clearly reflect income. See I.R.C. § 446(b). A taxpayer’s practice of expensing or capitalizing an expenditure has been held such a method of accounting. See Rev. Rul. 95-74, 1995-2 C.B. 36; Rev. Rul. 95-32, 1995-1 C.B. 8; Gen. Couns. Mem. 39,328 (Jan. 23, 1985). It should be noted that Glenn Walberg suggests that permanent capitalization of costs might not constitute a method of tax accounting because it arguably does not involve a timing element.

expenses actually generate that revenue.¹⁸⁷

A. Woodward/Hilton Hotels *and Origin of the Claim/Acquisition Cost Doctrine*

The origin of the claim doctrine holds that the transaction out of which an expenditure arises, rather than its consequences or the taxpayer's purpose for expenditure, controls its characterization for tax purposes.¹⁸⁸ The purpose of the doctrine is to prevent a taxpayer from distorting income by mismatching *timing* and/or *character* of income and expenses, lest the tax treatment of an expenditure or method of tax accounting for that item violate the clear reflection of income mandate of section 446.¹⁸⁹ The courts often speak of preventing "double deductions."¹⁹⁰ In the context of a capital transaction, income distortion would arise if a capital gain, preferenced as to individuals from 1942 until fifteen years ago by a 50% to 60% deduction (and now by a rate ceiling for individual capital gains roughly equivalent at many, but not all, brackets to a 50% deduction¹⁹¹), were coupled with an ordinary deduction for an

¹⁸⁷ See generally Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984).

¹⁸⁸ See, e.g., Lee & Murphy, *supra* note 3, at 484-99; Timothy A. Rodgers, Note, *The Transaction Approach to the Origin of the Claim Doctrine: A Proposed Cure for Chronic Inconsistency*, 55 BROOKLYN L. REV. 905 (1989) (citing Lee & Murphy, *supra* note 3); Edward J. Schnee & Nancy J. Stara, *The Origin of the Claim Test: A Search for Objectivity*, 13 AKRON TAX J. 97 (1997); Robert Willens, "Origin of the Claim" Doctrine Determines Whether an Expense May Be Deducted, 145 BNA DAILY TAX REP., Jul. 30, 2001, at J-1.

¹⁸⁹ *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283-84 (1967); I.R.C. § 446(b).

¹⁹⁰ Lee & Murphy, *supra* note 3, at 507, 525; John W. Lee & Mark S. Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. CORP. L. 137, 207 n.439 (1987).

¹⁹¹ Examples of rough equivalency or better in 2002 are 10% capital gains rate versus 25% individual income tax bracket; 18% capital gains rate versus 35% individual income tax bracket; the parallel disappears at the 18% capital gains rate versus 27%, 31%, and 38.5% income tax brackets, and especially the 8% capital gains rate versus the 10% individual income tax bracket, where there are almost no capital gains realized anyway. The complexity here is incredible. II STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., RECOMMENDATIONS TO SIMPLIFY THE FEDERAL TAX SYSTEM 103 (Joint Comm. Print 2001) ("Adopt a uniform percentage deduction for capital gains in lieu of multiple tax rates"); *NYSBA Tax Section Sends Tax Simplification Report*, TAX NOTES TODAY (Mar. 20, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 54-48).

expenditure related to its acquisition or disposition.¹⁹² Prevention of such distortion 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 from the amount realized to reduce the proceeds of the disposition of the capital asset.

The Supreme Court first fashioned the origin of the claim doctrine to deal with attempted *character of loss* distortion, or treating a loss as income-seeking rather than personal in origin, in *United States v. Gilmore*.¹⁹³ In *Gilmore*, the taxpayer deducted attorney's fees related to a divorce, arguing that the expenses were currently deductible under section 212 since the taxpayer's purpose was to "conserve" as much of his estate as he could from his ex-spouse's marital claims.¹⁹⁴ The Court in *Gilmore* sustained the Service's contention that deductibility turned on the origin and nature of the claim giving rise to the legal expense, here the personal marital relationship, such that the attorney's fees in a divorce contest were not deductible due to section 262, notwithstanding such preservation purpose or consequence.

In *Woodward v. Commissioner*¹⁹⁵ and *United States v. Hilton Hotels*,¹⁹⁶ the Supreme Court extended in sound common law fashion the origin of claim doctrine from such business versus personal situations to transactions where the context or purpose of the expenditure clearly was business or profit motivated, but where the character of the expenditure still was at issue. Now the issue was whether the expenditure constituted a current deduction or a capital expenditure, presumably amortizable over a number of years.¹⁹⁷ In the case of an expenditure incurred in connection with a business capital transaction, allowance of an ordinary deduction for the expenditure, although income from the transaction would constitute capital gains, would distort the taxpayer's income possibly as to timing

¹⁹² Lee & Murphy, *supra* note 3, at 474, 484, 489, 503.

¹⁹³ 372 U.S. 39 (1963).

¹⁹⁴ *Id.* at 43.

¹⁹⁵ *Woodward v. Commissioner*, 397 U.S. 572 (1970).

¹⁹⁶ *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).

¹⁹⁷ In the case of a cost incurred in connection with the acquisition of an intangible, depreciation is available only if the life of such intangible was determinable with certainty. Treas. Reg. § 1.167(a)-3 (as amended in 2000). This was often not the case resulting in "perpetual capitalization." See *infra* note 254 and accompanying text.

and certainly as to character.¹⁹⁸ Such mismatching of a current ordinary deduction and future capital gains has the practical effect of a forbidden “double deduction,”¹⁹⁹ and underlies seemingly disparate doctrines or rules. These rules include the origin of the claim doctrine as articulated in *Arrowsmith v. Commissioner*²⁰⁰ and *United States v. Skelly Oil Co.*²⁰¹ Other rules under this rubric are the tax benefit rule, the year two deduction under the claim of right doctrine, and the cancellation of indebtedness doctrine.²⁰² Justice Marshall correctly explained in *Skelly Oil*²⁰³ that prevention of the equivalent of double deduction was the conceptual or policy basis of the Court’s prior decision in *Arrowsmith*.²⁰⁴ “The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.”²⁰⁵

¹⁹⁸ Lee & Murphy, *supra* note 3, at 484, 488-89.

¹⁹⁹ *Charles Ilfield Co. v. Hernandez*, 292 U.S. 62 (1934) (Consolidated Return Regulations are not to be construed as permitting the practical equivalent of a double deduction of the same losses, first as subsidiary company losses in consolidated returns for earlier years, and again in the eventual loss to the parent company from its investment in the subsidiary); *see United States v. Skelly Oil Co.*, 394 U.S. 678, 685 (1969) (“[I]f money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.”); *Crane v. Commissioner*, 331 U.S. 1, 15-16 (1947) (stating that exclusion of allowable depreciation deductions from consideration in computing gain would result, in effect, in a double deduction on the same loss of assets); Lee & Bader, *supra* note 190, at 207 n.439.

²⁰⁰ 344 U.S. 6 (1952).

²⁰¹ 394 U.S. at 685; *see supra* note 198.

²⁰² Lee & Bader, *supra* note 190, at 205-25; Lee & Murphy, *supra* note 3, at 475, 503-04, 507-09, 525, 544-46.

²⁰³ 394 U.S. at 684-85; Lee & Bader, *supra* note 190, at 169-70 nn.211-20.

²⁰⁴ *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (explaining that annual accounting principle is not breached by examining year one transaction to determine character of year two transaction). *Arrowsmith* really constitutes the characterization component of the year two deduction for a repayment of an amount reported as income under a claim of right in year one. Lee & Bader, *supra* note 190, at 169 nn.213-14; Lee & Murphy, *supra* note 3, at 506-09; *cf.* Deborah H. Schenk, *Arrowsmith and Its Progeny: Tax Characterization by Reference to Past Events*, 33 RUTGERS L. REV. 317, 338-41 (1981).

²⁰⁵ *Skelly Oil*, 394 U.S. at 685. Joel Rabinovitz, *Effect of Prior Year’s Transaction on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85, 87-94, 102-04, 127-30 (1972), erred in looking for a literal constructive sale or exchange in year two instead of conceptualizing the year two transaction as a

The *Woodward* and *Hilton Hotels* decisions capitalized a corporation's transaction costs relating to buy-outs of dissenting shareholders expressly in order to prevent just such distortion of income. The Court explicitly rejected the taxpayers' argument that their "primary purpose" in paying for an appraisal of the shares of minority shareholders who did not agree to a perpetual extension of the corporation's charter was to allow its business to continue.²⁰⁶ The Court reasoned that the argument "would encourage resort to formalisms and artificial distinctions."²⁰⁷ Instead, the Court in both *Woodward* and *Hilton Hotels* applied the *Gilmore* origin of the claim standard to the capital versus ordinary deduction issue.²⁰⁸ Since establishing the price of the dissenters' shares was a crucial part of the purchase of the capital assets – in this case, their shares of stock – the appraisal costs were characterized as part of the cost of the stock acquired and not a deductible expense.²⁰⁹ As discussed below,²¹⁰ *A.E. Staley Manufacturing Co. v. Commissioner*²¹¹ effectively revived a primary purpose test with its intent to facilitate or hinder a capital transaction test.²¹²

The Fifth Circuit and the Claims Court extended the origin of the claim analysis to business expansion costs at least where a separate location or a separate license is required.²¹³ Moreover, the Court cited *Gilmore* with approval in *INDOPCO*.²¹⁴ The proper issue is whether the "asset" in such expansion and similar cases is the business as a whole, the license/branch, or a separate "freestanding," amortizable

balancing entry. Lee & Bader, *supra* note 190, at 212-13 n.468; see also Myron C. Grauer, *The Supreme Court's Approach to Annual and Transactional Accounting for Income Taxes: A Common Law Malfunction in a Statutory System?*, 21 GA. L. REV. 329, 338, 357-58, 362-67, 369-70 (1986).

²⁰⁶ Lee & Murphy, *supra* note 3, at 487, 523.

²⁰⁷ *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970).

²⁰⁸ In the companion case of *United States v. Hilton Hotels Corp.*, 397 U.S. 585 (1970), involving the cost of an appraisal arising from dissenters' rights in a merger, the taxpayer unsuccessfully sought to distinguish *Woodward* on the grounds that title to the dissenters' stock passed prior to a value being determined.

²⁰⁹ *Woodward*, 397 U.S. at 578-79.

²¹⁰ See discussion *infra* Part V.B.

²¹¹ 119 F.3d 482 (7th Cir. 1997), *rev'g and remanding* 105 T.C. 166 (1995).

²¹² See *id.* at 488.

²¹³ *Cent. Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1185 (5th Cir. 1984); accord *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 225, 229 (1985).

²¹⁴ *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 87-88 (1992).

intangible.²¹⁵

B. Idaho Power and Indirect Transaction Costs

The Court began to base capitalization of costs relating to the acquisition of a long-lived asset solely on the anti-timing distortion leg of the clear reflection of income mandate in *Commissioner v. Idaho Power Co.*²¹⁶ There, the Court faced the issue of “whether the construction-related depreciation is to be amortized and deducted over the shorter life of the equipment [used in the construction process] or, instead, is to be amortized and deducted over the *longer* life of the capital facilities constructed.”²¹⁷ Justice Blackmun set forth in *Idaho Power* the now-classic timing matching of income and expense rationale for the capitalization of indirect self-production costs of a tangible asset.²¹⁸ The matching of a current year’s expenses that benefit future years with such future years’ income (by capitalization and basis recovery) is necessary in order to prevent distortion of income under the section 446 requirement that a taxpayer’s method of tax accounting clearly reflect income. Under this rationale, the addition of capitalized transaction costs to the basis of a tangible asset would more closely match those costs to future income. Specifically, this would result from the depreciation of the cost of such tangible asset over its useful life under section 167 or a subsequently enacted statutory recovery period under section 168.

Justice Blackmun also based his decision in *Idaho Power* on the rule of “horizontal equity,” which holds that similarly situated taxpayers should be taxed in the same manner with respect to

²¹⁵ See Lee, *Start-Up Costs*, *supra* note 10, at 27-28; cf. *infra* notes 376-79 and accompanying text.

²¹⁶ 418 U.S. 1, 13-14 (1974).

²¹⁷ *Id.* at 10.

²¹⁸ There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1) But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired.

Id. at 11, 13. These indirect costs as to tangibles in most cases now would be capitalized under section 263A. See *infra* note 279.

economically identical transactions.²¹⁹ Under this judicial rule of tax parity, inside and outside transaction costs should be treated similarly in order not to provide a tax advantage to inside costs over identical outside costs of constructing or acquiring a tangible asset with future benefit.²²⁰

Justice Blackmun reaffirmed in *INDOPCO*²²¹ the future benefits analysis which he propounded two decades earlier in *Idaho Power*.²²² He reiterated in *INDOPCO* that when an expenditure benefits future periods, it generally should be capitalized instead of being currently deducted or expensed so that it might reflect net income more accurately. In short, the “matching” notion is that the capitalized expenditure will be amortized or depreciated over the period benefited by such expenditure.²²³ This article discusses below when

²¹⁹ *Idaho Power*, 418 U.S. at 14; *see also* *Lychuk v. Commissioner*, 116 T.C. 374, 398 (2001).

The Court [in *Idaho Power*] concluded that requiring the taxpayer to capitalize its depreciation would maintain tax parity between it and another taxpayer who retained an independent contractor to construct the improvements and additions for it. In the latter case, the Court stated, the depreciation on the equipment used by the independent contractor would be part of the cost that the contractor charged on the project. The Court believed it unfair to allow a taxpayer to deduct the cost of constructing its facility if it has sufficient resources to do its own construction work, while requiring another taxpayer without such resources to capitalize its cost including the depreciation charged by the contractor. The Court expressed no opinion as to the fact that the taxpayer in the *Idaho Power* case had been regularly and routinely improving its facilities throughout most of its long existence, nor that these improvements had for the most part been made by its employees.

Id. (citations and footnote omitted); *see also* Gen. Couns. Mem. 37,171 (June 20, 1977).

[T]he capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor and who must capitalize the entire cost of the contractor’s services, which would include depreciation allocable to the use of the contractor’s equipment in the construction work.

Gen. Couns. Mem. 37,171.

²²⁰ *See* *NCNB Corp. v. United States*, 651 F.2d 942, 963 (4th Cir. 1981). For discussion of the idea that the rule of parity may yield to administrative convenience, *see infra* notes 540-41 and accompanying text.

²²¹ *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

²²² 418 U.S. 1 (1974).

²²³ Due to the vagaries of tax depreciation and amortization, the match between

this theoretically correct matching should yield either to a current deduction or amortization over some safe harbor period to produce minimal distortion of income.²²⁴

Significantly, *Idaho Power* approvingly cited the Tax Court opinion in *Perlmutter v. Commissioner*,²²⁵ which required capitalization²²⁶ of the portion of the salaries of the top executives of a

the expenditure and the future benefit or income in fact is seldom very exact. Moreover, over the years, the varying "recovery periods" for real estate improvements under section 168 reflect at each turn political deals. The increase in the recovery period for real estate improvements from fifteen years to eighteen years in 1984 was a compromise instead of twenty years with the difference in revenues paid for by changes to installment reporting (section 453(i), taxing all depreciation recapture in the year of sale). Daniel Bernick, *Real Estate Write-off Change Approved by Finance Amidst Disagreements Within Industry*, TAX NOTES TODAY (April 9, 1984) (LEXIS, FEDTAX lib., TNT file, elec. cit., Apr. 9, 1984). This favored factory owners over real estate developers who tend more to churn. *Id.*; see *How the Options Industry and Realtors Escaped the Tax Bill's Axe*, TAX NOTES TODAY (July 20, 1984) (LEXIS, FEDTAX lib., TNT file, elec. cit., 84 TNT 153-22). The increase in the recovery period in 1993 from 31.5 years to 39 years for nonresidential real estate improvements was to pay for the section 469(c)(7) real estate operator exception to passive activity losses (PALs). *Unofficial Transcript of May 11 IRS Hearing on Passive Activity Losses*, TAX NOTES TODAY (May 18, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit., 95 TNT 97-37) (statement of Toby Bradley, representing National Association of Realtors). A rare exception yielding more exact matching may occur where the income forecast method of depreciation is available under section 167(g), which seeks to match capital recovery deductions with the income stream which the capital generates. Another even rarer exception possibly producing still closer matching may occur under *Associated Patentees v. Commissioner* and its progeny. *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945), *acq.* 1959-2 C.B. 3 (taxpayer paid as royalty for patent a percentage of income produced by it for fixed number of years; to clearly reflect income, taxpayer allowed to deduct as depreciation the amount paid each year under the formula). They permit an ordinary deduction of the entire amount paid during a tax year of, for instance, a theretofore contingent royalty payment tied to the taxpayer's profits or some other measure that correlates with his or her income for the period because such tack produces minimum distortion of income. *Sarkes Tarzian, Inc. v. United States*, 159 F. Supp. 253 (S.D. Ind. 1958) (installment cost payments for year pertained to that year since measured by income over that year); *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284 (1983) (such royalty payments accurately reflect the annual cost of patent with minimum distortion of income); Rev. Rul. 67-136, 1967-1 C.B. 58.

²²⁴ See discussion *infra* Part IV and notes 254-56 and accompanying text.

²²⁵ 44 T.C. 382, 404-05 (1965), *aff'd.*, 373 F.2d 45 (10th Cir. 1967).

²²⁶ *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 286 (1967), distinguished *Perlmutter* on the grounds that

the taxpayer conceded that some allocation of overhead was proper and that the sole dispute was as to the measure of the allocation. In any event,

real estate leasing corporation allocable to the three to five hours a week one top executive spent, and the five to seven hours a week the other spent in overseeing construction of a building for use in their rental business. One line of pre-section 263A authorities, epitomized by *Adolph Coors Co. v. Commissioner*,²²⁷ approved full absorption rules governing inventory accounting and requiring the capitalization of indirect costs of acquiring or constructing tangible assets²²⁸ in reliance upon *Idaho Power*.²²⁹

In contrast to the *Adolph Coors* line of cases, the Tax Court in *Fort Howard Paper Co. v. Commissioner*²³⁰ found that both full absorption and incremental accounting methods were equally permissible, in that both methods clearly reflected income under section 446 with which section 263 is “inextricably intertwined.”²³¹ Consequently, *Fort Howard Paper* permitted the taxpayer to deduct

in both of these cases, the taxpayer's very business was the construction of fixed assets, *i.e.*, buildings, and its personnel was employed for that very purpose. This is a far cry from the situation involved herein, where a large manufacturing concern engages in self-construction activities not at the expense of normal operating time but as a fill-in for slack periods.

Fort Howard Paper Co., 49 T.C. at 286 (citation omitted).

²²⁷ 519 F.2d 1280 (10th Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976).

²²⁸ The “full absorption” cost method involves capitalizing direct costs of materials and labor plus an allocable portion of all overhead. The “prime cost” method involves capitalizing only direct materials and labor costs. The “incremental cost” method involves capitalizing direct labor and material costs plus that portion of overhead which can be *directly identified* with the self-construction project. Where construction ordinarily takes place only where regular facilities and personnel are not being fully utilized (*i.e.*, during “slack” or “idle” time), there may be no overhead which can be *directly identified* with the project.

Fort Howard Paper Co., 49 T.C. at 283 n.4.

²²⁹ Treas. Reg. § 1.471-11(c)(2)(ii) (2002). STAFF OF JOINT COMMITTEE ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 504-05 (Joint Comm. Print 1987), noted this conflict between two lines of pre-section 263A cases. One line held that the Service is justified in requiring capitalization of overhead costs of construction, *i.e.*, full absorption accounting under “clear reflection of income” and *Idaho Power*. *Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976).

²³⁰ 49 T.C. at 283.

²³¹ *Id.* *Fort Howard Paper*'s undergirding of capitalization versus expensing with the concept of clear reflection of income lies at the heart of the concept of minimum distortion of income and provided the conceptual underpinning for *Cincinnati, New Orleans & Texas Pacific Railway v. United States*, 424 F.2d 563, 569 (Ct. Cl. 1970) for its adoption of a minimum capitalization rule under the clear reflection of income standard.

currently the portion of its overhead expenses allocable to repair and maintenance personnel who during their spare time constructed, renovated, and repaired fixed assets used in its manufacturing operations.²³² *Fort Howard Paper* was decided, however, prior to *Idaho Power*; and while employing a clear reflection of income analysis,²³³ it preceded that analysis with the background that the taxpayer had used the incremental method for thirty-five years and the Service had previously audited the taxpayer without objection to such method.²³⁴

The reasoning of the Office of Chief Counsel in General Counsel Memorandum 38,788 ably considered the teaching of *Idaho Power*, *Perlmutter*, and *Adolph Coors* with respect to indirect costs and overhead regarding the construction or acquisition of tangibles.²³⁵ It concluded that “[i]n each case the cost of doing the work or performing the contract included not only the direct costs of tools, supplies, materials and labor, but also all the indirect costs reasonably related or incidental to performance of the work or contract.”²³⁶

There is no sound policy-based reason looking solely at the origin of the claim and rule of tax parity doctrines to distinguish indirect costs and overhead incurred in creating or acquiring an intangible asset from such costs incurred in creating or acquiring a tangible asset.²³⁷ The possibility of a different result under a burden and

²³² The majority in *Lychuk v. Commissioner*, 116 T.C. 374, 398 (2001) significantly pointed out that “[t]he Court expressed no opinion as to the fact that the taxpayer in the *Idaho Power Co.* case had been regularly and routinely improving its facilities throughout most of its long existence, nor that these improvements had for the most part been made by its employees.” *Id.*

²³³ *Fort Howard Paper Co.*, 49 T.C. at 283-85.

²³⁴ *Id.* at 282.

²³⁵ Gen. Couns. Mem. 38,788 (Aug. 26, 1981).

²³⁶ *Id.* at 29-3.

²³⁷ David Lupi-Sher, *Proposed IRS Capitalization Rules Raise Questions*, 94 TAX NOTES 804, 807 (Feb. 18, 2002). According to law professor Martin McMahon, the “[i]nternal costs and external costs must be treated identically if they serve the same function.” *Id.* McMahon further commented that

“[i]n ignoring *Idaho Power*, the Eighth Circuit in *Wells Fargo* either totally misread settled law or was trying to create a distinction in the treatment of indirect costs of tangible assets on the one hand, and indirect costs of intangible assets and long-term benefits on the other hand. There is no sound basis for drawing such a distinction. Allowing a current deduction for internal costs that relate to the acquisition or disposition of a capital asset, whether tangible or intangible, or which produce an *INDOPCO*-like long-term benefit, distorts the tax base and is contrary to the sound reasoning of

benefits of capitalization analysis is discussed below.²³⁸

IV. BALANCING OF BURDENS AND BENEFITS OF CAPITALIZATION: ROUGH JUSTICE EXCEPTIONS TO FUTURE BENEFIT CAPITALIZATION

A. *Balancing of Burdens and Benefits of Capitalization: The Pragmatic Test*

INDOPCO, Inc. v. Commissioner indicates that future benefits are a strong characteristic of a capital expenditure, but the case is not controlling insofar as an “incidental” future benefit may be currently deducted.²³⁹ Assistant Solicitor General Kent Jones, when arguing *INCOPCO*, advocated the use of a “pragmatic” test: “The test is a functional one of properly matching expenses with the years they benefit income, but it’s a pragmatic test at the same time. It’s not pushed to extremes.”²⁴⁰

The emerging standard, manifested in *U.S. Freightways*, suggests that expenses with future benefits should nevertheless be currently deducted where the burdens to the taxpayer²⁴¹ of such capitalization

the Supreme Court in *Idaho Power*, as well as the deep theory behind Section 263A.”

Id.

²³⁸ See discussion *infra* Part VI. For the argument that burdens of capitalization can trump the rule of tax parity as well as future benefit see *infra* notes 576-77 and accompanying text.

²³⁹ *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 87-88 (1992). *INDOPCO* rejected the rule that an expenditure not creating or enhancing a separate asset was per se currently deductible in favor of a rule that an expenditure generating more than “incidental” future benefits should be capitalized in order to match the expense with such future benefits. The court capitalized the outside transaction costs (fees to investment bankers, attorneys, and accountants) paid by a corporation acquired in a friendly acquisition).

²⁴⁰ United States Supreme Court Official Transcript, *INDOPCO, Inc. v. Commissioner*, No. 90-1278, 1991 WL 636242, at *28 (Nov. 12, 1991); see also *id.* at *39.

²⁴¹ The emerging *U.S. Freightways v. Commissioner* standard would also assist the government in determining whether to contest the taxpayer’s deduction of the expenditures in question. See John W. Lee et al., *Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More-Trouble-Than-It’s-Worth?*, 17 VA. TAX REV. 161, 185-86 (1997) [hereinafter Lee et al., *Capitalizing Aircraft Maintenance*] (citing the reasoning in General Counsel Memorandum 34,262 (Jan. 30, 1970)); 1993 House Hearings, *supra* note 37 (the real concern with capitalization under *INDOPCO* should be avoiding litigation costs on both sides; I had in mind the pre-section 197 morass as to amortizable purchased intangibles). See generally *U.S. Freightways*

outweigh “the gain in precision for the taxing authorities” of more exact matching from capitalization.²⁴² The Seventh Circuit adopted just such an approach, agreeing with the Commissioner that

the mere fact that certain expenditures recur does not negate the distorting effect of expensing that predictably occurred here – the interest-free government loan that comes from the deduction remains the same regardless of whether the . . . expenses are unchanged throughout the corporate life of Freightways.

But perfection is a lot to ask for, even in the administration of the tax laws, which we acknowledge endeavor “to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.”

. . . [P]erfection in temporal matching comes at too high a price for these kinds of expenses. At some point the “administrative costs and conceptual rigor” of achieving a more perfect match become too great. *Encyclopedia Britannica*, 685 F.2d at 216. Here, there is a considerable administrative burden that Freightways and any similarly situated taxpayer will bear if it must always allocate one-year expenses to two tax years, year in and year out. It argues that the gain in precision for the taxing authorities is far outweighed by the administrative burden it will bear in performing this task. . . . The kind of change in the company’s tax accounting system for which the Commissioner is arguing will impose an administrative burden regardless of the way its financial accounts are kept.

Corp. v. Commissioner, 270 F.3d 1137 (7th Cir. 2001)

²⁴² *U.S. Freightways*, 270 F.3d at 1146 (arguing that the gain in precision for the taxing authorities from a more perfect matching of expense and income is outweighed by the administrative burden the taxpayer would bear in such matching); see Gen. Couns. Mem. 33,968 (Nov. 18, 1968) (advocating current deduction of writer’s prepublication expenses, which, it reasoned, conceptually creates an intangible capitalizable under authorities such as *Perlmutter*, as an “administrative policy” based on the difficulty of allocating continuing, recurring overhead type expenses); Gen. Couns. Mem. 34,959 (July 2, 1972) (advocating a de minimis rule based on the clear reflection of income mandate of section 446); Lee, *Capitalization Rules*, *supra* note 13, at 679-80, 683 (cited by *Sun Microsystems, Inc. v. Commissioner*, 66 T.C.M. (CCH) 997 (1993) by Judge Tannenwald, one of the three judicial giants as to capitalization along with Justice Blackmun and Judge Posner).

We conclude that, for the particular kind of expenses at issue in this case – fixed, one-year items where the benefit will never extend beyond that term, that are ordinary, necessary, and recurring expenses of the business in question – the balance of factors under the statute and regulations cuts in favor of treating them as deductible expenses under I.R.C. § 162(a).²⁴³

The Advance Notice commendably adopts a similar balancing test of whether the taxpayer's "administrative and record keeping costs associated with capitalization" outweigh "the potential distortion of income" from currently deducting such future benefit expenditures²⁴⁴ as the basis for its rough justice rules. This test includes a twelve-month limit and a de minimis rule in order "[t]o reduce the administrative and compliance costs associated with section 263(a)."²⁴⁵ I have long advised just such a balancing test,²⁴⁶ which is now the conventional wisdom among many academics,²⁴⁷ former high tax

²⁴³ *U.S. Freightways*, 270 F.3d at 1146-47 (citation omitted).

²⁴⁴ The forthcoming notice relating to proposed rulemaking "will recognize that many expenditures that create or enhance intangible assets or benefits do not create the type of future benefits for which capitalization under section 263(a) is appropriate, particularly when the administrative and record keeping costs associated with capitalization are weighed against the potential distortion of income." Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002); accord Susanne Pagano, *New Rule Proposal to Reduce Uncertainty, Administrative Issues, Treasury Official Says*, 14 BNA DAILY TAX REP., Jan. 22, 2002, at G-5 (Turgeon "said the proposal was an effort to balance competing tax policy goals of clear reflection of income and what is administrable."); see Brant Goldwyn, *Treasury and IRS Seek to Issue Rules on Capitalization in 2002*, 50 BNA DAILY TAX REP., Mar. 14, 2002, at G-9 ("Christine Turgeon, senior tax specialist in the Treasury Department's office of tax legislative counsel, said that the Treasury wants to balance the need for rules that clearly reflect income with the need to simplify tax administration and reduce the drag on IRS resources.").

²⁴⁵ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3462.

²⁴⁶ We recommended to the Service such a balancing of burdens and benefits of capitalization approach in our response to Notice 96-27. See Lee et al., *Rough Justice I*, *supra* note 17, at 665; Lee et al., *Rough Justice II*, *supra* note 25, at 1520. See generally, Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 180-82. Following the lead of Professor Alan Gunn, I have been advocating such a minimum distortion of income model for more than fifteen years. Lee, *Start-Up Costs*, *supra* note 10, at 13 & n.37.

²⁴⁷ Although the courts and the IRS have rarely referred directly to administrative concerns, they should be considered relevant, perhaps determinative in many cases. For example, the reservations that some

administrators,²⁴⁸ courts on their own,²⁴⁹ and the Advance Notice. The

courts have expressed about making significant future benefit a touchstone of capitalization likely reflect an unexpressed belief that this approach would extend capitalization to situations where the burden of separating capitalized costs from current costs would outweigh the benefits of greater accuracy in income measurement.

Lokken, *supra* note 35, at 1363-65.

[I]t may be harder to identify certain assets, assets of, say, short-term durability; and therefore, once we add administrative costs to the balance, we may be more justified in allowing expensing or a different treatment for short-term assets than for longer-lived assets. But that's why we have to think about it – because of the high costs of identification rather than because of lower benefits to capitalization. We should care as much about getting it right for these short-term assets, capitalization is equally important. It's only a question of costs of identifying these things or getting them right that would make us have a different type of regime.

Unofficial Transcript of Tax Simplification Conference, TAX NOTES TODAY (Jan. 25, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 17-37, ¶¶ 721-22) (statement of Professor David Weisbach); Evans & Gallagher, *supra* note 25, at 48, 54-55 (excellent analysis of political, administration, and theoretical factors; future benefit should not be allowed to prevail over the need for administrative feasibility and practicality) (Mr. Evans is currently in practice but was formerly an academic and before that served in the Treasury Department).

²⁴⁸ See, e.g., Kenneth W. Gideon, Laurence Neal Woodworth Memorial Lecture (Nov. 6, 1998), reprinted in Kenneth W. Gideon, *Tax Law Works Best When the Rules are Clear*, 81 TAX NOTES 999, 1003 (Nov. 23, 1998), and in Kenneth W. Gideon, *Assessing the Income Tax: Transparency, Simplicity, Fairness*, 25 OHIO N.U. L. REV. 101, 110 (1999).

Any proposal to capitalize ought have to overcome a threshold showing that the increased revenue flow to the government from it is at least as great as the extra compliance costs imposed on the taxpayer. Note that the more intensive the special purpose record-keeping system required to implement a capitalization proposal, the more difficult it is to satisfy this criterion.

Id. (former Chief Counsel and Assistant Secretary for Tax Policy); *Unofficial Transcript of Tax Simplification Conference*, *supra* note 247, ¶¶ 805-06 (comments of Jerry Cohen, former Chief Counsel); cf. Harry L. Gutman, *Reflections on the Process of Enacting Tax Law*, Laurence Neal Woodworth Memorial Lecture, 26 OHIO N.U. L. REV. 183, 190 (2000) (proposing legislative rough justice solution of expenditure classes in a combination of a section 168 and 197 model which, although distorting “accurate periodic income measurement,” is worthwhile where “the cost of measuring income accurately (even if we could) outweighs the benefits, in terms of compliance and other administrative costs, of a system that has struggled with, but has been unable, to determine, on an *ad hoc* basis, the appropriate tax treatment of these expenditures.”) (former Chief of Staff of the Joint Committee on Taxation and Deputy Tax Legislative Counsel, who was present at the birth of both sections 195 and 197).

Advance Notice's contemplated proposed safe harbors for current deduction of the costs of creating or acquiring intangibles produce less distortion of income than capitalization where no depreciation is available.²⁵⁰ This concept is also known as "perpetual capitalization."²⁵¹ Even where available depreciation would more closely match the expense with future income, and if the distortion of income is minimal and the burden is heavy, a current deduction is in order as *U.S. Freightways* recognized.²⁵² Such current deduction of future benefit expenditures may be viewed as rough justice or minimal distortion of income.²⁵³

The rough justice balancing exceptions to future benefit capitalization manifest several patterns where a current deduction produces minimal distortion of income: (1) future benefits of not more than twelve months, i.e., overlapping two-tax years; (2) insubstantial costs or incidental future benefits; (3) short term or variable future benefits; (4) regularly recurring expenditures; (5) difficulty in allocating the expenditure between current and future benefits; (6) future benefits are speculative; or (7) capitalization and depreciation are more trouble than they are worth, as in income forecast depreciation for writer's prepublication costs.²⁵⁴ Often the rough justice exceptions rest on more than one of these factors. Additionally, where a capitalized expenditure is not depreciable, or is depreciable but only over a much longer period than its actual future benefit, a current deduction may produce less income distortion than capitalization with no or slow depreciation.²⁵⁵ Avoidance of both extremes and allowance of depreciation over some fixed period if the expenditure is substantial and not recurring over a relatively short period would be even better, as a policy matter, than a current deduction.²⁵⁶

²⁴⁹ *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1146, 1146-47 (7th Cir. 2001).

²⁵⁰ See *infra* notes 361-73 and accompanying text.

²⁵¹ See, e.g., Gideon, *supra* note 248 at 109 (noting that perpetual capitalization distorts the taxpayer's income); see also Martha Kessler, *Parts of Coalition Capitalization Proposal May Be Overly Broad, Treasury Official Says*, 205 BNA DAILY TAX REP., Oct. 25, 2001, at G-4 ("[M]any IRS agents have proposed adjustments to capitalize costs (often with no amortization) that taxpayers have historically deducted.").

²⁵² *U.S. Freightways*, 270 F.3d at 1146-47.

²⁵³ See *supra* notes 220, 228, 243 and accompanying text.

²⁵⁴ See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 176-200.

²⁵⁵ See *infra* notes 367-73 and accompanying text.

²⁵⁶ See *infra* notes 383-87 and accompanying text.

B. The Twelve-Month Rule

*U.S. Freightways*²⁵⁷ approved a current deduction under a not more than twelve-month life rule as to recurring costs of licenses and insurance, reasoning that the gain in precision for the taxing authorities from a more perfect matching of expense and income was outweighed by the administrative burden the taxpayer would bear in such matching. Similarly, the Advance Notice announced that the Treasury Department and the Service expect to propose a twelve-month rule under which capitalization would not be required as to expenditures to create or acquire an intangible benefit unless its benefits “extend beyond the earlier of (i) twelve months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred.”²⁵⁸ Earlier authorities had applied this rule to tangible property.²⁵⁹ The Office of Chief Counsel has acknowledged that this one-year life overlapping two tax years rule may result in *some* distortion of income, but some departure from a “strict reading of Section 263” is called for here,²⁶⁰ as it would result in a minimal distortion of income. The one-year rule “is a ‘rule of reason’ that is clearly reasonable under the circumstances involved.”²⁶¹ The Seventh Circuit in *U.S. Freightways* agreed with both points, as did the pre-*INDOPCO* Fourth Circuit panel opinion in *NCNB Corp. v. Commissioner*.²⁶²

²⁵⁷ *U.S. Freightways*, 270 F.3d at 1146-47.

²⁵⁸ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002); accord *Lee et al., Rough Justice II*, *supra* note 25, at 1522.

²⁵⁹ Rev. Rul. 59-249, 1959-2 C.B. 55 (costs of tires and tubes on new equipment used in motor transportation currently deductible where used in tax year or average useful life is less than twelve months even though extends into next tax year). This Revenue Ruling was considered by Chief Counsel in General Counsel Memorandum 33,370 (Nov. 10, 1966). See also Gen. Couns. Mem. 38,618, at 2 n.3 (Jan. 23, 1981); Gen. Couns. Mem. 37,778 (Dec. 7, 1978).

²⁶⁰ Gen. Couns. Mem. 34,959, at 25 (July 25, 1972).

²⁶¹ *Id.*

²⁶² [W]here an expenditure will take no more than a year to generate the matching income, it may nevertheless apply partly in the current year, partly in the next. Theoretically, the part attributable to the latter year should be capitalized. However, the tax treatment will then vary between taxpayers depending on the time of year when the expenditure is made. [One] who pays in January would usually have a tax advantage over [one] who pays later in the year. Since income distortion is unlikely to be great, as a recognition of greater simplicity and convenience for all, a slight deviation

C. The De Minimis Rule

The Court of Claims (now Federal Circuit) in *Cincinnati, New Orleans & Texas Pacific Railway v. United States*²⁶³ permitted current deduction of de minimis or insubstantial capital expenditures (\$500) under a balancing test²⁶⁴ much like that approved by *U.S. Freightways* and as applied in the Advance Notice.²⁶⁵ The Advance Notice announces that the proposed regulations are expected to provide “‘de minimis rules,’ under which certain types of expenditures less than a specified dollar amount are not required to be capitalized.”²⁶⁶ Professor McMahon has “argued that there is no statutory foundation for a de minimis rule.”²⁶⁷ The Treasury Department, however, has authority under the clear reflection of income mandate of section 446 to permit a de minimis rule determined with a balancing of burdens and benefits standard,²⁶⁸ which the *U.S. Freightways* court effectively

from completely accurate accounting principles is permitted and capitalization is not required.

NCNB Corp. v. Commissioner, 651 F.2d 942, 953 n.21 (4th Cir. 1981) [hereinafter *NCNB I*], *rev'd*, 684 F.2d 285 (4th Cir. 1982) [hereinafter *NCNB II*], *overruled by* INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). We have wondered whether *INDOPCO*'s overturning of *NCNB II* revived *NCNB I*. See Lee et al., *Rough Justice I*, *supra* note 17, at 636 n.8.

²⁶³ 424 F.2d 563 (Ct. Cl. 1970).

²⁶⁴ Where the burden on both taxpayers and Service to account for each item of property separately is great, and the likelihood of distortion of income is nil or minimal, the Code is not so rigid and so impracticable that it demands that nevertheless all items be accounted for individually, no matter what the trouble or the onus. . . . The burden on plaintiff, if the minimum rule is not to be followed for income tax purposes, would be heavy; at the same time, the clearer reflection of income would be exceedingly slight if there were any at all.

Cincinnati, 424 F.2d at 587.

²⁶⁵ See *supra* notes 241-42 and accompanying text; see also Goldwyn, *supra* note 244 (Turgeon said de minimis rule “is a rule of administrative convenience and cannot necessarily be applied in other areas.”). The case-law rule originated, however, in the context of acquisition costs of tangibles.

²⁶⁶ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3462 (Jan. 24, 2002); see also Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 193-94; Lee, *Capitalization Rules*, *supra* note 13, at 680; Lee et al., *Rough Justice II*, *supra* note 25, at 1523-27.

²⁶⁷ Lupi-Sher, *supra* note 237, at 807 (according to law professor Martin McMahon, “[i]f Congress had to create de minimis expensing of tangible assets, it’s up to Congress, not the Treasury, to create de minimis expensing of intangible assets”).

²⁶⁸ See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 180-82; Lee et al., *Rough Justice I*, *supra* note 17, at 689 n.235, 708; Lee et al., *Rough Justice*

confirmed by espousing a one-year rule under a burdens and benefits balancing test.²⁶⁹ Recent Revenue Procedure 2002-27²⁷⁰ similarly based a safe harbor accounting method for tires on commercial vehicles on (1) the Commissioner's "broad authority to determine whether a method of accounting clearly reflects income," and (2) the administrative convenience of minimizing disputes over useful lives of original and replacement tires.²⁷¹

Id., *supra* note 25, at 1523-27. Both sources cite General Counsel Memorandum 34,959 (July 25, 1972), where relying on *Cincinnati*, Chief Counsel advocated a de minimis rule:

We recognize that by regulations and longstanding ruling practice the Service has definitely limited the Commissioner's discretion in this area. However, we are unaware of any such limits that would prevent the exercise of the discretion we now propose. As we suggested in [General Counsel Memorandum] 34,547, pp. 9-12, we believe section 461 gives the Commissioner authority to direct the timing of deductions in a manner that will clearly reflect income. Although the exercise of this authority has generally been aimed at proscribing methods that fail to clearly reflect income, there is little doubt that it is broad enough to permit the recognition of additional methods that allow a clear reflection of income, even though such methods may appear to be a variance with a narrow interpretation of specific language of the Code.

Gen. Couns. Mem. 34,959, at 13-14 (July 25, 1972); *see also* Gen. Couns. Mem. 33,784, at 45 (Mar. 28, 1968) (noting that "expenditures can not be currently deducted if they are expected to contribute more than incidentally to the realization of income in subsequent taxable years.").

²⁶⁹ *See supra* notes 239-40 and accompanying text.

²⁷⁰ Rev. Proc. 2002-27, 2002-17 I.R.B. 802.

²⁷¹ As we suggested (Lee et al., *Rough Justice I*, *supra* note 17, at 709-10; Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 182-86, 189; Rev. Proc. 2002-27, 2002-17 I.R.B. 802), the rough justice Original Tire Capitalization Method (OTCM) for tires on business vehicles was based upon the Commissioner's section 446(b) "broad authority to determine whether a method of accounting does not clearly reflect income." Rev. Proc. 2002-27, § 2.04. The procedure justified the result (a) capitalize original tires and depreciate over same MACRS recovery period as the vehicle and (b) replacement tires may be currently deducted, as an administrative rule, i.e., "to minimize disputes regarding the useful lives of original tires and replacement tires." Rev. Proc. 2002-27, § 2.06. In addition to administrative convenience, several safe harbor factors were probably present. *See infra* notes 321-22 and accompanying text. Capitalization of the cost of the original tires and depreciation over the recovery period for the vehicle is similar to composite depreciation; separate deduction of the original tires is similar to component depreciation. Component depreciation is barred under MACRS. STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., TECHNICAL EXPLANATION OF THE "JOB CREATION AND WORKER ASSISTANCE ACT OF 2002, at 25 n.38 (Joint Comm. Print 2002).

Incidentally, the suggested \$5000 de minimis amount²⁷² for intangibles is more or less equal to the 1940 \$500 de minimis rule approved in *Cincinnati* when adjusted for current cost of living increases.²⁷³ Applying the \$5000 de minimis amount to tangibles²⁷⁴ would, however, overlap section 179 and, depending on how the de minimis rule was applied in the aggregate, likely bypass its ceiling restrictions. If a ceiling amount of de minimis expenses or threshold approach were taken, a handy model based on section 179 would be a \$25,000 annual cap on expenditures each not exceeding \$5000, or stretching, perhaps a \$200,000 limit.²⁷⁵ This would, of course, effectively limit the benefits of this minimum expense rule to small-income taxpayers.

General Motors advocates, not as comments on the Advance Notice but instead as items that should be included in the 2002-03 "guidance priority" list, the use of an elective nominal asset value current tax deduction rule to the extent assets (implicitly including tangibles) are expensed for financial accounting purposes.²⁷⁶ This approach would bypass any de minimis dollar amount such as \$5000, as well as any aggregate limitations on de minimis deductions that might be proposed. The General Motors proposal would further obviate case law limitation of a de minimis rule based on *Cincinnati* where the amounts in the aggregate are insubstantial compared to gross and net income and depreciation.²⁷⁷ With respect to tangible assets, General Motors' book expensing rule would similarly bypass the ceilings under section 179 as to additional first year depreciation.²⁷⁸

²⁷² Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3462, 3463 (Jan. 24, 2002).

²⁷³ *Cincinnati*, New Orleans & Tex. Pac. Ry. V. United States, 424 F.2d 563, 572 (Ct. Cl. 1970). The Consumer Price Index has increased 12.82 times from 1940 to 2002. Federal Reserve Bank of Minneapolis, *Consumer Price Index Calculator*, at <http://woodrow.mpls.frb.fed.us/research/data/us/calc> (last visited Dec. 12, 2002).

²⁷⁴ See *supra* note 267 for the implication that a de minimis rule would not be applicable to so-called tangibles.

²⁷⁵ Section 179 provides for elective expensing of the cost of depreciable property purchased for use in the active conduct of a trade or business up to \$25,000 in aggregate (for tax years beginning on or after 2003 and \$24,000 for tax years beginning in 2002). The deduction, however, is phased out dollar for dollar by the amount such expenditures exceed \$200,000.

²⁷⁶ *General Motors Asks for Safe Harbor Guidance on 2002-03 Guidance Priority List*, TAX NOTES TODAY (May 21, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 98-20).

²⁷⁷ See *Cincinnati*, 424 F.2d at 572.

²⁷⁸ See *supra* note 274 and accompanying text.

Similarly, this book expensing rule would conflict with section 263A with respect to the capitalization of indirect costs and as to production or acquisition of tangible property.²⁷⁹ It is unlikely that Congress would have intended these results.

Public Choice analysis²⁸⁰ calls into question the financial expensing approach that General Motors proposes insofar as the General Motors method would extend a section 179 preference for extra depreciation to some taxpayers and the section 263A exceptions to other taxpayers. Public Choice would view the section 179 deduction and the exceptions under section 263A as tax expenditures granted by Congress largely to small business taxpayers. Courts and administrators must effectuate strictly the terms of such agreements, but should not extend the tax preferences to classes of taxpayers not covered by the Congressional agreement according to the Public Choice idea of Devil's Obligation.²⁸¹

Commentators on the Advance Notice, as usual,²⁸² often took positions reflecting their particular circumstances; for instance, some worried that a de minimis rule would act as a ceiling on the amount of future benefit expenditures that could be currently deducted.²⁸³ Other

²⁷⁹ Section 263A provides for the capitalization and inclusion in inventory costs of certain direct and indirect costs of acquisition of property for resale or creation of property by larger taxpayers. See *infra* note 582.

²⁸⁰ Public Choice theory views some legislation as a private contract between legislators seeking to retain their seats and private interests. See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 206-07.

²⁸¹ Where the fact-finder (i.e., the Service in rulings and the courts in litigated cases) can determine that a particular tax provision is the product of private compromise and that it produces asymmetrical benefits, as is the case with respect to simplified expensing and uniform capitalization lives, the terms of the statutory contract should not be extended to other similar tax items. Rather, taxpayers are entitled to the preferences that Congress explicitly awards by relying on form even in cases where there is little or no economic substance apart from such tax preferences; this is the Devil's Obligation. See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 207-08. I believe that this idea supports the Tax Court's statutory tax shelter rather than the generic tax shelter doctrine (as articulated in *Rose v. Commissioner*, 88 T.C. 386 (1987), *aff'd on other grounds*, 868 F.2d 851 (6th Cir. 1989)). For an excellent discussion of the generic tax shelter test, see Note, *The Tax Court's Rose Test: More Thorns in the Sides of Taxpayers*, 8 VA. TAX REV. 905 (1989). I also believe the notion of Congressionally intended subsidy underlies certain administrative practices. See, e.g., Rev. Rul. 79-300, 1979-2 C.B. 112. This Revenue Ruling was considered by Chief Counsel in General Counsel Memorandum 38,117 (Sept. 28, 1979).

²⁸² See Lee et al., *Rough Justice I*, *supra* note 17, at 667-68 n.122.

²⁸³ Though many of the costs associated with making certain types of loans may fall within the suggested threshold of \$5,000, the ABA [American

commentators suggested a \$10,000 ceiling,²⁸⁴ or that any ceiling take into account the taxpayer's size.²⁸⁵ On the other hand, some commentators suggested that there be no ceiling to the extent that expensing was permitted under a taxpayer's financial accounting method.²⁸⁶ Almost all commentators opposed any ceiling applied on

Bankers Association] is concerned that the underlying basis for allowing a current deduction for loan origination costs has been overlooked. We support the added administrative convenience of knowing a threshold safe-harbor may be available, provided such de minimis amount is applied to loan costs on a transactional basis. However, we continue to maintain that the historic tax treatment of loan origination costs as "ordinary and necessary" business expenses under IRC Section 162(a) must be preserved in future regulatory guidance. Therefore, it should be acknowledged in future guidance that "regular and recurring" loan costs that exceed any threshold amount are not subject to the general rule requiring capitalization.

Mark R. Baran, *Bankers Association Offers Suggestions for Rules on Capitalizing Costs of Intangibles*, TAX NOTES TODAY (Apr. 5, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit. 2002 TNT 66-26, ¶ 8).

²⁸⁴ Pamela J. Pecarich, *AICPA Suggests Changes to Proposed Regs on Capitalizing Expenditures*, TAX NOTES TODAY (May 17, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 96-18, ¶ 24) (recommending that "the de minimis threshold dollar amount be increased to \$10,000, and that the threshold be applied on a transaction-by-transaction basis.").

²⁸⁵ Fred T. Goldberg, Jr., *INDOPCO Submits Additional Comments on Proposed Capitalization Regs*, TAX NOTES TODAY (Apr. 25, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 80-38, ¶ 5) ("We agree that the regulations should provide a de minimis exception of at least \$5,000, and encourage the IRS and Treasury to provide a higher threshold amount for larger taxpayers."). Compare Fred Goldberg's comment with the following statement by Stephen Elkins:

No matter how diligently a taxpayer seeks to comply perfectly with the tax laws, it may be impossible accurately to capture and to analyze costs incurred daily and in the ordinary course by the various operations of a large company. Such costs (i) may or may not create or enhance intangible assets with respect to which capitalization under Section 263(a) is appropriate, (ii) relate to transactions that may or may not be consummated, (iii) may or may not result in an assets right that lasts beyond the end of next year, (iv) may or may not be de minimis individually or in the aggregate, and, (v) may or may not be regular and recurring.

Stephen Elkins, *Writers Comment on Proposed Regs on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Apr. 23, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 78-23, ¶ 22).

²⁸⁶ Scott Cahill, *Organization [National Retail Federation] Seeks Clarification of Deductible Expenses*, TAX NOTES TODAY (May 17, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 96-33). Conversely, many commentators opposed book conformity as a limitation on a current deduction but wanted its availability as a floor.

an aggregate basis.²⁸⁷ Allowing expensing of costs incurred in connection with intangibles that would otherwise be capitalized if incurred in connection with tangibles presumably would create economic inefficiencies between the costs of acquiring or enhancing tangibles and intangibles.²⁸⁸ The Service and the Treasury Department have thus requested comments on this problem:

The IRS and Treasury Department request comments on how expenditures should be aggregated for purposes of applying the de minimis exception, whether the de minimis exception should allow a deduction for the threshold amount where the aggregate transaction costs exceed the threshold amount, and

Financial, regulatory, and tax reporting have different objectives when measuring the recognition of income and expense and, as a result, frequently adopt differing standards. As a result, TEI recommends against prescribing a standard rule of capitalization whereby a taxpayer's income for tax purposes is determined by reference to financial or regulatory accounting methods. There may be limited circumstances, however, where, as a matter of administrative convenience, the taxpayer's financial or regulatory accounting method can serve as a reasonable proxy for an income tax accounting method (e.g., a de minimis expenditure rule for tangible or intangible assets otherwise subject to capitalization).

Robert L. Ashby, *TEI Suggests Changes to Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (May 15, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 94-26, ¶ 39); *INDOPCO Submits Additional Comments on Proposed Capitalization Regs*, TAX NOTES TODAY (April 25, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 80-38, ¶ 31); Victor Gomperts, *Organizations Comment on Possible Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (June 2, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 115-52, ¶ 8); *Companies Suggest Changes to Proposed Regs on Capitalization of Intangible Assets*, TAX NOTES TODAY (June 14, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 115-53, ¶¶ 6, 8); Charlotte M. Bahin, *[American Community Bankers] Says Loan Origination Costs Should Be Deductible*, TAX NOTES TODAY (May 8, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 89-26, ¶ 18); Mark R. Barkan, *Bankers Association Offers Suggestions for Rules on Capitalizing Costs of Intangibles*, TAX NOTES TODAY (Apr. 5, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 66-26, ¶ 15).

²⁸⁷ *PricewaterhouseCoopers Suggests Changes to Proposed Regs on Intangible Asset Capitalization*, TAX NOTES TODAY (Apr. 30, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 83-18); *Bankers Association Offers Suggestions for Rules on Capitalizing Costs of Intangibles*, TAX NOTES TODAY (Apr. 5, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 66-26); Thomas E. Wheeler, *CTIA Suggests Changes to Proposed Guidance on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Mar. 29, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 61-23).

²⁸⁸ Cf. *supra* note 237 and accompanying text.

whether there are certain expenditures for which the de minimis exception should not apply (e.g., commissions).²⁸⁹

The Tax Court decision in *Alacare Home Health Services, Inc. v. Commissioner*²⁹⁰ contains the seeds for an administrable approach to de minimis expenses in the aggregate. In that case, the taxpayer, a Medicare-certified home health care provider, expensed all capital items for which it paid less than \$500 in compliance with guidelines in the Medicare Provider Reimbursement Manual.²⁹¹ The Tax Court held that this method of accounting did not clearly reflect the taxpayer's income and distinguished *Cincinnati* on the grounds that the ratios of disputed items to various measures of the taxpayer's size were substantially larger than in *Cincinnati*.²⁹² The Tax Court also compared the disputed items to its gross receipts and to its operating expenses and found that the ratios were much higher than in *Cincinnati*.²⁹³ *Alacare Home Health Services* thus suggests that an aggregate ceiling be imposed on de minimis expenditures. Some possibilities are 15% of depreciation, 15% of assets on hand at the end of the year, some percentage of net profits, or a lower percentage of gross revenues. The Office of Chief Counsel²⁹⁴ similarly suggested a percentage of net or gross income ceiling or industry-wide guidelines. The Service, while recommending against requesting certiorari in *Cincinnati*, still took the position that "if in a case it is found that the taxpayer's 'minimum capitalization' rule for financial purposes is unreasonably high, so that use of that rule for tax purposes would produce a definite and substantial reduction of taxpayer's income, the

²⁸⁹ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3462, 3464 (Jan. 24, 2000). See *infra* p. 360.

²⁹⁰ 2001 T.C.M. (CCH) 1794 (2001).

²⁹¹ *Id.* at 1795-96.

²⁹² For example, in *Cincinnati*, the taxpayer's disputed items were less than one percent of the taxpayer's net income in the 3 years at issue, see *Cincinnati, New Orleans & Tex. Pac. Ry. Co. v. United States*, 424 F.2d at 571; in the instant case, the disputed items were 165 percent of petitioner's 1995 taxable income and 83.5 percent of its 1996 taxable income. In *Cincinnati*, the taxpayer's disputed items were less than 2 percent of its total deduction for depreciation for the years in issue; in contrast, petitioner's disputed items were 288 percent and 189 percent of its total depreciation deduction for 1995 and 1996.

Id. at 1798.

²⁹³ The taxpayer's ratios of "de minimis" items to its gross receipts were ten to twenty-eight times larger than those in *Cincinnati*; the ratios of "de minimis" items to its operating expenses were fourteen to 112 times larger than those in *Cincinnati*. *Id.*

²⁹⁴ Gen. Couns. Mem. 34,959, at 31-33 (July 25, 1972).

issue will be raised.”²⁹⁵

D. Short-Term or Variable Benefit

The Advance Notice makes no reference to a safe harbor for short-lived assets lasting more than twelve months; however, the notion that current deduction of short-lived and recurring assets produces minimal distortion of income had pre-*INDOPCO* case law support and is a key concept to defensibly currently deducting certain transactions costs. One such pre-*INDOPCO* case is *Iowa-Des Moines National Bank v. Commissioner*,²⁹⁶ which, in allowing a current deduction for purchased credit information, emphasized that such information was short-lived and subject to sudden change.²⁹⁷ These characteristics would preclude depreciation under the certainty requirement for intangibles. The Court of Claims applied similar reasoning in *Southland Royalty Co. v. United States*,²⁹⁸ in finding that capitalization without amortization resulted in both distortion of income and hardship to the taxpayer. Since the asset, an oil and gas survey, had an unpredictable and variable life, and therefore amortization was unavailable, a clear reflection of income required a current deduction of the survey costs. This suggests that *Lychuk v. Commissioner* was incorrect in requiring capitalization of regularly recurring origination costs of automobile loans that had an average duration of less than twenty-four months and were rather uncertain since made to high credit risk car buyers.²⁹⁹ Regularly recurring costs

²⁹⁵ A.O.D. 1977-97 (July 15, 1977).

²⁹⁶ 592 F.2d 433 (8th Cir. 1979).

²⁹⁷ Any credit information is short-lived and subject to sudden change. Thus, credit information must be current to be valuable and the taxpayers soon had a history of who did or did not pay the credit card charges. This new information was far more useful to taxpayers than the information purchased with the payments in dispute here. The fact that there may be some ensuing benefit and future effect from the expenditure beyond the taxable year when paid is not controlling. Where the prospective benefit is very slight, capitalization is not easily supported.

Id. at 436 (citation omitted).

²⁹⁸ 582 F.2d 604, 618 (Ct. Cl. 1978).

²⁹⁹ See 116 T.C. 374, 376 (2001) (holding that overhead expenses were currently deductible because they were indirectly related to acquisition of loans which the taxpayer then serviced, and hence provided only incidental future benefits; salaries to the extent allocable to the 60% of loan applications which the company rejected were currently deductible; 40% of salaries allocable to the loans that the company reviewed and accepted had to be capitalized). The average lives of accepted car loans were 17.5 months and 19.5 months for the tax years at issue. *Id.* at 420 n.1 (Swift, J., concurring

of intangibles, such as those on at least a two- or three-year cycle, should be currently deductible. In the context of repairs to tangible assets, the Tax Court in *Ingram Industries, Inc. v. Commissioner*³⁰⁰ permitted current deduction of insubstantial costs of inspecting tow boat engines recurring on a three-year cycle when the tow boats were still operable. This might suggest that the costs of making a repair on a three-year cycle should be currently deductible at least where they amount to less than a specified percentage of the value of a reconditioned item.³⁰¹

Similar to *Southland Royalty*'s notion that current deductibility of survey costs, rather than amortization, is appropriate where an asset has an unpredictable and variable life,³⁰² General Counsel Memorandum 33,784,³⁰³ in considering Revenue Ruling 68-561,³⁰⁴

mostly to show that *PNC Bancorp* erred in its reasoning).

³⁰⁰ 80 T.C.M. (CCH) 532 (2000).

³⁰¹ [I]f the cost of a used towboat (approximately \$2 million) is used, the cost-to-maintenance ratio would be 5 percent (\$100,000 divided by \$2 million). If the cost of new engines is used (\$1.5 million) the ratio would increase to almost 7 percent (\$100,000 divided by \$1.5 million). Finally, if the cost of a [sic] completely overhauled or rebuilt engines is used (\$600,000), the ratio would be almost 17 percent (\$100,000 divided by 600,000). Ultimately, the difference between the cost of the procedures to maintain (\$100,000) and the cost of completely overhauled or rebuilt engines (\$600,000) is more telling. Plus, there is also the extra cost of removal, installation, and refitting a new or rebuilt engine.

Id. at 539 n.7. Compare *id.*, with *Vanalco, Inc. v. Commissioner*, 78 T.C.M. (CCH) 251 (1999), *aff'd sub nom.* *Smith v. Commissioner*, 300 F.3d 1023 (9th Cir. 2002). In *Vanalco*, the parties stipulated that the recovery period for "repairs" made every three years in replacing bricks in walls of aluminum ore reduction cells was three years. The Tax Court required capitalization under the general plan of rehabilitation doctrine where the brick replacement costs amounted to 22% of the costs of a reconditioned cell. *Id.* at 256 n.8. The difference between the 17% of reconditioned value cost of the repair in *Ingram Industries* and the 22% cost in *Vanalco* does not seem material. The Ninth Circuit in affirming the Tax Court on this issue did not discuss the general plan of rehabilitation, notwithstanding doing so as to another issue.

³⁰² The useful life of the survey is very uncertain; as the trial judge found, the estimates in a reserve study are subject to change at any time and have to be updated every few years to take account of subsequent developments. In those circumstances, it is not compulsory to amortize such a recurring item over a fixed time-interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort *Southland*'s income.

582 F.2d at 618. See generally *Lee, Capitalization Rules*, *supra* note 13, at 680; *Lee et al., Rough Justice II*, *supra* note 25, at 1527-28.

³⁰³ Gen. Couns. Mem. 33,784 (Mar. 29, 1968) (explaining that promotional

reasoned that the difficulty in determining the useful life of intangibles created by salaries paid to employees conducting promotions supported a current deduction.³⁰⁵ This reasoning is a critical component of the balancing of burdens and benefits analysis of inside transaction costs.

E. Regularly Recurring

The Service and the Treasury Department are also considering additional administrative relief, for example, by providing a “regular and recurring rule,” under which transaction costs incurred in transactions that occur on a regular and recurring basis in the routine operation of a taxpayer’s trade or business are not required to be capitalized.³⁰⁶ The Advance Notice raises another aspect of this issue:

The IRS and Treasury Department are considering alternative approaches to minimize uncertainty and to ease the administrative burden of accounting for transaction costs. For example, the rules could allow a deduction for all employee compensation (including bonuses and commissions that are paid with respect to the transaction), be based on whether the transaction is regular or recurring, or follow the financial or regulatory accounting treatment of the transaction. The IRS and Treasury Department request comments on whether the recurring or nonrecurring nature of a transaction is an appropriate consideration in determining whether an expenditure to facilitate the transaction must be capitalized under section 263(a) and, if so, what criteria should be applied in distinguishing between recurring and nonrecurring transactions. In addition, the IRS and Treasury Department request comments on whether a taxpayer’s treatment of transaction costs for financial or regulatory accounting purposes should be taken into account when

payments produce less speculative future benefits than ordinary advertising because acquisition of new customers can be attributed directly to particular expenditures; depreciation allowed over the life of the constructed building).

³⁰⁴ 1968-2 C.B. 117 (determining that cash allowances made to construct all gas homes or to convert heating systems to gas result in future benefits through increased sales of gas as a result of obtaining new customers; salaries and advertising are less directly and significantly productive of future benefits).

³⁰⁵ Cf. *infra* notes 354-57 and accompanying text.

³⁰⁶ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002).

developing simplifying assumptions.³⁰⁷

Minimal distortion of income is produced by the current deduction of an expenditure with future benefits where the expenditure recurs regularly or annually in roughly equivalent amounts as illustrated by Judge Posner in *Encyclopaedia Britannica v. Commissioner*:

We can think of a practical reason for allowing authors to deduct their expenses immediately, one applicable as well to publishers though not in the circumstances of the present case. If you are in the business of producing a series of assets that will yield income over a period of years – which is the situation of most authors and all publishers – identifying particular expenditures with particular books, a necessary step for proper capitalization because the useful lives of the books will not be the same, may be very difficult, since the expenditures of an author or publisher (more clearly the latter) tend to be joint among several books. Moreover, allocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code desiderates, because the taxable income of the author or publisher who is in a steady state (that is, whose output is neither increasing nor decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book – on each book expenses and receipts will be systematically mismatched – but the same on average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.³⁰⁸

Judge Posner noted a further distinction between recurring and nonrecurring expenses in *Encyclopaedia Britannica*. If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period in which the expenditure is made (conventionally one year),³⁰⁹ the result will be to force the capitalization of virtually every business expense. Judge

³⁰⁷ *Id.* at 3464.

³⁰⁸ *Encyclopaedia Britannica v. Commissioner*, 685 F.2d 212, 215 (7th Cir. 1982).

³⁰⁹ *See United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968).

Posner noted that this is a result courts naturally avoid.³¹⁰ Such an approach would require capitalizing every salesman's salary since such selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. Judge Posner remarked that the 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.

The Service frequently has used this recurring analysis in Private Letter Rulings and Technical Advice Memoranda.³¹¹ Moreover, *U.S. Freightways*³¹² approvingly cites *Britannica* for a regular and recurring exception to future benefit capitalization as well as its conceptual rigor point:

Recurrent expenses are more likely to be ordinary and necessary business expenses. . . . Because they recur every year, there is less distorting effect on income from future tax year benefits over time. In every year, that is, while Freightways will be able to reap the tax advantage of deduction for some part of the following twelve months, it will have "lost" the deductions for the months covered by the prior year's licenses, for which it has already received the benefit. In a hypothetical last year of Freightways' corporate life, it would finally be entitled to only a prorated deduction for licenses (if any) that are acquired during that year, partially evening out the score with the first year of deductions.³¹³

As we pointed out in our article,

³¹⁰ See, e.g., *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973).

³¹¹ See Lee et al., *Rough Justice II*, *supra* note 25, at 1530-32.

³¹² *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137 (7th Cir. 2001). In *U.S. Freightways*, 46% of the expenditures for assets purchased in the current tax year benefited the taxpayer in the current year and 54% benefited the next tax year. The Commissioner proposed capitalization and permitted ratable deduction of the current year's expenditure between the current and next tax year. The Seventh Circuit reasoned that such expenditures benefit only the current and next tax years because "they recur with clockwork regularity" due to the strict twelve-month life of the annual permits, licenses, significant annual fees, and insurance premiums at issue. Thus, the expenditures lack the "permanence" necessary to constitute a "permanent improvement or betterment," the prerequisite for capitalization under section 263 or under section 162 as not "ordinary." *Id.* at 1144-45.

³¹³ *Id.* at 1145.

[r]ecurring payments alone may not justify an immediate deduction when the benefits obtained from the expenditures lack a similar recurring pattern. If a substantial useful life remains when the taxpayer next incurs the recurring expense, the recurring expense is not incidental. The objective of minimizing income distortion seeks to match expenses with the income they produce. Mismatching occurs when expenditures of a fairly constant amount produce benefits that are disproportionally realized in future years: immediate deductions understate income in early years when the benefits occur in later years. In these situations, the duration of the future benefits properly requires taxpayers to consider capitalizing the costs as directed by *INDOPCO*.³¹⁴

Significantly, the Office of Chief Counsel has linked a de minimis rule with recurring items.³¹⁵ It also reasoned that “[i]t is clearly within the Commissioner’s discretion under section 446(b) to allow expensing of such items as long as income is clearly reflected under such method.”³¹⁶ Similarly, in advising an administrative rule to allow a current deduction of a writer’s prepublication costs of a “continuing nature,” the Office of Chief Counsel recommended that such deduction should only “be allowed for expenses of a recurring nature, such as rent, secretarial salaries or writing supplies.”³¹⁷ The primary basis for the recommendation to allow a current deduction of a writer’s recurring prepublication costs was the difficulty of allocation and the use of a “rather complex cost accounting system, based on careful records of time spent on various projects.”³¹⁸

This reading of section 446³¹⁹ and the Commissioner’s broad discretion in determining whether the taxpayer’s method of accounting for an item clearly reflects income reappears in Revenue Procedure 2002-27,³²⁰ which also involves recurring items. Revenue Procedure 2002-27 provides an optional safe harbor,³²¹ the “Original

³¹⁴ Lee et al., *Rough Justice II*, *supra* note 25, at 1539-40.

³¹⁵ Gen. Couns. Mem. 34,959, at 26 (July 25, 1972) (“We believe that the Service is not inalterably bound to abide by a strict capitalization rule when dealing with minor, recurring-type small items.”).

³¹⁶ *Id.*

³¹⁷ Gen. Couns. Mem. 33,968, at 10 (Nov. 18, 1968).

³¹⁸ *Id.* at 8; *see* discussion *infra* Part IV.F.

³¹⁹ *See* I.R.C. § 446(b).

³²⁰ 2002-17 I.R.B. 802.

³²¹ Taxpayers not so electing are to be taxed under the tax common law, which requires capitalization of new and replacement truck tires with useful lives longer

Tire Capitalization Method,” under which the original tires on certain business vehicles³²² are capitalized and depreciated over the same recovery period and at the same rate as the “qualifying vehicle;” replacement tires are currently deductible. The revenue procedure justifies this two-part rule, pursuant to the Commissioner’s broad authority to determine whether a method of tax accounting clearly reflects income,³²³ on the basis of administrative convenience – “[t]o minimize disputes regarding the useful lives of original tires and replacement tires for certain vehicles.”³²⁴ The two-part rule could, however, be justified upon the rough justice factors of regularly recurring,³²⁵ apparently short or variable term lives,³²⁶ and perhaps insubstantial in amount³²⁷ compared to the total value of truck, trailer, or tractor. The Service should issue a revenue ruling grounded in these principles and referring to Revenue Procedure 2002-27. The proposed regulations should, in turn, follow such Revenue Ruling.

Commentators Evans and Gallagher advise against a steady state recurring rule due to the permanent deferral of tax,³²⁸ the same point made by Professors Larry Lokken³²⁹ and earlier by Cal Johnson.³³⁰

than one year as separate assets. *Id.* ¶ 4.02; *see also* 2001 FSA LEXIS 26 (Jan. 30, 2001) (stating that despite taxpayer’s contention that “tires and tubes are rapidly consumable separate assets[, t]he Service believes that its ongoing factual development will show that Taxpayer’s tires and tubes last several years”, and concluding that “[i]f the factual development indicates that the tires and tubes at issue have a useful life of more than one year, the cost of the tires and tubes must be capitalized and recovered through depreciation.”).

³²² Light and heavy general-purpose trucks, tractor units for use over-the-road, trailers and trailer-mounted containers, etc. *See* Rev. Proc. 2002-27, ¶ 3.01; Rev. Proc. 87-56, 1987-2 C.B. 674, ¶¶ 00.242, 00.26, 00.27.

³²³ *See* Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 187-88; Lee et al., *Rough Justice I*, *supra* note 17, at 708-12.

³²⁴ Rev. Proc. 2002-27, ¶ 2.06. Administrative convenience also supports the allowance in Revenue Procedure 2001-10, 2001-2 I.R.B. 272, for “small taxpayers” with average gross receipts of \$1 million or less to use the cash method of tax accounting rather than the accrual method while maintaining inventories or supplies that are not incidental.

³²⁵ *See supra* notes 308-17 and accompanying text.

³²⁶ *See supra* notes 296-97 and accompanying text.

³²⁷ *See supra* notes 264, 266 and accompanying text.

³²⁸ Evans & Gallagher, *supra* note 25, at 63. Judge Posner, however, pointed out that where a taxpayer’s income is in a steady state, i.e., output is neither increasing nor decreasing, his taxable income will be approximately the same whether recurring expenses are capitalized or expensed. *See supra* note 308 and accompanying text. The burdens of capitalization in such circumstances outweigh the benefits, although technically some distortion of income occurs.

³²⁹ Lokken, *supra* note 35, at 1363.

Specifically, Evans and Gallagher argue that recurring expenses make it “worthwhile to incur the expense of accurate precise accounting for the items correctly.”³³¹ Such permanent deferral is real, but the Seventh Circuit pointed out in *U.S. Freightways* that permanent deferral always arises with the current deduction of recurring expenses.³³² The only difference between a twelve-month rule and a recurring rule is the duration of the deferral. The fundamental issue still is whether the administrative burdens of capitalization outweigh the benefits of conceptual rigor. While a steady state recurring might provide an incentive to the taxpayer to keep track of exact matching, review courts may be more likely to reverse capitalization. Thus, the administrative burden on the Service is increased, not decreased, by recurring expenses, as may be seen in the case of replacement truck tires.³³³

Heather Malloy, Associate Chief Counsel, Income Tax and Accounting, has pointed out a perceived difficulty with a regular and recurring costs exception: “the Service’s goal was to eliminate controversy, not to move the debate to a different issue.”³³⁴ In other words, the Service should not move the question from whether a cost should be capitalized to whether the cost is regular and recurring. Andrew Keyso, in the same division, added that the Service has not been able to come up with a bright-line rule.³³⁵ One solution would be to allow a current deduction when the recurrence cycle is up to three years,³³⁶ and particularly where it is annually recurring in the

³³⁰ Calvin H. Johnson, *Soft Money Investing under the Income Tax*, 1989 U. ILL. L. REV. 1019, 1072-77 (1989) (criticizing “steady state fallacy”).

³³¹ Evans & Gallagher, *supra* note 25, at 51.

³³² *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137, 1145-46 (7th Cir. 2001).

³³³ See *supra* notes 321-24 and accompanying text.

³³⁴ Jon Almeras, *ABA Tax Section Meeting: Officials Talk Capitalization and Lease Stripping*, TAX NOTES TODAY (May 13, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 92-21).

³³⁵ See *id.*

³³⁶ The Service in private rulings has permitted a current deduction for expenses recurring every two years. See, e.g., Tech. Adv. Mem. 96-18-004 (Jan. 23, 1996) (the current deduction by the taxpayer of the cost of minor repairs routinely performed by the taxpayer every one or two years “has not been raised by the agent in the present case”). In addition, the Service once suggested that a current deduction for expenses recurring every year in the aggregate but on a three-year cycle as to the particular item, as in annual dredging one-third of a harbor, was easier administratively than capitalization with subsequent depreciation over a three-year period. See Gen. Couns. Mem. 34,102 (Apr. 17, 1969) (whether such dredging benefited prior three years or future years “conjures visions in legalistic semantics”). This also suggests a

aggregate, and to capitalize with subsequent depreciation over the entire recurrence cycle when the cycle is more than three years.³³⁷

Under the suggested approach, the short and variable lives of the high-risk auto loans in *Lychuk*³³⁸ imply that capitalizing a small part of the loan review employees' compensation in proportion to the percentage of loans approved was incorrect on the facts, since the acquired automobile loans had an average duration of less than twenty-four months and were uncertain since the loans were made to high credit risk car buyers. Transaction costs and other indirect costs of acquiring or enhancing intangible assets, such as the *Lychuk* loans, should be currently deductible when the costs are regularly recurring over cycles of either twenty-four or thirty-six months. If the cycle is longer, then the costs could be treated as a deferred charge or intangible depreciable ratably over the cycle, as in *Wolfsen Land & Cattle Co. v. Commissioner*.³³⁹

As an alternative to amortization over the recurrence period of three years or more, a "sliding scale" amortization schedule might be easier to administer. One approach would be a current deduction if the estimated useful life of the asset is two years or less; if the estimated useful life or the ACRS class life is three years, there should be 50%, 25%, and 25% deductions for tax years one, two, and three,³⁴⁰ respectively; for four years, deductions of 50%, 30%, 15%, and 5%; and for five years or longer, deductions of 45%, 35%, 10%, 5%, and 5% should be taken. Under this approach, there would be no legal question as to whether an expenditure was sufficiently regular and recurring as to be currently deductible. Instead, there would be a factual question as to the duration of the recurrence cycle or the year under the sliding scale in the case at hand.

better rationale for the result in *Ingram Industries, Inc. v. Commissioner*, 80 T.C.M. (CCH) 532 (2000). See *supra* note 301 and accompanying text.

³³⁷ Lee et al., *Rough Justice II*, *supra* note 25, at 1543-56. I would not require the first expenditure in an expected three-year cycle to be capitalized on the grounds that it is not yet recurring. Glenn Walberg points out that otherwise the taxpayer might be required to change the relevant tax accounting method if the taxpayer wished to deduct the costs of the first recurrence. E-mail from Glenn Walberg, Accounting Methods and Inventory, Ernst & Young, to John Lee, Professor of Law, College of William and Mary School of Law (August 20, 2002) (on file with author).

³³⁸ *Lychuk v. Commissioner*, 116 T.C. 374, 376 (2001); see *supra* note 299.

³³⁹ 72 T.C. 1 (1979).

³⁴⁰ Service Notice 88-62, 1988-1 C.B. 548 inspired this suggestion. See *infra* note 445 and accompanying text.

F. Difficulty of Allocation Between Current and Future Benefits

Difficulty of expenditure allocation between current and future tax years is one of the oldest and strongest rough justice factors supporting a current deduction. The current deduction of advertising expenses has rested for more than fifty years on this factor.³⁴¹ Revenue Ruling 92-80 held that “[t]he *INDOPCO* decision does not affect the treatment of advertising costs under section 162(a) of the Code. These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising.”³⁴² The Staff of the Joint Committee on Taxation explains that considerations of administrative convenience³⁴³ underlie the current deductibility of

³⁴¹ The unusual treatment of expenditures for ordinary business advertising manifest in Rev. Rul. 92-80, *supra*, is longstanding. Its genesis is in efforts by taxpayers in the early years of income taxation to capitalize the costs of large-scale advertising campaigns and to amortize the capitalized amounts over a period of years, efforts that were consistently opposed by the Commissioner on the ground that allocating advertising expenditures between current expenses and capital outlays was not feasible. See, e.g., *Northwestern Yeast Co. v. Commissioner* [Dec. 1842], 5 B.T.A. 232, 237 (1926). Although the courts did not entirely foreclose the propriety of capitalizing some advertising expenditures, taxpayers found it difficult to prove an appropriate allocation between current and long-term benefits. In time, this insistence on evidence hardened into a rule of law that capitalization is proper only if the taxpayer can establish “that the future benefits can be determined precisely and are not of indefinite duration.” *A. Finkenberg’s Sons, Inc. v. Commissioner* [Dec. 18,662], 17 T.C. 973, 982-983 (1951); see also *E.H. Sheldon & Co. v. Commissioner* [54-2 USTC ¶ 9526], 214 F.2d 655, 659 (6th Cir. 1954) (taxpayer must show “with reasonable certainty the benefits resulting in later years from the expenditure”), *affg in part, and rev’g and remanding in part* [Dec. 19,358] 19 T.C. 481 (1952). See the discussion of advertising expenses in BITTKER & LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS*, par. 20.4.5 at 20-86 to 20-88 (2d ed. 1989). But see *Durovic v. Commissioner* [76-2 USTC ¶ 9732], 542 F.2d 1328 (7th Cir. 1976) (cost of free samples must be capitalized; amortization denied in absence of proof of limited life), *affg*. [Dec. 33,534] 65 T.C. 480 (1975).

RJR Nabisco, Inc. v. Commissioner, 76 T.C.M. (CCH) 71, 82 (1998) (relying on *Northwestern Yeast*, a 1926 excess profits case where the government opposed capitalization of advertising costs because it would reduce a corporation’s excess profits tax, which was much greater than the corporate income tax at that time). See generally, Mona L. Hymel, *Consumerism, Advertising, and the Role of Tax Policy*, 20 VA. TAX REV. 347, 422-36 (2000).

³⁴² 1992-2 C.B. 57.

³⁴³ The Service often uses “administrative” convenience or policy to refer to

advertising costs.³⁴⁴ The Tax Court in *RJR Nabisco* applied this analysis after *INDOPCO* to the costs of cigarette package designs.³⁴⁵ The *RJR Nabisco* court declined to accept the Commissioner's distinction between the costs of developing advertising campaigns and the costs of executing such campaigns by, for instance, producing

allowing, for example, a current deduction of costs that under strict application of precedent would be capitalized, on the grounds of difficulty of the taxpayer complying with the conceptually pure rule. See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 182-86; Lee et al., *Rough Justice I*, *supra* note 17, at 704-08. This is, of course, the main justification in general for the rough justice rules permitting a current deduction under a balancing of burdens and benefits of capitalization. See *supra* notes 244-45 and accompanying text; U.S. Freightways Corp. v. Commissioner, 270 F.3d 1137, 1146 (7th Cir. 2001).

³⁴⁴ STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX 83 (Joint Comm. Print 1996). See generally Lee et al., *Rough Justice I*, *supra* note 17, at 640. The tax revenue at issue as to deduction versus amortization of advertising costs is substantial. For instance, capitalizing and then amortizing 20% of advertising costs was estimated to increase tax revenues by \$37.9 billion in 1987, *Revenue Options Book Released but Is It a Best Seller?*, TAX NOTES TODAY (June 29, 1987) (LEXIS, FEDTAX lib., TNT file, elec. cit., 87 TNT 125-1), and \$18 billion over five years in 1993, Alexander Polinsky, *News Analysis: Amortizing Advertising Expenses – Not in the Foreseeable Future*, TAX NOTES TODAY (Sept. 27, 1993) (LEXIS, FEDTAX lib., TNT file, elec. cit., 93 TNT 199-2). The pressure group opposition to capitalization of advertising costs is even more substantial. Polinsky, *supra*; Barbara Kirchheimer, *Proposal to Capitalize Advertising Expenses Draws Fire at W&M Revenue Hearing*, TAX NOTES TODAY (Sep. 5, 1993) (LEXIS, FEDTAX lib., TNT file, elec. cit., 93 TNT 187-1). Hence, nothing legislative came to pass from staff proposals over the past decade to capitalize a portion (say 20%) of such costs which then would have been amortizable over four years or so. STAFF OF JOINT COMM. ON TAXATION, 103D CONG., DESCRIPTION OF MISCELLANEOUS REVENUE PROPOSALS SCHEDULED FOR A HEARING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS ON SEPTEMBER 8, 21, AND 23, 1993 AND THE HOUSE COMMITTEE ON WAYS AND MEANS ON SEPTEMBER 9, 1993, Proposal II.B.3 (Joint Comm. Print 1993), reprinted in *JCT Releases Description of Miscellaneous Revenue Items*, TAX NOTES TODAY (Sept. 20, 1993) (LEXIS, FEDTAX lib., TNT file, elec. cit., 93 TNT 194-50).

³⁴⁵ *RJR Nabisco, Inc. v. Commissioner*, 76 T.C.M. (CCH) 71 (1998). The litigated capitalization versus expensing costs in *RJR Nabisco* principally involved graphic design of cigarette packaging materials and in a relatively small amount involved package design, i.e., the physical construction of the package. Graphic design "is a combination of verbal information, styles of print, pictures or drawings, shapes, patterns, colors, spacing, and the like that make up an overall visual display" while package design "refers to the design of the physical construction of a package." *Id.* at 79. Graphic designs are developed for cigarette cartons, packages, messages temporarily applied to cartons or packages, tipping around the filter, cigarette papers, foils, and closure seals for soft packs.

television commercials on the basis of short-term benefits such as advertising campaigns and long-term benefits such as advertising executions because both types of benefits posed the same administrative difficulty of allocation between current and future tax years.³⁴⁶ The court explained that “at the time graphic designs or advertising campaigns are introduced, no one can determine how long the graphic designs, advertising campaigns, or elements of such designs will be used, including whether or not they will be used for more or less than a single year.”³⁴⁷ Thus, capitalization would not be followed by amortization because it requires a length of useful life that can be “estimated with reasonable accuracy.”³⁴⁸ Accordingly, a rough justice current deduction produces minimal distortion of income because the deduction causes less distortion than capitalization without amortization.³⁴⁹ *RJR Nabisco* found that successful advertising builds goodwill whether in the form of trade dress, created by graphic designs or long-term advertising campaigns.³⁵⁰ Therefore, the litigated costs were deductible as advertising costs.³⁵¹

Prior to *INDOPCO*, the Fourth Circuit in *NCNB I*³⁵² reached a similar conclusion with respect to the difficulty of allocation regarding expenditures in general. The Fourth Circuit, based upon financial accounting principles, reasoned that

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

³⁴⁶ *Id.*

³⁴⁷ *Id.*

³⁴⁸ Treas. Reg. § 1.167(a)-3 (as amended in 2000).

³⁴⁹ My notion that capitalization without depreciation produces more distortion than a current deduction has become conventional wisdom. See Hal I. Gann, *Capitalization: Get Back to Where You Once Belonged*, 149 U.S.C. ANN. TAX INST. (MAJOR TAX PLAN.) ¶¶ 200, 205.3, at 2-21 (1997); Brett M. Alexander, Note, *An Analysis of INDOPCO, Inc. v. Commissioner*, 54 OHIO ST. L.J. 1505, 1516-19 (1993).

³⁵⁰ *RJR Nabisco, Inc.*, 76 T.C.M. (CCH) at 84.

³⁵¹ The Commissioner conceded that graphic design costs “fit the textbook definition of advertising.” *Id.* at 80.

³⁵² *NCNB Corp. v. United States*, 651 F.2d 942 (4th Cir. 1981).

future projects.”³⁵³

The Office of Chief Counsel, in Private Letter Rulings prior to *INDOPCO*, also recognized the difficulty of allocation to costs in contexts other than advertising. For instance, the Office of Chief Counsel’s reasoning in General Counsel Memorandum 35,681³⁵⁴ – that salaries, rents, and mortgages incurred in originating a mortgage and not directly attributable to the acquisition of a mortgage should be currently deductible – turned on difficulty of allocation. Specifically, the Office of Chief Counsel stated, “[t]o determine which portion of otherwise current operating expenses benefits future periods would be impossible to do accurately.”³⁵⁵ This difficulty of allocation analysis supports the results in several of the post-*INDOPCO* circuit court cases treating transaction costs, such as, *PNC Bancorp, Inc. v. Commissioner*³⁵⁶ and *Wells Fargo & Co. v. Commissioner*.³⁵⁷ Significantly, the Third Circuit in *PNC Bancorp* pointed out that the Service did not include the capitalized loan origination costs in the basis of each loan.³⁵⁸

G. Speculative Future Benefits

The Advance Notice discusses a contemplated proposed requirement to capitalize amounts “paid to another person to induce

³⁵³ *Id.* at 961-62 (footnotes omitted) (citing AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT NO. 4: BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (1970)).

³⁵⁴ Gen. Couns. Mem. 39,417 (Feb. 19, 1974).

³⁵⁵ *Id.*

³⁵⁶ 212 F.3d 822 (3d Cir. 2000).

³⁵⁷ 224 F.3d 874 (8th Cir. 2000), *rev’g* *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

³⁵⁸ For example, if the loan origination costs were required to be capitalized, it would seem to follow that these costs would have to be included in the basis of each loan. Such inclusions would apparently be a departure from current practice However, *the IRS conceded at oral argument that a requirement of capitalization of loan origination costs would probably mean that these complex basis adjustments would need to be made.* The IRS’s apparent failure to consider these and other tax ramifications of capitalization suggests that the IRS’s borrowing of the line that the SFAS 91 standards draw between current-year costs and deferred costs was not based on any independent tax analysis, but was simply a “bootstrapping” of the financial accounting standards into the tax arena.

PNC Bancorp, 212 F.3d at 832-33 n.16 (emphasis added) (citations omitted).

that person to enter into, renew, or renegotiate an agreement that produces contract rights enforceable by the taxpayer, including payments for leases, covenants not to compete, licenses to use intangible property, customer contracts and supplier contracts.”³⁵⁹ It notes, however, that “[t]his rule also would not require a taxpayer to capitalize a payment that does not create enforceable contract rights but, for example, merely creates an expectation that a customer or supplier will maintain its business relationship with the taxpayer.”³⁶⁰ Authorities before and after *INDOPCO* allowed a current deduction of costs yielding only speculative future benefits.

Tax Court Judge Tannenwald, in exploring *INDOPCO*’s incidental future benefit limitation in *Sun Microsystems, Inc. v. Commissioner*,³⁶¹ took a speculative benefits tack. There, the taxpayer, a new high-tech company (SMS), maintained that warrants were included as an incentive to purchase \$20 million and \$30 million worth of workstations; the issuance of stock warrants – with exercise rights contingent upon the volume of future purchases – to a new major customer (CV) constituted currently deductible sales discounts.³⁶² The Commissioner argued that under *INDOPCO*’s “new look,” the warrants should be capitalized as an investment made to develop a long-term relationship with a customer. Judge Tannenwald responded by pointing to the parties’ stipulation that “the anticipated long-term benefits to SMS from the relationship with CV were ‘softer’ and were speculative, compared to the immediate benefits to SMS of

³⁵⁹ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3463 (Jan. 24, 2002).

³⁶⁰ *Id.* (citing *Van Iderstine Co. v. Commissioner*, 261 F.2d 211 (2d Cir. 1958)).

³⁶¹ 66 T.C.M. (CCH) 997 (1993).

³⁶² Revenue agents have argued that *Sun Microsystems* is merely a discount case. See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 179. I believe that Judge Tannenwald, while indicating that such narrow analysis resolved the controversy in front of him, deliberately pointed to the precedent permitting current deduction of future benefit expenses to give meaning to “incidental” future benefit:

Snyder v. United States, 674 F.2d 1359, 1365 (10th Cir. 1982) (author’s expenses in connection with a book to be published in future held deductible); Primuth v. Commissioner, 54 T.C. 374 (1970) (fee in order to secure employment held deductible); Rev. Rul. 92-80, 1992-2 C.B. 57 (*INDOPCO* does not preclude deduction of advertising expenses having a future benefit); Lee, “Doping out the Capitalization Rules after *INDOPCO*,” 57 Tax Notes 669 (Nov. 2, 1992)

Sun Microsystems, 66 T.C.M. 997. I like to speculate that Judge Tannenwald was implicitly approving a balancing test minimum distortion of income analysis as it was a major theme of my article that he cited.

the anticipated sales of computer workstations to CV under the Purchase Agreement.”³⁶³

The Service followed *Sun Microsystems*' incidental/speculative benefit reasoning in Technical Advice Memorandum 96-45-002, extensively discussing deductibility of pre-opening costs incurred by a retailer opening new stores in the *same* field.³⁶⁴ Indeed, the Service has long followed such a speculative benefit approach. The reasoning of the Office of Chief Counsel took the same tack for allowing current deduction of advertising costs in a sales campaign by public utilities to increase sales of gas or electricity through providing incentives to builders and owners to install equipment using substantial amounts of electricity or natural gas.

[I]n the case of ordinary advertising it is generally recognized that there is only a hope that new customers will be secured by the expenditure, and there is no guarantee that new customers will be so obtained. Furthermore, the benefits that will result in later years from the expenditure cannot usually be ascertained with reasonable certainty. In light of these facts, the Service and the Courts have generally held that such advertising costs are deductible currently as ordinary and necessary business expenses.³⁶⁵

Thus, the reasoning of the Office of Chief Counsel appeared to turn both on speculative benefits and on an inability to depreciate if capitalized. The former was clearly more important:

On the other hand, however, where the acquisition of new customers can be attributed directly to particular expenditures, those expenditures must be capitalized since they have resulted in the acquisition of a benefit extending into subsequent years, i.e., the increased earning capacity to be generated from the new customers obtained.³⁶⁶

Such capitalized costs would not have been depreciable unless the life of this intangible benefit could have been determined with certainty. A memo attached to General Counsel Memorandum 33,784 reveals that the Associate Chief Counsel would have allowed a

³⁶³ *Sun Microsystems*, 66 T.C.M. 997.

³⁶⁴ See Tech. Adv. Mem. 96-45-002 (June 21, 1996).

³⁶⁵ Gen. Couns. Mem. 33,784 (March 29, 1968) (considering Revenue Ruling 68-561, 1968-2 C.B. 117).

³⁶⁶ *Id.*

current deduction for the salaries to the taxpayer's sales representatives conducting the campaign and the costs of the advertising campaign for a slew of broader reasons consonant with the modern rough justice factors.³⁶⁷ The Office of Chief Counsel concurred in the result suggested by the Associate Chief Counsel,³⁶⁸ but the published ruling considered in General Counsel Memorandum 33,784, articulated as the basis for allowing a current deduction of the salaries paid to the taxpayer's representatives and advertising payments in the sales campaign that they were "less directly and significantly productive of intangible assets having a value extending beyond the taxable years in which they were paid or incurred."³⁶⁹ The incentives to the builders and owners were required to be capitalized.³⁷⁰ Interestingly, this analysis is similar to that later adopted by the Tax Court in *Lychuk* in allowing the current deduction of overhead costs associated with loan origination operations.³⁷¹ The distinction between similar costs on the grounds of depreciability was also drawn in Revenue Ruling 94-38³⁷² with respect to soil remediation costs, as well as in several landmark pre-*INDOPCO* decisions.³⁷³ Ultimately, the availability or not of depreciation if the costs in question are capitalized is one of the rough justice distinctions between costs incurred in connection with the acquisition, creation, or

³⁶⁷ *Id.* (salaries of representatives and advertising costs are not as closely connected to the acquisition of future benefits as the bonus payments and "could be said to be in payment for the services currently being rendered;" the connection with a future benefit of increased electricity consumption is tenuous; establishing a direct connection between the advertising expenses and increases in the future consumption of electricity would be inherently difficult; "capitalization of salary and advertising expenditures could logically be extended to other businesses and industries where traditionally an expense deduction has been allowed;" and another objection to capitalization of the salaries and advertising costs "is the difficult task of determining the useful life of the asset acquired." The suggestion of using "the useful life of the building involved" was rejected "[s]ince the salaries and advertising costs do not appear to be related to any particular building").

³⁶⁸ *Id.*

³⁶⁹ Rev. Rul. 68-561, 1968-2 C.B. 117.

³⁷⁰ Gen. Couns. Mem. 33,784 (March 29, 1968) (Associate Chief Counsel Memorandum).

³⁷¹ See *Lychuk v. Commissioner*, 116 T.C. 374, 392 (2001).

³⁷² 1994-1 C.B. 35; see also John W. Lee & W. Eugene Seago, *Policy Entrepreneurship, Public Choice, and Symbolic Reform Analysis of Section 198, the Brownfields Tax Incentive: Carrot or Stick or Just Never Mind?*, 26 WM. & MARY ENVT'L. L. & POL'Y REV. 613, 702-03, 716-17 (2002) (discussing this point).

³⁷³ See, e.g., *Southland Royalty Co. v. United States*, 582 F.2d 604, 618 (Ct. Cl. 1978).

enhancement of tangible and intangible assets.

H. Slow or No Depreciation is More Trouble than It Is Worth

Both *Southland Royalty*³⁷⁴ and *Iowa-Des Moines*³⁷⁵ held that capitalization was not appropriate where depreciation was not available.³⁷⁶ Perhaps *Colorado Springs National Bank v. United States*,³⁷⁷ a business expansion decision, most extensively analyzes this notion.³⁷⁸ I believe that this is also the better ground in Revenue Ruling 94-38³⁷⁹ for currently deducting soil remediation costs.³⁷⁹ As shown in the preceding section, this was also one of the reasons for allowing the current deduction of the salesmen's salaries and the advertising costs of the promotions to use or convert to electric or gas heat. This reasoning, however, was not reflected in the final published ruling, for the Service historically has appeared reluctant explicitly to pursue this route. Avoidance of "perpetual capitalization,"³⁸⁰ or capitalization

³⁷⁴ *Id.*

³⁷⁵ *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433 (8th Cir. 1979).

³⁷⁶ See *supra* notes 297-98 and accompanying text.

³⁷⁷ The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable. They are recurring. At the most they introduced a more efficient method of conducting an old business. The government suggests no way in which they could be amortized. The government's theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.

505 F.2d 1185, 1192 (10th Cir. 1974).

³⁷⁸ 1994-1 C.B. 35.

³⁷⁹ Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 197 n.140. Perhaps the strongest point of Lee, *Capitalization Rules*, *supra* note 13, was that rough justice administrable solutions are preferable to overreaching capitalization by the Service without allowing adequate capital recovery. See also Alexander, *supra* note 349, at 1516-17. Some but not all judges are tempted to award a current deduction as less income distorting. It is possible that this point was behind the compromise in Technical Advice Memorandum 93-15-004 (Dec. 17, 1992) of providing amortization of capitalized toxic waste soil remediation costs over a surrogate of the life of the taxpayer's core business asset. See 1993 House Hearings, *supra* note 37, at 1689, 1702; Hal Gann & Roy Strowd, *INDOPCO – Time for the Second Shoe to Drop*, TAX NOTES TODAY (Nov. 21, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit., 95 TNT 227-140). For interesting practitioner tips on how to convince a revenue agent of the theorem of less (or minimum) distortion of income, see Gann, *supra* note 349, at 2-21 to 2-26.

³⁸⁰ See *supra* note 251.

without depreciation, has often convinced tribunals³⁸¹ other than the Tax Court. In this regard, *Wolfsen Land & Cattle*³⁸² is a welcome exception. Even where these exceptions are not applicable, several authorities hold that if depreciation is not available, capitalization is not appropriate because capitalization without depreciation would distort the taxpayer's income.³⁸³ Moreover, where depreciation is available, distortion of income would also result when the recovery period is much longer than the future benefit of the expenditure. This was the unacknowledged problem presented in *Ingram Industries*³⁸⁴ and the aircraft engine inspection Technical Advice Memorandum.³⁸⁵ In both instances, the recovery period for the capitalized expenditure was more than twice as long as the repair cycle. Thus, a current deduction or amortization over an arbitrary period would produce *less* distortion of income, or minimal distortion of income, than such *ideal* slow or no depreciation would cause.³⁸⁶ This "second best" approach is demanded by clear reflection of income as a rule of equity or rough

³⁸¹ See *supra* notes 297-98 and accompanying text.

³⁸² *Wolfsen Land & Cattle Co. v. Commissioner* 72 T.C. 1 (1979); see *infra* notes 396-403 and accompanying text.

³⁸³ See *Southland Royalty Co. v. United States*, 582 F.2d 604, 618 (Ct. Cl. 1978); Lee, et al., *Rough Justice II*, *supra* note 25, at 1549. In the repair versus improvement context, Revenue Ruling 94-38, 1994-1 C.B. 35, reasoned alternatively that where amortization is not available, capitalization is not appropriate.

³⁸⁴ *Ingram Indus., Inc. v. Commissioner*, 80 T.C.M. (CCH) 532 (2000).

³⁸⁵ Tech. Adv. Mem. 96-18-004 (Jan. 23, 1996); see Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 163-64, 213.

³⁸⁶ Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 214-16. Support for this approach is found in *Wolfsen Land & Cattle*.

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 grounds that its deductibility is contaminated by its relationship to an asset of indefinite life, i.e., the land, would similarly require an uneven reporting of income.

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

Wolfsen Land & Cattle, 72 T.C. at 13; see Lee, *Capitalization Rules*, *supra* note 13, at 680. This approach was in effect followed in the repair versus improvement context in Technical Advice Memorandum 93-15-004 (Dec. 14, 1994). See also *supra* note 358.

justice.³⁸⁷

I. Amortization Periods

The Advance Notice announces that the Service and the Treasury Department “expect to provide safe harbor recovery periods and methods for certain capitalized expenditures that do not have readily ascertainable useful lives.”³⁸⁸ Both the Service and the Treasury Department requested comments “regarding whether guidance should provide one uniform period or multiple recovery periods and what the recovery periods and methods should be.”³⁸⁹ Case law has resolved, on occasion, the current deduction versus capitalization without depreciation dilemma by fashioning an amortization period for the expense, or even a deferred charge or freestanding amortizable intangible. The Service also has offered this golden mean, based upon its clear reflection of income authority, as the resolution of intractable capitalization issues.³⁹⁰

More than two decades ago, *NCNB I*³⁹¹ showed that the ideal answer to many of the future benefit expenses controversies, particularly where the issue was posed as a choice between the income distorting extremes of current deduction or perpetual capitalization, was depreciation of an intangible over some period. Many courts once permitted current deduction of business expansion costs creating intangibles benefiting future years under the now discredited definitional separate, saleable asset doctrine. Courts adopted this approach in order to prevent distortion of income where amortization of the capitalized amounts would not be allowed by the Service³⁹² on the grounds that the life of the resulting intangible could not be

³⁸⁷ See *infra* notes 403-04 and accompanying text.

³⁸⁸ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3464 (Jan. 24, 2002).

³⁸⁹ *Id.*

³⁹⁰ See *infra* notes 405-19 and accompanying text for a discussion of writer's prepublication costs and package design safe harbor amortization.

³⁹¹ *NCNB I*, 651 F.2d 942, 947, 962-63 (4th Cir. 1981).

³⁹² Rejecting a scheme under which “an expenditure, *concededly of temporal value*, may be neither expensed nor amortized,” the court allowed the current-expense deduction. “The government suggests no way in which they could be amortized.” It was, in short, an attempted overreaching by the tax collector. If he failed, he had less basis for protest than if he had confined his demands to those which were properly Caesar's.

Id. at 959-60 (quoting *Colorado Springs National Bank v. United States*, 505 F.2d 1185, 1192 (10th Cir. 1974)).

“estimated with reasonable accuracy.”³⁹³ The *NCNB I* panel reasoned that a court’s flexibility in avoiding distortion of income as to business expansion costs instead should lie in a *Cohan*-like³⁹⁴ approximation of the amounts of the benefit allocable to current and future tax years.³⁹⁵ The conceptually correct approach, however, would have been to estimate the useful life of the capitalized expenditure; or if that life is sufficiently short or variable, or the amount is insubstantial, the court should determine that a current deduction would produce minimal distortion of income.

The Tax Court in *Wolfsen Land & Cattle*,³⁹⁶ faced with a similar dilemma, came up with the innovative and more conceptually correct solution of treating the expenditure itself as a “deferred charge” in financial accounting terms³⁹⁷ or freestanding intangible amortizable over the period benefited. In this case, the taxpayer operated a ranch with an irrigation system that prevented the ranch from being a bog of little or no worth.³⁹⁸ It could have maintained the system by annual draglining the ditches, or it could “dragline periodically when and where necessary to prevent dysfunction.”³⁹⁹ As it worked out, the ditches could be ignored for about nine years and continue to function even though gradually clogging up, then in the tenth year the clogging would have “gone far enough to affect drastically the ditch’s hydraulic capacity.”⁴⁰⁰ The cost of draglining the ditch was about the same for its original creation, for *each* year in annual maintenance, or for draglining in the tenth year.⁴⁰¹ Not surprisingly, the taxpayer chose to dragline the ditch only when it clogged up to the extent that it could not be used. The Tax Court characterized the issue as a current deduction or “perpetual capitalization.”⁴⁰² Reasoning that both alternatives would distort the taxpayer’s income, the *Wolfsen Land &*

³⁹³ Treas. Reg. § 1.167(a)-3 (as amended in 2000).

³⁹⁴ *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

³⁹⁵ *NCNB I*, 651 F.2d at 947, 962. Of course, the panel decision was overly influenced by financial accounting notions. See *id.* at 952-53. Tax accounting does not allocate to each year the actual use of a capitalized intangible (except perhaps in income forecast depreciation), but rather estimates the period of benefit and then depreciates under the straightline method. See Lee, *Start-Up Costs*, *supra* note 10, at 38-41, 58-62.

³⁹⁶ 72 T.C. 1 (1979).

³⁹⁷ *NCNB I*, 651 F.2d at 948-50.

³⁹⁸ *Wolfsen Land & Cattle*, 72 T.C. at 6.

³⁹⁹ *Id.* at 11.

⁴⁰⁰ *Id.* at 12.

⁴⁰¹ *Id.*

⁴⁰² See Gideon, *supra* note 248, at 109.

Cattle court concluded that:

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.⁴⁰³

I would add that if the period benefited is short or highly variable, so that amortization is difficult or impossible, and the expenditure is at least “steady-state” recurring, then the cost treated as a separate asset should be expensed in its entirety in the year made.⁴⁰⁴

Ironically, the Service has often offered the ideal of amortization over some fixed period of expenditures creating intangibles too late in the process, and that offer has been successfully rejected by taxpayer groups in favor of a current deduction. Perhaps the best known example is package design costs. In this instance, the Service first took the tack of capitalizing and denying any deduction due to lack of a life that could be estimated with reasonable certainty.⁴⁰⁵ Amortization over a fixed period, instead of the all-or-nothing current deduction or “perpetual capitalization,”⁴⁰⁶ was apparently offered too late to the industry by the Service.⁴⁰⁷ Resting on “administrative convenience” to “minimize disputes,”⁴⁰⁸ the Service offered

⁴⁰³ *Wolfsen Land & Cattle*, 72 T.C. at 13.

⁴⁰⁴ See *Southland Royalty Co. v. United States*, 582 F.2d 604, 617 (Ct. Cl. 1978); *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 436, 436 (8th Cir. 1979); *Encyclopaedia Britannica v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982).

⁴⁰⁵ See, e.g., Tech. Adv. Mem. 86-11-005 (Nov. 26, 1985) (costs of a new product package design must be capitalized since they create “intangible assets with useful lives in excess of the taxable year in which such costs were incurred”). The design at issue was a unique cardboard base hosting an extending container for marketing women’s hosiery, which enjoys wide customer recognition. See Gen. Couns. Mem. 39,483 (Mar. 5, 1986) (the “L’Eggs” GCM). Revenue Ruling 89-23, 1989-1 C.B. 85, required package design costs incurred after 1986 to be capitalized and denied depreciation under Treasury Regulation 1.167(a)-3 because a useful life could not be ascertained.

⁴⁰⁶ See Gideon, *supra* note 248, at 109.

⁴⁰⁷ Instead, the result was the current deduction taxpayer victory in *RJR Nabisco, Inc. v. Commissioner*, 76 T.C.M. (CCH) 71 (1998). See *supra* notes 346-51 and accompanying text.

⁴⁰⁸ See Rev. Proc. 90-63, 1990-2 C.B. 664, ¶ 3.05; Rev. Proc. 89-17, 1989-1 C.B. 827, ¶ 3.02; cf. Gen. Couns. Mem. 36,074 (Nov. 11, 1974) (“In view of the lack of any

amortization procedures for package design costs. The Service permitted sixty-month amortization on a design-by-design basis or forty-eight-month amortization on a pool-of-cost basis, as set forth in a series of Revenue Procedures referred to by commentators as “administrative grace.”⁴⁰⁹ The most widely discussed of these was Revenue Procedure 90-63,⁴¹⁰ and the most recent is Revenue Procedure 98-39.⁴¹¹ Such safe harbor amortization became the preferred model for Chief Counsel’s tax treatment of recurring costs benefiting a number of years. For instance, Associate Chief Counsel Glenn Carrington pointed to Revenue Procedure 90-63 as a model for amortization over five to ten years to resolve capitalization issues. “Asked whether IRS believes it has regulatory authority to ‘arbitrarily’ require capitalization over a fixed period, such as five years or [ten] years, Carrington responded, ‘It would be arbitrary, but we’ve done arbitrary – reasonably arbitrary – things in the past.’”⁴¹² The rest of the story is *RJR Nabisco*,⁴¹³ where, ironically, the Service’s lawyers argued for capitalization without providing for such compromise amortization.⁴¹⁴ Predictably,⁴¹⁵ the court granted instead a current deduction due to the difficulty of allocating the expenditure between current and future benefits.⁴¹⁶

Exactly the same thing happened with writers’ prepublication

demonstrable legislative purpose or legal reason, we think it appropriate to consider questions of administrative convenience.”).

⁴⁰⁹ Gann & Strowd, *supra* note 379.

⁴¹⁰ 1990-2 C.B. 664.

⁴¹¹ 1998-1 C.B. 1320.

⁴¹² *IRS Environmental Cleanup Guidance May Be Out by July, Official Says*, 1993 DAILY TAX REP., May 11, 1993, at G-8. Carrington said that Chief Counsel’s office was considering a five-year amortization period for all clean-up costs but was doubtful that the industry would sign on to such an approach. See also J. Andrew Horner, *Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, TAX NOTES TODAY (May 12, 1993) (LEXIS, FEDTAX lib., TNT file, elec. cit., 93 TNT 102-10); F.R. Nagle, *IRS’s Carrington Says Asbestos Abatement TAM Under Reconsideration*, TAX NOTES TODAY (Feb. 9, 1993) (LEXIS, FEDTAX lib., TNT file, elec. cit., 93 TNT 31-2) (Carrington said that one suggestion in the Service to aid firms with asbestos remediation was to allow amortization over seven or ten years).

⁴¹³ *RJR Nabisco, Inc. v. Commissioner*, 76 T.C.M. (CCH) 71 (1998).

⁴¹⁴ See Fred T. Goldberg, Jr., *Filling the Void: Can the IRS Restructuring Bring Purpose and Meaning to the Random World of Tax Litigation?*, 77 TAXES 179, 185 (Mar. 1999) (former Chief Counsel, Commissioner, and Assistant Secretary for Tax Policy).

⁴¹⁵ See Lee, *Capitalization Rules*, *supra* note 13, at 677.

⁴¹⁶ See *supra* notes 346-48 and accompanying text. In theory, the Service does not follow *RJR Nabisco*. See 2001 FSA LEXIS 158 (Aug. 15, 2001).

costs. Service Notice 88-62 attempted to resolve the issue of deductibility of writers' prepublication costs by allowing a current deduction of a writer's prepublication costs over a three-year period on the sliding-scale basis of 50%/25%/25%.⁴¹⁷ In the early stages of development of the three-year safe harbor adopted in Service Notice 88-62, the Service considered allowing (1) current deduction of a fixed amount of a writer's prepublication expenses (such as \$5,000-\$10,000) to be deducted annually, and (2) amortization of expenses above that level ratably over the next three years.⁴¹⁸ Probably tasting blood in the water, the Writers Coalition, a special interest group, opposed compromise as still requiring allocations and decisions as to whether income forecast recovery would be more favorable and argued that the floor was too low for any writer with an office.⁴¹⁹

The acquisition cost doctrine is compatible with the timing-minimal 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 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 summary, the free-standing asset model entails a two-step analysis: (1) look at whether current deduction of an expenditure will distort the taxpayer's income because the expenditure provides future benefits and is neither sufficiently insubstantial nor recurring frequently enough to be nondistorting if currently deducted; if this is the case, then (2) estimate the period benefited by the expenditure (i.e., the useful life), and amortize the expenditure as a free-standing asset over the period.⁴²⁰

⁴¹⁷ I.R.S. Notice 88-62, 1988-1 C.B. 548.

⁴¹⁸ See Letter from Writers Coalition, New York, to Don Chapoton, Assistant Secretary for Tax Policy, Department of Treasury (Oct. 5, 1987), reprinted in *Writers Object to Proposed Section 263A Compromise*, TAX NOTES TODAY (Oct. 8, 1987) (LEXIS, FEDTAX lib., TNT file, elec. cit., 87 TNT 196-9).

⁴¹⁹ *Id.* The coalition represented almost fifty groups. *Id.* At this time there were 61,000 free-lance writers, 20,000 photographers, and the later-formed Artists for Tax Equity of forty-five groups led by the 3500 member Graphic Artists Guild. See Anne Constable, *Write-Off – or Tax Shelter; Artists Try to Erase Part of the New Tax Law*, TIME, Apr. 18, 1988, at 57; Judith Michaelson, "The Boston Tea Party of the Arts," *Visual and Free-lance Artists Claim New Tax Law Unfairly Limits Deductions*, L.A. TIMES, Mar. 29, 1988, at 6-1.

⁴²⁰ See Lee, *Start-Up Costs*, *supra* note 10, at 12-15. For suggestions as to safe

J. Conclusion

In essence, the rough justice rules advocated are simplified tax accounting methods. This strongly suggests, as a broad tax policy matter, that they be limited to the same class of taxpayers to whom such simplified methods traditionally have been granted in order to reduce transaction and tax costs, as well as provide a tax subsidy. The statutory limitations on use of the cash method of income tax accounting under section 448 constitute a Congressional highlighting of the classes of taxpayers for whom it believes the burdens of more complex rules outweigh the clearer reflection of income. Even closer conceptually are the limitations on expensing small amounts of depreciable assets under section 179. The Joint Committee Staff has pointed out that small businesses are granted many exceptions from the normal tax accounting rules, amounting to tax preferences, in order "to serve the dual purpose of easing the administrative burdens of, and providing a tax subsidy to, small businesses."⁴²¹

Should expensing and amortization safe harbors also be limited to small income taxpayers? Approaching the question solely from a taxpayer's cost/benefits analysis perspective, I would answer yes.⁴²² Apart from a general populist perspective in my more recent work,⁴²³ I have long advocated a two-track regulatory system with simpler rules whenever greater numbers of smaller taxpayers are affected.⁴²⁴ Elaborate, more theoretically correct rules may be in order for those who can handle them.⁴²⁵ Arguably, that is the case for more theoretically correct, but frightfully complex provisions, like section 263A. Congress appears to have recognized this in its small business

harbors here, see text following *supra* note 340.

⁴²¹ STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX 74 (Joint Comm. Print 1996).

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

Id.

⁴²² See Lee et al., *Rough Justice I*, *supra* note 17, at 732-38.

⁴²³ See Lee, *Business Tax Entities*, *supra* note 60, at 962-79.

⁴²⁴ John W. Lee, *The Art of Regulation Drafting: Structured Discretionary Justice under Section 355*, 44 TAX NOTES 1029, 1031 n.18 (Aug. 28, 1989) [hereinafter Lee, *Art of Regulation Drafting*].

⁴²⁵ *Id.* at 1031.

exceptions⁴²⁶ and, above all, time value of money provisions.⁴²⁷

Nevertheless, the rough justice proposals should apply to large income taxpayers for both a practical reason and a statutory interpretation reason. The practical reason is the inefficiency of devoting such a high percentage of the Service's enforcement resources to transaction costs issues.⁴²⁸ Capitalization and expensing are currently significant audit issues only at the big, usually public, C corporation level.⁴²⁹ Concentrating audit resources on these issues when large corporations are abusing corporate tax shelters is analytically equivalent to rearranging deck chairs on the Titanic as it began to tilt while the band kept on playing.⁴³⁰

The second reason is that, theoretically, an interpretative regulation can rise not higher than the statute and its case-law glosses. Unlike Congress, the authorities have tended not to draw distinctions between large and small taxpayers⁴³¹ and, indeed, as a corollary of the audit patterns, most of the cases with *INDOPCO* issues to date have involved large taxpayers. For example, in *U.S. Freightways*, the taxpayer had a fleet of 14,766 trucks and growing in 1993; the twelve-

⁴²⁶ See I.R.C. §§ 263A(b)(2)(B); 453A(b)(1), (b)(2)(B).

⁴²⁷ See, e.g., I.R.C. §§ 1274(c)(3)(A), (c)(3)(C); 1274A; 7872(c)(2), (d).

⁴²⁸ See Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002); *supra* note 182 and accompanying text.

⁴²⁹ Lee et al., *Rough Justice I*, *supra* note 17, at 654-63. I note, however, that the SB/SE as well as LMSB divisions of the Service are issuing directives as to the Advance Notice. See, e.g., Memorandum from Larry R. Langdon, Commissioner, Large and Mid-Size Business Division, and Joseph G. Kehoe, Commissioner, Small Business/Self-Employed Division, to LMSB and SB/SE Employees (Feb. 26, 2002), reprinted in *Internal Guidance for Applying Proposed Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Feb. 28, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 40-12); Memorandum from Larry R. Langdon, Commissioner, Large and Mid-Size Business Division, and Joseph G. Kehoe, Commissioner, Small Business/Self-Employed Division, to LMSB and SB/SE Employees (Apr. 26, 2002), reprinted in *IRS Memo Provides Guidance for Intangibles*, TAX NOTES TODAY (May 9, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 90-8).

⁴³⁰ The media has widely reported the drop in the tax audit rate for large firms, growth in the use of tax shelters by such firms as audit scrutiny faded, and the decline in reported taxable income while book earnings soared. See *supra* notes 124-26 and accompanying text.

⁴³¹ A rare exception proving the point is the dissenting opinion of Judge Murnaghan in *NCNB II*, 684 F.2d 285, 296 (4th Cir. 1982) (Murnaghan, J., dissenting) ("Other taxpayers must capitalize and not deduct all at once expenditures having extended lives or applications. The taxpayer here, and others, preeminently banks, who will benefit from the decision of the *en banc* majority, can by no means merit description as 'economically deprived.' The benefit heaped upon them further contributes to the deserved description of our income tax system as a disgrace.").

month licenses and permits were more than \$5 million a year.⁴³² Incidentally, the rough justice proposals should explicitly be made inapplicable to tax shelters.⁴³³

V. POST-*INDOPCO* APPELLATE DECISIONS, TRANSACTION COSTS, AND THE ADVANCE NOTICE

A. Introduction

1. Advance Notice

The Advance Notice contemplates that the proposed regulations will require capitalization of transaction costs that “facilitate” a capital transaction while permitting a current deduction of costs that do not so facilitate.⁴³⁴ This contemplated rule appears to be derived from *A.E. Staley*.⁴³⁵ Additionally, “this rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead (e.g., rent, utilities and depreciation), or costs that do not exceed a specified dollar amount, such as \$5000.”⁴³⁶

This regular salary rule is expressly based on *Wells Fargo*.⁴³⁷ The general fixed overhead rule appears to be based upon *Lychuk*.⁴³⁸ The Advance Notice further contemplates that outside transaction costs

⁴³² U.S. Freightways Corp. v. Commissioner, 270 F.3d 1137 (7th Cir. 2001).

⁴³³ See Lee et al., *Rough Justice I*, *supra* note 17, at 733-34; Rev. Proc. 2001-10, 2001-2 I.R.B. 272 (making elective simplified accounting method inapplicable to tax shelters).

⁴³⁴ See Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3463 (Jan. 24, 2002) (capitalization of amount in excess of the safe harbor amount “paid to facilitate the acquisition, production, or installation of tangible property that is owned by a person other than the taxpayer” resulting in intangible future benefits to the taxpayer); *id.* at 3464 (capitalization required of “transaction costs that facilitate the taxpayer’s acquisition, creation, or enhancement of intangible assets,” but is not required of “post-acquisition integration costs or severance payments made to employees as a result of an acquisition transaction because such costs do not facilitate the acquisition.”).

⁴³⁵ *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), *rev’g and remanding* 105 T.C. 166 (1995).

⁴³⁶ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3464.

⁴³⁷ *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *rev’g in part* *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999); see Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3464.

⁴³⁸ *Lychuk v. Commissioner*, 116 T.C. 374, 376 (2001); see *supra* note 434 and accompanying text.

such as loan origination costs (credit history and property appraisal to facilitate a loan) *not* in excess of a de minimis amount would not have to be capitalized and that “the taxpayer also would not be required to capitalize the amount of salaries paid to employees or overhead costs of the taxpayer’s loan origination department.”⁴³⁹ The latter rule appears to be based on *PNC Bancorp.*⁴⁴⁰ In short, a “practical” line can be drawn between inside and outside transaction costs on the basis of difficulty in allocation to the particular asset benefited.

In this context, the Advance Notice stated, “IRS and Treasury Department are considering alternative approaches to minimize uncertainty and to ease the administrative burden of accounting for transaction costs. For example, the rules could allow a deduction for all employee compensation (including bonuses and commissions that are paid with respect to the transaction)”⁴⁴¹

Whether the cost is an outside or inside commission, generally, there should be little difficulty in allocating it to the transaction for which the commission was paid. A current deduction of inside commissions, therefore, should turn on whether the transaction is de minimis, yields short-term benefits, or is recurring and insubstantial. Otherwise, a current deduction for such commissions ultimately must rest on the administrative difficulties of the Service in policing unprincipled deductions. This rationale, standing alone, is unconvincing.

On the other hand, if the commission is more like a bonus that is not tied to specific transactions,⁴⁴² then the difficulty of allocation

⁴³⁹ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3464. The implication is that such outside costs would be required to be capitalized if in excess of the threshold dollar amount. The Advance Notice expressly provides that amounts paid for portfolios of loans or the amounts loaned to borrowers would have to be capitalized. *Id.* at 3462. In most cases, inside transaction costs would be more difficult to allocate than such outside transaction costs.

⁴⁴⁰ See *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), *rev’g* 110 T.C. 349 (1998) (permitting a current deduction of the loan reviewers’ salaries). The Third Circuit had decided *National Starch & Chemical Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990). In *INDOPCO*, Justice Blackmun affirmed *National Starch* on much the same reasoning as the Third Circuit.

⁴⁴¹ Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3464.

⁴⁴² The American Institute of Certified Public Accountants (AICPA) favors deducting inside bonuses, and in any event where the “bonus or commission is paid to the employee for overall performance above a set floor of acquisition or other activity.” Letter from Pamela J. Pecarich, Tax Accounting Technical Resource Panel, AICPA, to Pamela F. Olson, Acting Assistant Secretary for Tax Policy, Department of the Treasury, and Charles O. Rossotti, Commissioner, Internal Revenue Service

factor could apply. The Advance Notice implies that the contemplated revisions probably would provide that outside transaction costs in excess of a de minimis amount must be capitalized.⁴⁴³ Picking up on this, the AICPA argues correctly that requiring capitalization of outside transaction costs while allowing a deduction for comparable inside transaction costs creates a tax disparity favoring “taxpayers that can support in-house legal and financial resources. Accordingly, to minimize the disparity in

(May 14, 2002) [hereinafter AICPA Comment], *reprinted in AICPA Suggests Changes to Proposed Regs on Capitalizing Expenditures*, TAX NOTES TODAY (May 17, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 96-18). This makes sense. The next step is external costs that are difficult to allocate to particular tangibles because the taxpayer’s accounting system does not capture them. See Letter from Stephen Elkins and Craig Jones, Tax Team, American Chemistry Council (ACC), to the Internal Revenue Service (Mar. 25, 2002), *reprinted in Writers Comment on Proposed Regs on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Apr. 23, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 78-23). Others want to go further. ACC argued that an inside bonus on a deal that closes includes compensation for deals that fell through. *Id.*; see also *Organization Seeks Clarification of Deductible Expenses*, TAX NOTES TODAY (May 17, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 96-33). The *INDOPCO* Coalition argues that employee compensation in any form should be deductible. See Letter from Fred T. Goldberg, Jr., Skadden, Arps, Slate, Meagher & Flom LLP, Harry L. Gutman, KPMG LLP, and Nick Giordano, Ernst & Young LLP, on behalf of *INDOPCO* Coalition, to Mark Weinberger, Assistant Secretary (Tax Policy), Department of the Treasury, Charles Rossotti, Commissioner, Internal Revenue Service, and B. John Williams, Chief Counsel, Internal Revenue Service (Apr. 8, 2002), *reprinted in INDOPCO Submits Additional Comments on Proposed Capitalization Regs*, TAX NOTES TODAY (Apr. 25, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 80-38); accord Memorandum from Abraham N. M. Shashy, Jr., KPMG LLP, on behalf of Cellular Telecommunications & Internet Association, to Mark Weinberger, Assistant Secretary (Tax Policy), Department of the Treasury, Charles Rossotti, Commissioner, Internal Revenue Service, and B. John Williams, Chief Counsel, Internal Revenue Service (Mar. 20, 2002), *reprinted in CTIA Suggests Changes to Proposed Guidance on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Mar. 29, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 61-23).

⁴⁴³ The IRS and Treasury Department expect to propose a rule that requires a taxpayer to capitalize certain transaction costs that facilitate the taxpayer’s acquisition, creation, or enhancement of intangible assets or benefits [T]his rule would not require capitalization of . . . costs that do not exceed a specified dollar amount, such as \$5,000.

Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3464. Implicitly, outside transaction costs would have to be capitalized. Inside transaction costs would be excepted from capitalization because the above transaction costs “rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), [or] fixed overhead (e.g., rent, utilities and depreciation)” *Id.*

treatment resulting from this proposed rule, the AICPA recommends that the de minimis threshold dollar amount be increased to \$10,000, and that the threshold be applied on a transaction-by-transaction basis.”⁴⁴⁴ A number of commentators agreed on both points. For instance, America’s Community Bankers forthrightly argued that as a matter of tax parity, *outside* transaction costs should be deductible as well so that larger firms would not competitively injure smaller firms without inside counsel.⁴⁴⁵ This would nicely sidestep *INDOPCO* in many cases, but appears to lack a policy basis beyond a bootstrapping rule of tax parity.

⁴⁴⁴ AICPA Comment, *supra* note 442, ¶ 24.

⁴⁴⁵ We also believe that expenses for legal fees paid to an outside attorney, or outside law or consulting firm for routine legal or administrative work on a recurring basis should be deductible, not capitalized. For example, fees paid to attorneys who routinely conduct settlements for a bank or who perform other routine duties such as reviewing documents and other regular tasks should be deductible. Smaller community banks are less likely to have large legal or management staffs and may have to rely on outside sources for these services. They will be placed at a competitive disadvantage if they cannot deduct costs for routine services provided by outside firms while competitors who have larger in-house staff performing the same functions can take a deduction.

Letter from Charlotte M. Bahin, Director of Regulatory Affairs and Senior Regulatory Counsel, America’s Community Bankers, to the Internal Revenue Service ¶ 14 (Apr. 18, 2002), *reprinted in ACB Says Loan Origination Costs Should Be Deductible*, TAX NOTES TODAY (May 8, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 89-26); *cf.* Letter from Joseph Barry Schimmel, Cohen Chase Hoffman & Schimmel P.A., Miami, to the Internal Revenue Service ¶ 24 (Mar. 11, 2002), *reprinted in Attorney Suggests Changes to Proposed Regs on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Mar. 27, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 59-20).

[W]ith regard to the capitalization of legal fees paid to outside attorneys (or to other fees paid to outside consultants), the rule should state the purpose of differentiating between outside attorneys and consultants versus in-house attorneys and other employees. Such a rule does provide some administrative convenience, but at the cost of substantial potential unfairness. Larger organizations are more likely to be able to provide service “in-house,” and thus to avoid capitalization. Attorneys and other professionals kept “on retainer” may, for practical (non-tax) purposes be in-house counsel (and may be unable to allocate their fees between acquisitions and other transactions), yet their fees would be treated differently than that of “in-house” counsel.

Letter from Joseph Barry Schimmel, Cohen Chase Hoffman & Schimmel P.A., Miami, to the Internal Revenue Service ¶ 24 (Mar. 11, 2002), *reprinted in Attorney Suggests Changes to Proposed Regs on Rules on Capitalizing Cost of Intangibles, supra*.

2. Case Law and Customary Expenses

In response to the Commissioner's and the Tax Court's broad reliance on *INDOPCO* and future benefits in capitalizing everyday recurring costs in the taxpayer's business or costs incurred in connection with a nondepreciable intangible, a series of circuit court decisions have allowed a current deduction for such costs by either ignoring or taking an excessively narrow approach to the origin of the claim doctrine and to the creation of a separate asset where dealing with "customary" expenses. The Seventh Circuit in *A.E. Staley*,⁴⁴⁶ the Third Circuit in *PNC Bancorp*,⁴⁴⁷ and the Eighth Circuit in *Wells Fargo*⁴⁴⁸ each reversed the Service's and Tax Court's future benefit capitalization of expenditures customarily⁴⁴⁹ deducted by taxpayers and allowed them a current deduction. Unfortunately, *Wells Fargo* and *A.E. Staley* failed to consider explicitly (1) a burdens and benefits balancing test as to distortion of income arising from lack of depreciation;⁴⁵⁰ (2) the possible character distortion aspect of incurring a cost incident to a restructuring of the target corporation taxpayer which is treated as an ordinary deduction while the target taxpayer *realizes* income associated with, but not *recognized* in, the restructuring; or (3) administrative costs to the taxpayer and the government in enforcement of capitalization with conceptual vigor.

In short, the reasoning in all three circuit court opinions distorted or at least eroded the acquisition cost and origin of the claim doctrines and the rule of tax parity.⁴⁵¹ At the same time, all or part of the results reached in each could have been supported on some more functional test theory that would balance the burdens and benefits of capitalization.⁴⁵² Pursuing such a course would have been far better

⁴⁴⁶ *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), *rev'g* 105 T.C. 166 (1995).

⁴⁴⁷ *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998); *see supra* note 440.

⁴⁴⁸ *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *rev'g* *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

⁴⁴⁹ In *PNC Bancorp*, the transaction costs arose from the taxpayer's customary business activities; in *Wells Fargo*, from customary salary and insubstantial activities; and in *A.E. Staley*, from activities customary in industry.

⁴⁵⁰ The *Wells Fargo* court also did not consider application of such a balancing test taking into account both insubstantiality of costs and the difficulty of costs' allocation arising either in identifying them or identifying the particular asset to which they are to be allocated and the recovery period or lack thereof.

⁴⁵¹ *See supra* Part III.

⁴⁵² *See supra* Part VI.

than the definitional approaches actually taken by each appellate decision which have wreaked havoc with the traditional doctrines applicable to acquisition of tangible assets and have failed explicitly to follow a policy of minimal distortion of income.⁴⁵³ Ironically, that policy probably influenced in a nontransparent fashion the outcome of these appellate decisions.⁴⁵⁴ Hopefully, the proposed capitalization/expensing intangibles regulations will avoid the same mistake by (1) explicitly stating as the basis for their transactional cost rules a balancing of taxpayer and government burdens and benefits of the capitalization standard, and (2) fitting the various rules into such a balancing paradigm.

B. Facilitating the Acquisition of a Capital Asset

In *A.E. Staley*, the Seventh Circuit claimed that the Supreme Court in *INDOPCO* “was merely reaffirming settled law that costs incurred to facilitate a capital transaction are capital costs.”⁴⁵⁵ The

⁴⁵³ See *supra* Part IV.

⁴⁵⁴ [Professor] Lokken believes that the courts are paying more attention to the potential administrative burdens of capitalization than they are willing to admit. In his view, that explains the Eighth Circuit’s refusal to require capitalization of bank officer’s salaries allocable to the acquisition in *Wells Fargo*, a decision that Lokken called wrong.

... [In that case, t]he Eighth Circuit got hung up on the word “ordinary,” which is the initial inquiry that determines whether the expenditure is any kind of business cost for which the law permits recovery, not the touchstone of immediate deduction.

Lee A. Sheppard, *NYU/TA Tax Conference – Participants Consider INDOPCO, Alternative Minimum Tax*, 90 TAX NOTES 992, 993 (Feb. 19, 2001); see also Lokken, *supra* note 35, at 1363-65.

⁴⁵⁵ *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482, 488 (7th Cir. 1997). Field Service Advisory, 1993 WL 1470162 (1993), took much the same tack. “Since items are deductible under Lincoln Savings if certain conditions are met, we should not cite *INDOPCO* to support capitalization of an item which would have been deductible under these conditions before the case was handed down.” *Id.* (citation omitted); accord Rev. Rul. 94-12, 1994-1 C.B. 36; Rev. Rul. 94-77, 1994-2 C.B. 19; Rev. Rul. 96-62, 1996-2 C.B. 9; I.R.S. Notice 96-7, 1996-1 C.B. 359. See generally Lee A. Sheppard, *News Analysis – What Part of “Capitalize” Don’t You Understand?*, 88 TAX NOTES 1435 (Sept. 18, 2000). The Service’s former Associate Chief Counsel (Domestic), Stuart Brown, once candidly admitted, however, that the Service had not known prior to *INDOPCO* what that law was. *Brown Lists Factors that Could Be Used to See if Cleanup Costs Must Be Capitalized*, DAILY TAX REP., Mar. 10, 1993, at G-11. An excellent discussion from the Treasury Department’s viewpoint is presented in *Transcript of Conference on Tax Legislative Process, Day Two, supra* note 34, ¶¶ 498-506 (comments of Joseph Mikrut, Treasury) (“Our plan was to take

Seventh Circuit reversed the Tax Court's capitalization of the costs of unsuccessfully defending against a hostile takeover because the taxpayer's *purpose* for incurring such costs was defending its business rather than "facilitating a capital transaction."

In fact, *A.E. Staley* relied on precedents that generally did *not* use the term "facilitate a capital transaction."⁴⁵⁶ Instead, these precedents mostly used the broader term "in connection with" a capital transaction.⁴⁵⁷ Justice Blackmun in *INDOPCO* did, however, cite an article, which he read as concluding that "expenses incurred to facilitate transfer of business ownership do not satisfy the 'carrying on [a] trade or business' requirement of § 162(a)."⁴⁵⁸ That article

those issues off the table to do some safe harbors, to provide some rough justice, to try to develop new types of guidance that take issues away for an entire industry"). In fact, rejection of the separate asset test did affect a sea change in the understanding of capitalization, but the inquiry should have shifted to a balancing standard. Examination was not cautious and government litigators failed to argue for a balancing standard. See *id.* ¶¶ 522-23 (comments of Mark Mullett, with Verizon Communications); accord *id.* ¶ 526 (comments of Pamela Olson, Treasury) ("I find often in audit situation that the *INDOPCO* issue seems to come up because it's something that the agents understand."). The understandability factor may underlie an LMSB agent's vehement opposition to the Advance Notice. *IRS Agent Criticizes Proposed Guidance on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Mar. 29, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 61-22).

"Facilitate" might be more relevant to future benefit capitalization than to distortion of character capitalization. On the other hand, the ultimate basis for the origin of the claim test is avoidance of distortion of income (more character than timing). See *supra* notes 189-92 and accompanying text. Therefore, it probably should be subject to the same balancing of burdens and benefits.

⁴⁵⁶ *INDOPCO*'s reference in a footnote to an article using the facilitating terminology could be viewed as an exception to this statement. See *infra* note 458 and accompanying text.

⁴⁵⁷ [A]n expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred *in connection with* the acquisition of a capital asset. The function of these rules is to achieve an accurate measure of net income for the year by matching outlays with the revenues attributable to them and recognizing both during the same taxable year. When an outlay is *connected to the acquisition* of an asset with an extended life, it would understate current net income to deduct the outlay immediately. To the purchaser, such outlays are part of the cost of acquisition of the asset, and the asset will contribute to revenues over an extended period.

Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 (11th Cir. 1982) (footnote omitted) (emphasis added), *cert. denied*, 463 U.S. 1207 (1983); see also *Fishing Tackle Prods. Co. v. Commissioner*, 27 T.C. 638, 645 (1957) (expenses incurred by taxpayer "in connection with increasing its capitalization" constituted capital expenditures).

⁴⁵⁸ *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 90 n.8 (1992) (citing Brian R. Greenstein, *The Deductibility of Takeover Costs After National Starch*, 69 TAXES 48,

contrasted defense of a business with facilitation of a takeover,⁴⁵⁹ as did *A.E. Staley*. Justice Blackmun, however, surely cited the article for the point that costs of facilitating a transfer of ownership are not related to *carrying on a trade or business* in order to dismiss the government's argument that capitalization of transaction costs of a target's acquisition was necessary to prevent character and timing distortions of income.⁴⁶⁰

In reality, once a target corporation is "put in play," it generally is acquired by one corporation or another.⁴⁶¹ Thus, the purpose of

49 (1991)).

⁴⁵⁹ See Greenstein, *supra* note 458.

⁴⁶⁰ Assistant Solicitor General Kent Jones in arguing *INDOPCO* relied upon *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872 (2d Cir. 1936), for the proposition that

the Second Circuit emphasized that reorganization expenses don't provide any current benefit to the corporation. They do not assist in the production of current income, they do not – they are not incurred in the ordinary course of producing income, certainly none of the expenses incurred by Indopco have anything to do with generating income for the corporation in 1978, the year they were incurred.

United States Supreme Court Official Transcript, *INDOPCO, Inc. v. Commissioner*, No. 90-1278, 1991 WL 636242, at *33-34 (Nov. 12, 1991) (oral argument by Kent L. Jones on behalf of the respondent). Other authorities and commentators more clearly articulate a distortion of income basis for capitalization of expenses incurred in connection with a nonrecognition or other tax preferred transaction. See *Missouri Pacific Corp. v. United States*, 5 Cl. Ct. 296, 308-11 (1984); Lee & Murphy, *supra* note 3, at 521-26, 545; Alan Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COM. L. REV. 443, 492-95 (1974); Calvin H. Johnson, *Capitalization After the Government's Big Win in INDOPCO*, 63 TAX NOTES 1323 (1994); Paul J. Green, *Authors' Prepublication Expenses: The Second Circuit's Response to the Capitalization Versus Deduction Question: Hadley v. Commissioner*, 54 BROOK. L. REV. 673, 703 (1988); Lee et al., *Rough Justice II*, *supra* note 25, at 1521 & n.147.

⁴⁶¹ Because of the arbitrageur activity, the perception that a corporation is "in play" tends to become a self-fulfilling prophesy. Once arbitragers buy up the stock of a corporation, the willingness of the corporation shareholders to sell is established, and the management's ability to resist an acquisition is effectively reduced. The certain knowledge that the arbitragers own working control of the target company's stock in turn makes sure that the potential acquirer's bidding for the corporation stock will surely be successful.

Leveraged Buyouts and Corporate Debt: Hearings Before the Senate Comm. on Fin., 101st Cong., 1st Sess. 7 (1989) (statement of Nicholas Brady, Secretary, Department of the Treasury). The "rest of the story" is that junk bond issuers, viz., allegedly Michael Milken and Drexel Burnham Lambert, Inc., fed tips about the upcoming targets to arbitrageurs, viz., allegedly Ivan Boesky, etc. See *In re Ivan F. Boesky Sec.*

defending the target is inseparable from the board of directors' duty to obtain the best ultimate price for the target's shareholders in the auction for control.⁴⁶² Such efforts clearly result in a capital expenditure, if not a dividend to shareholders.⁴⁶³ More fundamentally erroneous is *A.E. Staley*'s looking at the taxpayer's purpose for the expenditure. This is revealed by the *A.E. Staley* court's statement that "[t]he purpose of the expenditures was not to facilitate a change in corporate structure, but to prevent such change."⁴⁶⁴ Contrary to this focus on taxpayer purpose, many progeny of *Woodward* flatly state that the taxpayer's intent or purpose for the transaction is not relevant,⁴⁶⁵ which is correct since *Woodward* specifically rejected a primary purpose test⁴⁶⁶ just as *Gilmore* had.⁴⁶⁷ Moreover, the pre-*INDOPCO* case law following *Idaho Power*⁴⁶⁸ capitalized indirect costs incurred in connection with acquisition of tangible assets.⁴⁶⁹

Notwithstanding all of this, the "facilitate the transaction" notion will surely prevail. For instance, the Tax Court in *Lychuk*, in providing the most recent detailed analysis of the origin of the claim doctrine, pointed out that the Supreme Court in *Woodward* "held that the central inquiry was whether the expenditure originated in 'the

Lit., 125 F.R.D. 402 (S.D.N.Y. 1989); *In Re The Drexel Burnham Lambert Group, Inc.*, 995 F.2d 1138 (2d Cir. 1993); Priv. Ltr. Rul. 96-01-025 (Jan. 17, 1995).

⁴⁶² See generally Mark J. Loewenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule*, 63 S. CAL. L. REV. 65, 68 (1989) (discussing changes in the law of tender offers toward the model that "once a bona fide offer is made for a corporation, its directors should react in a way that maximizes the return to shareholders, generally through an auction for the corporation's shares."); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989 (1993).

⁴⁶³ Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization are Dividends to the Shareholders: (Psst, Don't Tell the Supreme Court)*, 53 TAX NOTES 463 (Oct. 28, 1991). But see 1993 FSA LEXIS 191 (June 16, 1993) (Service should not raise whether expenses incurred by a publicly-held target corporation in being acquired are constructive distributions to the target shareholders).

⁴⁶⁴ *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482, 486 (7th Cir. 1997) (describing reasoning of dissenting judge below, with which the Seventh Circuit agreed).

⁴⁶⁵ See, e.g., *Newark Morning Ledger Co. v. United States*, 539 F.2d 929, 935 (3d Cir. 1976); *Keller St. Dev. Co. v. Commissioner*, 688 F.2d 675 (9th Cir. 1982); *Frederick Weisman Co. v. Commissioner*, 97 T.C. 563 (1991); *Am. Stores Co. v. Commissioner*, 114 T.C. 458 (2000).

⁴⁶⁶ *Woodward v. Commissioner*, 397 U.S. 572 (1970).

⁴⁶⁷ *United States v. Gilmore*, 372 U.S. 39 (1963).

⁴⁶⁸ *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

⁴⁶⁹ See *supra* notes 225-36 and accompanying text.

process of acquisition.”⁴⁷⁰ *Lychuk*’s “process of acquisition” is not necessarily limited to the *A.E. Staley* notion of facilitating the acquisition; rather, *Lychuk* focuses more on the distinction between direct and indirect costs.⁴⁷¹ Nevertheless, subsequent Tax Court decisions have followed *A.E. Staley*’s “facilitate” formulation explicitly.⁴⁷² The Advance Notice consistently uses the “facilitate” concept.⁴⁷³ It appears to be a bad idea whose time has come.

*C. Costs Incurred in Connection with Acquisition of Loans Do Not
“Create” Loans*

The Advance Notice requests comments about whether a “separate and distinct asset test” could “be used to identify other costs that should be capitalized under section 263(a) and the administrability of such principles.”⁴⁷⁴ Simply put, the rule requiring the capitalization of costs that “create or enhance a separate asset” is not administrable. For instance, the Third Circuit in *PNC Bancorp*, adopting a “technical argument not articulated before,”⁴⁷⁵ excluded from the term “create or enhance a separate and distinct asset,” the taxpayer bank’s *recurring* origination costs associated with, and related to, the creation of loans.⁴⁷⁶ The Third Circuit’s approach conflicts with rules as to the creation, acquisition, or enhancement of tangible assets and thus renders the separate asset test inadministrable.⁴⁷⁷ *PNC Bancorp*, reasoning that the loan origination

⁴⁷⁰ *Lychuk v. Commissioner*, 116 T.C. 374, 390 (2001) (quoting *Woodward*, 397 U.S. at 577).

⁴⁷¹ See discussion *infra* Part V.E.

⁴⁷² See, e.g., *Stark v. Commissioner*, 77 T.C.M. (CCH) 1181 (1999); *Am. Stores Co. v. Commissioner*, 114 T.C. 458, 470 (2000) (“[W]e must determine whether the costs incurred in defending the State of California’s antitrust litigation are better viewed as costs associated with defending a business or as costs associated with facilitating a capital transaction”) (citing *Woodward*, 397 U.S. 572).

⁴⁷³ The Advance Notice uses “facilitate” in Part B.7, Amounts Paid in Connection with Tangible Property Owned by Another, and especially in Part C, Transaction Costs. See Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3463-64 (Jan. 24, 2002).

⁴⁷⁴ *Id.* at 3464.

⁴⁷⁵ Barton Massey, *PNC Bancorp Heightens Need for Broad Capitalization Guidance*, 88 TAX NOTES 160 (July 10, 2000) (paraphrasing Henry Ruempler of Ernst & Young).

⁴⁷⁶ See *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822, 830 (3d Cir. 2000) (expenses were merely associated with originating the loans, they did not become part of the balance of the loan).

⁴⁷⁷ See *Perlmutter v. Commissioner*, 44 T.C. 382, 404 (1965), *aff’d*, 373 F.2d 45

costs were incurred in the day-to-day maintenance of the taxpayer bank's business, allowed a current deduction of those costs.⁴⁷⁸ This holding has been adopted in part in the Advance Notice.⁴⁷⁹

The Tax Court below held that a corporation that acquired the interests of two banks must capitalize loan origination costs which the banks incurred when making loans, because the loans had lives extending beyond the year in which the expenditures were incurred.⁴⁸⁰

(10th Cir. 1967) (salaries of officers capitalized to basis of building constructed by corporate taxpayer).

⁴⁷⁸ *PNC Bancorp*, 212 F.3d at 828. Some of these costs, such as recording a security interest, traditionally would have been viewed as acquisition costs and capitalized. Hopefully, the proposed regulations will change this result. *See infra* notes 479-80.

⁴⁷⁹ The IRS and Treasury Department expect to propose a rule that requires a taxpayer to capitalize certain transaction costs that facilitate the taxpayer's acquisition, creation, or enhancement of intangible assets or benefits described above In addition, this rule would require a taxpayer to capitalize transaction costs that facilitate the taxpayer's acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. However, *this rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction)*, fixed overhead (e.g., rent, utilities and depreciation), or costs that do not exceed a specified dollar amount, such as \$5,000. The IRS and Treasury Department request comments on how expenditures should be aggregated for purposes of applying the de minimis exception, whether the de minimis exception should allow a deduction for the threshold amount where the aggregate transaction costs exceed the threshold amount, and whether there are certain expenditures for which the de minimis exception should not apply (e.g., commissions).

. . . .

Conversely, a taxpayer that originates a loan to a borrower in the course of its lending business would not be required to capitalize amounts paid to secure a credit history and property appraisal to facilitate the loan where the total amount paid with respect to that loan does not exceed the threshold dollar amount. The taxpayer also would not be required to capitalize the amount of salaries paid to employees or overhead costs of the taxpayer's loan origination department.

Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. at 3464 (emphasis added).

⁴⁸⁰ *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349, 364 (1998), *rev'd*, 212 F.3d 822 (3d Cir. 2000). Unlike *Lychuk*, there was no evidence as to the specific lives of the loans. *Id.* at 364 n.14. The costs went far beyond the inside salaries and overhead which together with de minimis outside costs are all that the Advance Notice indicated can be currently deducted.

The Tax Court rejected PNC's arguments that the loan origination costs were currently deductible because they were (1) recurring, (2) an integral part of daily banking operations, and (3) provide only short-term benefits,⁴⁸¹ holding that a current deduction is allowable only if the expenditures do not create a separate property interest.⁴⁸² Actually, they appeared to be more like a purchased intangible, which in a tax year beginning after 1993⁴⁸³ would have been amortizable over fifteen years by the purchaser, even though previously deducted by the seller, and probably not subject to recapture⁴⁸⁴ (although it should be).⁴⁸⁵ As to whether the costs were an integral part of the banks' business, the Tax Court was satisfied that the costs the banks deferred for purposes of SFAS 91 were "only those directly related to the creation of the loans. They do not include costs associated with loans

The costs at issue include amounts paid to record security interests and amounts paid to third parties for property reports, credit reports, and appraisals. In the case of FNBP, the costs at issue also include an allocable portion of the salaries and fringe benefits paid to employees for evaluating the borrower's financial condition, evaluating guaranties, collateral and other security arrangements, negotiating loan terms, preparing and processing loan documents, and closing the loan transaction.

Id. at 364.

⁴⁸¹ *Id.* at 364-65. The Tax Court admitted that

[w]hile the specific information available when a loan is made may become outdated in a relatively short period of time, the quality of the decision to make a loan (and thereby acquire an asset) is predicated on such information. The soundness of the decision to make a loan is assimilated into the quality and value of the loan. Thus, the direct costs of the decision-making process should be assimilated into the asset that was acquired.

Id. at 370. Under a minimum distortion of income analysis the credit information costs should have been treated as a separate asset and thus so short lived as to be currently deductible. See *supra* note 404 and accompanying text. Additionally, the record did not contain a breakdown of recording costs, which conceptually should be added to the cost of the individual loans, and credit costs, which suggests a difficulty in allocation. *PNC Bancorp*, 110 T.C. at 369 n.21. Such cost allocation was not done with respect to each loan, anyway. See *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822, 832-33 n.16 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998).

⁴⁸² *PNC Bancorp*, 110 T.C. at 364-65.

⁴⁸³ The effective date of section 197 is August 10, 1993. Omnibus Revenue Reconciliation Act of 1993, Pub. L. 103-66, § 13,261(g), 107 Stat. 312, 540.

⁴⁸⁴ The tax benefit rule does not apply to intangibles created and expensed by the taxpayer. Rev. Rul. 85-186, 1985-2 C.B. 84.

⁴⁸⁵ Compare section 198(e) with Justice O'Connor's reference in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 386 n.20 (1983), to statutory recapture as a codified tax benefit rule.

that were not completed, nor do they include costs incurred after the closing of a loan.”⁴⁸⁶

The Third Circuit, reversing the Tax Court, believed “that the Tax Court took too broad a reading of what *Lincoln Savings* meant by ‘separate and distinct assets,’ as well as an overbroad reading of what can be said to ‘create’ such assets.”⁴⁸⁷ The taxpayer argued that

[w]hile purporting to apply the *Lincoln Savings* language, both the Tax Court and the government effectively have transformed that language, by subtle but significant degrees, from a test based on whether a cost “creates” a separate and distinct asset, into a much more sweeping test that would mandate capitalization of costs incurred “in connection with” or “with respect to” the acquisition of an asset.⁴⁸⁸

⁴⁸⁶ *PNC Bancorp*, 110 T.C. at 369.

The costs at issue are directly connected to the creation of loans, which constitute separate and distinct assets that are the banks’ primary source of income. Revenues, in the form of interest payments, are received over the life of the individual loans. In order to accurately measure the banks’ net income, the direct costs of originating the loans must be capitalized and amortized over the life of the loans.

Id. at 372.

⁴⁸⁷ *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822, 830 (3d Cir. 2000), *rev’g* 110 T.C. 349 (1998).

On the “separate and distinct” issue, the Third Circuit elaborated that unlike *PNC Bancorp*, in *Commissioner v. Lincoln Savings & Loan Ass’n*, 403 U.S. 345 (1971), “the Secondary Reserve fund was an asset that existed quite apart from Lincoln’s main daily business[,] . . . [was] separate from FLSIC’s other revenues, and was distinctly earmarked as Lincoln’s property.” *PNC Bancorp*, 212 F.3d at 830.

As for the “create” issue,

the Tax Court proceeded from the clearly accurate premise that the expenses in question were associated with the loans, incurred in connection with the acquisition of the loans or “directly related to the creation of the loans” to the faulty conclusion that these expenses themselves created the loans. We conclude that the term “create” does not stretch this far. In *Lincoln Savings*, it was the payments *themselves* that formed the corpus of the Secondary Reserve; therefore, it naturally follows that these payments “created” the reserve fund. In PNC’s case, however, the expenses are merely costs associated with the origination of the loans; the expenses themselves do not become part of the balance of the loan.

Id. (citations omitted) (emphasis in original).

⁴⁸⁸ Appellant’s Reply Brief at 4, *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (No. 95-16002) (quoted in *PNC Bancorp*, 212 F.3d at 830).

The Third Circuit “decline[d] to follow the Tax Court’s broad interpretation, for to do so would be to expand the type of costs that must be capitalized so as to drastically limit what might be considered as ‘ordinary and necessary’ expenses.”⁴⁸⁹

The Third Circuit overlooked, however, the “in connection with” approach of *Woodward*,⁴⁹⁰ *Hilton*,⁴⁹¹ and their progeny as well as the rule of parity and clear reflection of income approach of *Idaho Power*.⁴⁹² It relied upon cases addressing the expansion of bank credit cards as supporting its “finding that *Lincoln Savings* does not compel a conclusion that FNPC’s and UFB’s costs should be capitalized.”⁴⁹³ In fact, each of these bank credit card cases used a no separate asset analysis and was heavily relied upon by *NCNB II* in its adoption of the no separate asset test.⁴⁹⁴ The Supreme Court in *INDOPCO* specifically rejected both this test and *NCNB II*,⁴⁹⁵ which it saw as conflicting with *National Starch*.⁴⁹⁶ Indeed, the Court granted certiorari to resolve just this conflict.⁴⁹⁷ Nevertheless, most of the

⁴⁸⁹ *PNC Bancorp*, 212 F.3d at 830.

⁴⁹⁰ *Woodward v. Commissioner*, 397 U.S. 572, 574 (1970).

⁴⁹¹ *United States v. Hilton Hotels Corp.*, 397 U.S. 580, 582-84 (1970).

⁴⁹² *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 15 & n.10 (1974).

⁴⁹³ *PNC Bancorp*, 212 F.3d at 830.

The Eighth Circuit Court of Appeals in *Iowa Des Moines*, anticipating the “future benefit” concerns later stated in *INDOPCO*, emphasized the “short useful life” of credit information as a reason for deductibility. *Iowa Des Moines*, 592 F.2d at 436. The Iowa court stated that the prospective future benefit that could accrue beyond the taxable year as a result of credit screening was “very slight,” and thus capitalization was “not easily supported.” *Id.* In *National Starch*, the decision that the Supreme Court affirmed in *INDOPCO*, we found that these credit card cases contained the seed of the “future benefit” analysis, citing these cases as evidence that several Courts of Appeals “look[ed] to whether an ensuing benefit was created to determine whether the expense was ordinary and necessary,” *National Starch*, 918 F.2d at 431, and that these courts found that future benefit was not substantial in situations similar to the case at bar. *See id.* (citing *Iowa Des Moines* and *Colorado Springs*). We conclude that the credit card cases not only continue to have vitality after *INDOPCO*, but in fact anticipated some of the concerns addressed by *INDOPCO*.

PNC Bancorp, 212 F.3d at 833-34.

⁴⁹⁴ *See NCNB II*, 684 F.2d 285, 290-91, 293-94 (4th Cir. 1982), *overruled by* *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

⁴⁹⁵ *See INDOPCO*, 503 U.S. at 83 & n.3, 86-87.

⁴⁹⁶ *Id.* at 83 & n.3, 86-87 (discussing taxpayer as overreading *Commissioner v. Lincoln Savings & Loan Ass’n*, 403 U.S. 345 (1971)).

⁴⁹⁷ *Id.* at 83 & n.3.

bank credit card cases, along with the circuit court cases decided after *INDOPCO*, could have been justified on the basis of rough justice exceptions under a balancing of burdens and benefits of capitalization.⁴⁹⁸ *PNC Bancorp* was on somewhat more sound ground in concluding that “the Tax Court erred in its interpretation of the ‘future benefit’ analysis by relying on the fact that the loan *itself* was usually of several years’ duration and by reasoning that the loan origination costs were, thus, essentially directed at future benefit.”⁴⁹⁹ I have long argued that where the benefits of an expenditure are shorter than the life of the asset in connection with which it is incurred, the expenditure should be treated as a freestanding amortizable asset.⁵⁰⁰ The Third Circuit, however, concluded that no distortion of income arose “because of the regularity of these expenses.”⁵⁰¹

The fact that the costs were incurred in the day-to-day operation of the bank’s business was the driving force behind the Third Circuit’s decision in *PNC Bancorp*.⁵⁰² The court relied upon *Welch v.*

⁴⁹⁸ See, e.g., *Colorado Springs Nat’l Bank v. United States*, 505 F.2d 1185, 1192 (10th Cir. 1974) (no depreciation); *Iowa-Des Moines Nat’l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) (short term, recurring, and difficulty of allocation); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973) (regularly recurring).

⁴⁹⁹ *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822, 834 (3d Cir. 2000) (emphasis in original).

[W]e must remember that the “future benefit” analysis adopted in *INDOPCO* is not meant as a talismanic, bright-line test. See *A.E. Staley Manufacturing Co. v. Commissioner*, 119 F.3d 482, 489 (7th Cir. 1997) (“[T]he Court did not purport to be creating a talismanic test that an expenditure must be capitalized if it creates some future benefit.”). Rather, the *INDOPCO* analysis demonstrates the contextual, case-by-case approach to determining whether an expenditure better fits under the “ordinary and necessary” language of section 162(a) or the “permanent improvements or betterments” language of § 263(a). We conclude that the loan origination expenses incurred by UFB and FNPC have the characteristics of the former, rather than the latter, statutory language.

Id.

⁵⁰⁰ Lee, *Start-Up Costs*, *supra* note 10, at 27-28.

⁵⁰¹ *PNC Bancorp*, 212 F.3d at 835.

⁵⁰² *Id.* at 828.

[T]he loan marketing activities at issue here lie at the very core of the banks’ recurring, routine day-to-day business. The Commissioner has not been able to articulate a principled reason why these normal costs of doing business must be capitalized, while other ordinary banking costs need not

*Helvering*⁵⁰³ and *Deputy v. du Pont*⁵⁰⁴ for “ordinary” as customary.⁵⁰⁵ Some published rulings do hint at an ordinary course of business justification for current deduction of expenditures with future benefit.⁵⁰⁶ Such an exception might seem to flow from the Supreme Court’s classic, but perhaps dated, definition in *Welch* and *du Pont* of “ordinary” as “normal, usual, or customary” in a taxpayer’s trade or business. Justice Stewart, in *Commissioner v. Tellier*⁵⁰⁷ stated much later, however, that “the principal function of the term ‘ordinary’ in section 162(a) 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.”⁵⁰⁸ Judge Ruwe of the Tax Court combined both the *Tellier* and the *du Pont* definitions in *PNC Bancorp.*⁵⁰⁹ To some extent, *PNC Bancorp* as well as *Wells Fargo* reflect Judge Posner’s insight in *Encyclopaedia Britannica* that the [appellate] “courts naturally shy away from” capitalizing every expenditure yielding future benefits, because that would require capitalization of virtually all business expenses.⁵¹⁰ In the words of Judge Posner, “[i]t would require capitalizing every salesman’s salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. The administrative costs of conceptual rigor are too great.”⁵¹¹

PNC Bancorp provides a particularly transparent instance of

be. Instead, the Commissioner relies on the line drawn by SFAS 91, a standard whose rationale we conclude is far removed from the concerns of the tax system We remain unconvinced that the line drawn by the FASB in SFAS 91 has any relevance here for tax purposes.

Id. at 834.

⁵⁰³ 290 U.S. 111, 113-15 (1933).

⁵⁰⁴ 308 U.S. 488, 495-96 (1940).

⁵⁰⁵ *PNC Bancorp*, 212 F.3d at 828.

⁵⁰⁶ See Rev. Rul. 73-463, 1973-2 C.B. 34; Rev. Rul. 96-62, 1996-2 C.B. 9.

⁵⁰⁷ *Commissioner v. Tellier*, 383 U.S. 687 (1966).

⁵⁰⁸ *Id.* at 689-90.

⁵⁰⁹ See *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349, 362-63 (1998); see also Cheryl A. Cunagin, Note, *The Double Standard Under Section 162: Why the Employee Business Deduction Is No Longer for Employees*, 82 KY. L.J. 771, 775-76 (1994) (discussing the lack of a clear standard of what is “ordinary” and what is “necessary” in various cases).

⁵¹⁰ *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982).

⁵¹¹ *Id.* Although not cited in *Encyclopaedia Britannica*, preceding it Professor Boris Bittker had used virtually the same reasoning and example. See *infra* note 584.

shying away from capitalizing virtually all business expenses. In this case, the Third Circuit focused on the loan origination costs such as appraisals and credit checks as being incurred in the “normal method of doing business.”⁵¹² Of course, in the case of tangibles, the direct and indirect costs of creating and acquiring assets must be capitalized, even if this is the taxpayer’s normal method of doing business.⁵¹³ The Third Circuit, in questioning the rationale for the Commissioner’s insistence upon capitalization of these costs,⁵¹⁴ parallels the anti-stealth tax movement in Congress. This movement opposes administrative changes that raise the effective tax rate of a market segment of taxpayers⁵¹⁵ that Congress cannot then reverse without

⁵¹² We cannot conclude that in performing credit checks, appraisals, and other tasks intended to assess the profitability of a loan, the banks “stepped out of [their] normal method of doing business” so as to render the expenditures at issue capital in nature. *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982). As we stated in *National Starch*, an important determination is whether given expenditures “relate to the corporation’s operations and betterment into the indefinite future,” indicating the need for capitalization, or are instead geared toward “income production or other current needs,” suggesting deductibility. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 433 (3d Cir.1990), *aff’d*, *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 112 S.Ct. 1039, 117 L.Ed.2d 226 (1992). The facts before us demonstrate that loan operations are the primary method of income production for the subject banks. We have no doubt that the expenses incurred in loan origination were normal and routine “in the particular business” of banking. See *Deputy v. du Pont*, 308 U.S. at 496, 60 S.Ct. 363.

PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822, 829 (3d Cir. 2000) (alteration in original). PNC overlooked that the loan operations generated loans yielding income over a number of years. A taxpayer’s direct costs in acquiring or creating tangible assets must be capitalized under *Idaho Power* or section 263A even if such acquisition/construction is normal and routine and the everyday source of its income. Thus, another rationale must be found if the PNC loan origination costs are to be currently deductible.

⁵¹³ *Lychuk v. Commissioner*, 116 T.C. 374, 389-92 (2001), sets forth the precedents quite nicely. See *supra* notes 227-29, 235-36 and accompanying text for a discussion of full absorption accounting.

⁵¹⁴ *PNC Bancorp*, 212 F.3d at 824. The court’s partial answer to this question was that *INDOPCO* “may well have been viewed by the IRS as a green light to seek capitalization of costs that had previously been considered deductible in a number of businesses and industries.” *Id.*

⁵¹⁵ See, e.g., Stealth Tax Prevention Act, S. 276, 107th Cong. (2001) (referred to the Senate Committee on Governmental Affairs as of Feb. 7, 2001).

Congress passes a law. We want to tax at a certain level and a certain group of people. A lot of times those laws have been in place for a long period of

meeting the “pay-as-you-go” budget rules.⁵¹⁶ The Tax Court in effect rejected the taxpayer’s argument in *PNC Bancorp.* Specifically, the taxpayer unsuccessfully argued that it should be permitted to take current deductions for its loan origination costs in view of (1) Congress’s legislation concerning the income taxation of banks and capitalization without addressing the deductibility of loan origination costs, and (2) a long-standing industry practice of currently deducting such costs.⁵¹⁷

In the end, the Third Circuit’s opinion in *PNC Bancorp* rested on the costs being incurred in the banks’ normal method of doing business.⁵¹⁸ Its result cannot be justified, however, on traditional acquisition cost or origin of the claim doctrines. While the current deduction of *internal* costs might be justified on the grounds of

time. Congressional intent was followed for a long period of time. And then there is somebody sitting in some bureaucracy – in this case, the Treasury Department – that says, oh, no, that is not what Congress intended; this is what they intended. Then he changes it. We don’t have a process for reviewing that. This legislation will give a process for that review. But we will not find ourselves in a position of having to correct something that is contrary to congressional intent, but also with the idiotic situation that we somehow have to come up with revenue to offset a change of policy that we never intended in the first place.

144 CONG. REC. S4419 (1998) (remarks of Senate Finance Chairman, Sen. Charles E. Grassley, R-Ia.); accord 147 CONG. REC. S1132 (daily ed. Feb. 7, 2001) (statement of Sen. Burns); see also *Transcript of Conference on Tax Legislative Process, Day Two*, *supra* note 34, ¶¶ 515-16 (Ken Gideon stated that capitalizing under *INDOPCO* traditionally deducted expenses raises taxes “just as surely as if you had passed an explicit tax increase,” generating a bad reaction).

⁵¹⁶ See Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 503-04 & n.6 (1998) (“the ‘pay-as-you-go’ provision (“PAYGO”) enacted in the Budget Enforcement Act of 1990 . . . requires advocates for new tax expenditures to pay for them in one of three ways: raising taxes, reducing current tax subsidies, or reducing spending for existing entitlement programs.”) (footnote omitted) (citing the Budget Enforcement Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-573 (codified as amended at 2 U.S.C. § 902 (1994))). This forces Congress to pay for remedial reforms of inadministrable rules obtained by judicial victories even if taxpayers generally have been reporting differently than those new rules so that there would be no revenue loss in the real world or further erosion of the actual tax base as contrasted with the theoretical tax base. See Goldberg, *supra* note 414, at 183, 186; accord 144 CONG. REC. S4419 (1998) (remarks of Senate Finance Chairman, Sen. Charles E. Grassley, R-Ia.).

⁵¹⁷ *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349, 374-75 (1998), *rev’d*, 212 F.3d 822 (3d Cir. 2000).

⁵¹⁸ *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822, 829 (3d Cir. 2000), *rev’g* 110 T.C. 349 (1998).

difficulty of allocation or administrability, the *outside* costs cannot be so justified.⁵¹⁹ The Third Circuit's strained definition of "create" would seemingly apply to the creation of tangible and intangible assets, thereby permitting a purchaser of rental real estate to deduct currently the recording costs of the acquisition. This should not be the case since such costs clearly constitute acquisition costs.⁵²⁰

The appellate courts shy away from capitalization even more, albeit less transparently, where depreciation is not available at all, as in *A.E. Staley*⁵²¹ and *Wells Fargo*.⁵²² The ideal answer to taxation of transaction costs would be amortization over a fixed period, say sixty months.⁵²³ Nevertheless, Congress's opposition to depreciation of transaction costs of tax-free reorganizations manifested in section 197⁵²⁴ should be noted.⁵²⁵ Such a practical rough justice solution would

⁵¹⁹ See discussion *infra* Part VI.E.

⁵²⁰ Cf. *Oriole Homes Corp. v. United States*, 705 F. Supp. 1531 (S.D. Fla. 1989) (impact fees required for the approval and recordation of plats for subdivisions constitute capital expenditures); *Von-Lusk v. Commissioner*, 104 T.C. 207 (1995) (costs of obtaining permits, zoning variances and negotiating permit fees constitute indirect costs that a taxpayer can capitalize under section 263A).

⁵²¹ See *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), *rev'g and remanding* 105 T.C. 166 (1995).

⁵²² See *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *rev'g* *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

⁵²³ Cf. I.R.C. § 248 (providing for sixty-month amortization of costs of organizing a corporation, which would otherwise be conceptually nondeductible since property is received tax-free by a corporation upon its incorporation. See *Lee & Murphy, supra* note 3, at 524).

⁵²⁴ See I.R.C. § 197(e)(8).

⁵²⁵ The transparent origin of this provision was a desire to backstop *INDOPCO*. See STAFF OF HOUSE COMM. ON WAYS & MEANS, 103D CONG., 1ST SESS., FISCAL YEAR 1994 BUDGET RECONCILIATION RECOMMENDATIONS OF THE COMMITTEE ON WAYS AND MEANS 332-33 (Comm. Print 1993) [hereinafter *WAYS & MEANS REPORT*]; Technical Memorandum from Calvin H. Johnson, Professor of Law, University of Texas, to Fred J. Goldberg, Jr., Assistant Secretary for Tax Policy, Department of Treasury (July 8, 1992), *reprinted in Texas Law Professor Suggests Modifications to Amortization Proposal*, TAX NOTES TODAY (July 23, 1992) (LEXIS, FEDTAX lib., TNT file, elec. cit., 92 TNT 150-72). A nontransparent reason, however, may have been covert opposition to mergers in general. See *Staff Recommendations to Revise Subchapter C: Hearing before the Subcomm. on Taxation and Debt Mgmt., Senate Comm. on Fin.*, 99th Cong., 1st Sess. 121-22 (1986) (colloquy between Sen. Danforth, R-Mo., and Assistant Secretary Ron Pearlman). On the other hand, Congress expressly stated that "no inference is intended regarding the proper treatment of professional fees or transactions costs in other circumstances under present law." *WAYS & MEANS REPORT, supra*, at 333.

probably be too late at this point.⁵²⁶ The appellate courts predictably⁵²⁷ have rejected capitalization in favor of a current deduction where no depreciation is available, as in *A.E. Staley and Wells Fargo*. It is thus an easy, but false, step to reach the same result where depreciation is available as in *PNC Bancorp.*⁵²⁸

D. Customary Executive Salaries

In *Wells Fargo*, the Eighth Circuit held that officers' salaries of an acquired subsidiary paid during the year of acquisition, as well as legal and investigatory expenses incurred before the acquisition, are deductible. The Eighth Circuit reasoned that the Tax Court below had mistakenly interpreted *INDOPCO*.⁵²⁹ Therefore, in *Wells Fargo*, the Eighth Circuit concluded that the officers' salaries were "incidental,"⁵³⁰ to the future benefit and were common or frequently

⁵²⁶ See *supra* notes 515-25 and accompanying text.

⁵²⁷ See *Lee, Capitalization Rules*, *supra* note 13, at 677 n.72 ("unjust rules, capitalization without adequate amortization, will cause some (but not all) courts to seek other solutions promoting uncertainty"). Further, *Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987), "is another example of judicial overreaction to the Service's income distorting adjustment [requiring depreciation over thirty years of costs that would be repeated in three years]." *Id.* at 677.

⁵²⁸ The same progression occurred where precedents permitting current deduction of recurring short-term benefit costs for which no deduction was permitted under the start-up cost doctrine was improperly extended to long-lived costs. See *First Sec. Bank of Idaho, N.A. v. Commissioner*, 592 F.2d 1050, 1053 (9th Cir. 1979) (Duniway, J., concurring in part and dissenting in part) (recurring costs of advertising, etc., are properly deductible, but the cost of a computer program used for five years and costing a substantial amount should be capitalized and amortized over that period rather than currently deducted under the majority's separate, saleable asset test); *NCNB II*, 684 F.2d 285 (4th Cir. 1982) (permitting current deduction of an expenditure for a branch banking permit with indefinite life); *Lee, Start-Up Costs*, *supra* note 10, at 25.

⁵²⁹ *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *rev'g in part* *Norwest Corp. v. Commissioner*, 112 T.C. 89, 100 (1999).

⁵³⁰ The Tax Court below had held that the costs were "incurred . . . before and incidentally with its acquisition." *Norwest Corp. v. Commissioner*, 112 T.C. 89, 100 (1999). The Tax Court surely meant at the same time or in connection with. A common formulation of the origin of the claim doctrine speaks of costs "incident" to a capital transaction. See, e.g., *Estate of Baier v. Commissioner*, 533 F.2d 117, 120 (3d Cir. 1976) ("We are satisfied that the 'origin of the claim test' applies to expenses incident to the disposition of property, as well as to the acquisition of property."); *Brown v. United States*, 75-1 U.S.T.C. ¶ 9123 (E.D. Mich. 1974) (fees incurred incident to the sale of stock are capitalized under the origin of the claim doctrine), *rev'd*, 526 F.2d 135 (6th Cir. 1975); *Brown v. United States*, 312 F. Supp. 286, 288 (E.D. Mich. 1970) ("origin and character of the claims, incident to which legal

occurring expenses. Noting that the transaction costs in *INDOPCO* were *directly* related to the acquisition of the taxpayer in a friendly takeover, the *Wells Fargo* court held that the salaries before it were at best *indirectly* related to the acquisition and hence were deductible.⁵³¹ In so holding, it misread the origin of the claim doctrine, or at least the acquisition cost doctrine of *Idaho Power*,⁵³² as applying only to costs directly related to an acquisition. The *Wells Fargo* court also misread a series of Technical Advice Memoranda and a Private Letter Ruling⁵³³ involving severance payments,⁵³⁴ bonus payments to equal taxes triggered on stock options triggered by going private,⁵³⁵ and payments upon cancellation of stock options and stock appreciation rights paid incident to a reorganization,⁵³⁶ as holding “that payments made by an employer are deductible when they are made to employees, are compensatory in nature, and directly related to the employment relationship (and only indirectly related to the capital transaction, which provides the long term benefit).”⁵³⁷ The Eighth Circuit does not mention that most of these authorities carefully noted that the disputed compensation was not for services incident to the reorganization itself and was for past services.⁵³⁸ The issue in all of these authorities was whether the “origin-of-the-claim” was (a) the triggering reorganization, or (b) the pre-transaction compensatory

expenses were incurred”); Rev. Rul. 67-125, 1967-1 C.B. 31 (“legal fees incurred for services performed in drafting a corporate merger agreement are to be capitalized as incident to the reorganization since the effect of a merger is to change the capital structure of the surviving corporation.”). On appeal, the Eighth Circuit court twisted this unfortunate choice of words into *INDOPCO*’s “incidental future benefit,” *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 87 (1992), which does not have to be capitalized. “Thus, the Court did not create a new test requiring capitalization whenever an expenditure is incidentally connected with some future benefit.” *Wells Fargo*, 224 F.3d at 885 (footnote omitted).

⁵³¹ *Wells Fargo*, 224 F.3d at 886.

⁵³² *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

⁵³³ See *Wells Fargo*, 224 F.3d at 886.

⁵³⁴ Priv. Ltr. Rul. 93-26-001 (Mar. 18, 1993) (severance pay was not intended as compensation for services rendered to effectuate merger); Tech. Adv. Mem 97-21-002 (Jan. 24, 1997); Tech. Adv. Mem 97-31-001 (Jan. 31, 1997) (based on years of service with target; none of service payments made for service attributable to the merger).

⁵³⁵ Tech. Adv. Mem. 95-27-005 (Mar. 15, 1995) (compensation for past services).

⁵³⁶ Tech. Adv. Mem. 95-40-003 (June 30, 1995) (options constituted compensatory obligations from prior years).

⁵³⁷ *Wells Fargo*, 224 F.3d at 887.

⁵³⁸ I am assuming that the court read carefully the cited authorities. Possibly, the briefs slanted discussion of these authorities and the court did not go beyond the briefs.

obligation. Moreover, the Eighth Circuit overlooked that each of these authorities cited Revenue Ruling 73-580,⁵³⁹ which held that the portion of compensation paid by a corporation to its employees attributable to services performed in connection with corporate acquisitions must be capitalized. An early Field Service Advice (FSA), however, spoke of “salaries of the executives involved in the leveraged buyout were deducted [by the taxpayer] because these were either fixed or computed using a fixed formula regardless of the nature of their work.”⁵⁴⁰ The FSA, however, applied the origin of the claim test to capitalize expenses incident to the corporate restructuring.⁵⁴¹

The Advance Notice follows *Wells Fargo* with respect to regular compensation of employees who are performing services in connection with a capital transaction, but distinguishes regular compensation, as *Wells Fargo* did, from commissions or bonuses paid to such employees in connection with a capital transaction.⁵⁴² While the landmark decision in *Acer Realty Co. v. Commissioner*⁵⁴³ involved special compensation to corporate officers that was tied to a specific construction project that they oversaw, this was not the case in *Perlmutter*,⁵⁴⁴ a Tax Court decision that the Supreme Court relied upon in *Idaho Power*.⁵⁴⁵ The Tax Court in *Perlmutter* required capitalization of the portion of the top executives’ salaries of a real estate leasing corporation allocable to the three to five hours a week one top executive spent, and the five to seven hours a week the other spent, overseeing construction of a building for use in their rental

⁵³⁹ 1973-2 C.B. 86.

⁵⁴⁰ 1993 FSA LEXIS 7, *54 (Sept. 20, 1993); accord 1997 FSA LEXIS 119, *5 (Dec. 15, 1997) (citing Revenue Ruling 73-580, 1973-2 C.B. 86).

You should also inquire into whether the options might have been paid for services rendered or to be rendered by the officers in connection with the acquisition, rather than in connection with the ordinary course of the taxpayer’s business. If this were to be the case, the expenses should be capitalized.

Id.

⁵⁴¹ See 1993 FSA LEXIS 7 (Sept. 20, 1993).

⁵⁴² See Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3464 (Jan. 24, 2002); cf. *Wells Fargo*, 224 F.3d 874, rev’g in part *Norwest Corp. v. Commissioner*, 112 T.C. 89, 100 (1999).

⁵⁴³ 132 F.2d 512 (8th Cir. 1942).

⁵⁴⁴ See *Perlmutter v. Commissioner*, 44 T.C. 382, 404 (1965), aff’d, 373 F.2d 45 (10th Cir. 1967).

⁵⁴⁵ See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974); *supra* note 225 and accompanying text.

business.⁵⁴⁶

The *Wells Fargo* approach does have support in some pre-*INDOPCO* decisions that adopted rough justice balancing approach reasoning. For instance, *Southland Royalty*, a pre-*INDOPCO* decision, took an approach analogous to *Wells Fargo*'s "customary" tack.⁵⁴⁷ In that case, the then Court of Claims (now the Court of Federal Claims), noting that the reserve survey was not used to determine whether oil drilling was feasible prior to acquiring the mineral interest,⁵⁴⁸ allowed the deductions because they were "functionally part of, and indistinguishable from, expenditures for ordinary management planning."⁵⁴⁹ 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. At the same time, the decision turned on the fact that the lives of the surveys were short and indeterminable with the result that amortization was not available.⁵⁵⁰ Similarly, the Eighth Circuit in *Iowa-Des Moines* reasoned that "had taxpayers directly acquired credit information, capitalization of the expense, including employee wages, would not have been required. Credit screening is a necessary and ordinary part of the banking business; it is not a capital expenditure."⁵⁵¹ The Eighth Circuit further noted that "[a]lthough the Government contends that the law is not certain that such expenditures need not be capitalized, we note that it has not appealed from the adverse judgment of the Tax Court regarding expenditures incurred when employees of the taxpayers accumulated additional credit information."⁵⁵² Nevertheless, these decisions are inconsistent with the reasoning of the full absorption cases resting on clear reflection of income mandate of section 446.⁵⁵³ Moreover, both *Southland Royalty* and *Iowa-Des*

⁵⁴⁶ See *Wells Fargo*, 224 F.3d 874; *Perlmutter*, 44 T.C. 382. *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 286 (1967), distinguished *Perlmutter* on the grounds that the parties stipulated to an allocation. See *supra* note 226.

⁵⁴⁷ See *Southland Royalty Co. v. United States*, 582 F.2d 604, 616 (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.").

⁵⁴⁸ See *id.* at 617 n.20.

⁵⁴⁹ *Id.* at 617.

⁵⁵⁰ See *supra* note 298 and accompanying text.

⁵⁵¹ *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) (footnote omitted).

⁵⁵² *Id.* at 436 n.5.

⁵⁵³ See I.R.C. § 446(b); *Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th

Moines also employed a balancing of burdens and benefits of capitalization standard, and they were strongly moved by the notion that capitalization without depreciation distorted the taxpayer's income.⁵⁵⁴

U.S. Freightways implicitly agreed with Judge Posner's observation that courts shy away from the conceptual rigor of future benefit capitalization where "the result will be to force the capitalization of virtually every business expense"⁵⁵⁵ and expressly adopted his conclusion that "the 'administrative costs [of] conceptual rigor' . . . become too great."⁵⁵⁶ These cases must be rationalized⁵⁵⁷ on the balancing approach inherent in Posner's observation which *U.S. Freightways* makes even more explicit.⁵⁵⁸

E. Overhead Expenses

The *Lychuk* court concluded that "in connection with" meant "directly related"⁵⁵⁹ and that the overhead costs did not originate in the process of acquisition of the loans.⁵⁶⁰ The Tax Court distinguished *Perlmutter* on the grounds that it preceded *Woodward*,⁵⁶¹ but overlooked that in *Idaho Power*, the Supreme Court relied on *Perlmutter*⁵⁶² in requiring capitalization of inside indirect acquisitions incurred in connection with the acquisition of a *tangible* asset. The *Lychuk* court determined, in contrast, that the costs of salaries of employees who spent almost all their time on the acquisition of installment obligations had to be capitalized to the extent allocable to *successful* acquisitions, which was 38%.⁵⁶³ The *Lychuk* majority cited *Idaho Power*, *Woodward*, and a number of circuit decisions⁵⁶⁴ that

Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976).

⁵⁵⁴ See *supra* notes 374-77 and accompanying text.

⁵⁵⁵ *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982).

⁵⁵⁶ *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137, 1146 (7th Cir. 2001) (quoting *Encyclopaedia Britannica*, 685 F.2d at 217).

⁵⁵⁷ See discussion *infra* Part VI.

⁵⁵⁸ See *supra* note 243 and accompanying text.

⁵⁵⁹ *Lychuk v. Commissioner*, 116 T.C. 374, 386 (2001).

⁵⁶⁰ *Id.* at 392.

⁵⁶¹ *Id.* at 392-93 (citing *Perlmutter v. Commissioner*, 44 T.C. 382, 403-05 (1965), *aff'd*, 373 F.2d 45 (10th Cir. 1967); *Woodward v. Commissioner*, 397 U.S. 572 (1970)).

⁵⁶² See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974).

⁵⁶³ See *Lychuk*, 116 T.C. at 386 n.9.

⁵⁶⁴ *Commissioner v. Idaho Power Co.*, *supra* 418 U.S. at 13; see *Woodward v. Commissioner*, 397 U.S. at 575 ("It has long been recognized, as a general

“reflect a longstanding, firmly established body of law under which expenditures incurred ‘in connection with’ the acquisition of a capital asset are considered capital expenditures includable in the acquired asset’s tax basis.”⁵⁶⁵

Further, while the reasoning of the *Lychuk* court with respect to the salaries paid to the taxpayer’s loan origination department employees is more consonant with *Idaho Power* on its facts, the capitalization result is inconsistent with a balancing of the burdens and benefits of capitalization analysis due to the short life (with an average of around eighteen months) of the loans recurrently created. Additionally, current deduction of both overhead and of the loan officers’ salaries can be justified under a balancing of burdens and benefits of capitalization due to difficulty of allocation to individual loans since time spent on each loan under consideration probably varies greatly and time sheets apparently were not kept detailing the time spent on each loan.

matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures”); see also *Johnsen v. Commissioner*, 794 F.2d 1157, 1162 (6th Cir. 1986) (“costs incurred in connection with the acquisition or construction of a capital asset are capital expenditures”), revg. on other grounds 83 T.C. 103 (1984); *Ellis Banking Corp. v. Commissioner*, *supra* at 1379 (“an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset”); cf. *A.E. Staley Manufacturing Co. & Subs. v. Commissioner*, 119 F.3d 482, 489 (7th Cir. 1997) (costs are capital expenditures if they are “associated with” facilitating a capital transaction), rev’g. on other grounds and remanding 105 T.C. 166 (1995); *Central Tex. Sav. & Loan Association v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984) (“expenditures incurred in the acquisition of a capital asset must generally be capitalized”); *Commissioner v. Wiesler*, 161 F.2d 997, 999 (6th Cir. 1947) (“well settled rule that expenditures incurred as an incident to the acquisition or sale of property are not ordinary and necessary business expenses, but are capital expenditures which must be added to the cost of the property”), affg. 6 T.C. 1148 (1946).

Lychuk, 116 T.C. at 389. *PNC Bancorp v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), is criticized (see *supra* notes 477, 493 and accompanying text) for holding that employee salaries incurred in connection with the acquisition of capital assets (credit checks, etc., as to loans) do not come within the definition of *acquiring* a capital asset. See *supra* notes 475-76 and accompanying text.

⁵⁶⁵ *Lychuk*, 116 T.C. at 388-89.

VI. BALANCING BURDENS AND BENEFITS: PROPOSING A RESOLUTION TO THE TRANSACTION COSTS CASES

A. Introduction

The circuit opinions in *PNC Bancorp.*⁵⁶⁶ *Wells Fargo*,⁵⁶⁷ and *Lychuk*⁵⁶⁸ conflict with the origin of the claim doctrine and *Idaho Power's*⁵⁶⁹ approach to both tax parity and the matching of expenses with future benefit.⁵⁷⁰ A burdens and benefits of capitalization balancing standard, on the other hand, can explain these decisions. When the burdens of capitalization are heavy to both the taxpayer⁵⁷¹ and the government,⁵⁷² and the revenue advantage to the government is slight,⁵⁷³ then the balance of factors under the Code and the

⁵⁶⁶ *PNC Bancorp.*, 212 F.3d 822 (permitting the current deduction of the salary of loan origination employees).

⁵⁶⁷ *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000) (permitting the current deduction of target corporation officers investigating the acquiring company), *aff'g in part and rev'g in part* *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

⁵⁶⁸ *Lychuk*, 116 T.C. 374 (permitting current deduction of overhead of the loan origination department).

⁵⁶⁹ *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

⁵⁷⁰ See discussion *supra* Part V.

⁵⁷¹ See *supra* note 241 and accompanying text.

⁵⁷² See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 185-86.

When you have this much controversy about something that it is a fundamental business activity and when you've got an income measurement problem so fundamental you have to ask yourself whether have [sic] you have your rules right. *INDOPCO* after all is not an issue that anybody can think of as a tax shelter, a tax abuse. I think the answer is if we're having this much controversy, maybe we don't. We probably do need, either legislation or a super regulation project. But we ought to be able to do a lot better than we're doing on an issue that is as core as this one to our tax system.

....

Even if you want to have a special set of tax rules such as MACRS, as we have always had, recognizing that there will be boundary drawing issues and recognizing that those boundary drawing issues will cause some to believe that the system has been unjust, I suggest to you that MACRS, even with its issues and 197 are a lot better place than the world we are jumping off into with infinite *INDOPCO* litigation.

Transcript on Conference on Tax Legislative Process, Day Two, supra note 34, ¶¶ 519, 546 (comments of Ken Gideon).

⁵⁷³ See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 181-82 & n.79 (citing *Iowa-Des Moines National Bank v. Commissioner*, 592 F.2d 433, 436 (8th

Regulations cuts in favor of a current deduction under section 162.⁵⁷⁴ Unlike the origin of the claim doctrine and the tax parity rule as articulated in *Idaho Power*, such balancing could produce *different results* between internal and external costs⁵⁷⁵ because external costs usually can be clearly identified and allocated. Two commentators in particular acknowledge that such different results between inside and outside costs create “significant concerns of allocative efficiency (and perhaps fairness)” but, in spite of this risk, they “believe that the benefits of reducing the administrative and compliance costs of these rules will exceed the costs of making the system more nonuniform.”⁵⁷⁶ Given the relationship between the government’s allocation of compliance resources at the LMSB level and the corporate tax shelter problem,⁵⁷⁷ I wholeheartedly agree.

Note that the Advance Notice’s “overhead” rule is supported by the Tax Court’s holding with respect to overhead expenses in *Lychuk* as well as the single earlier decision applying a “facilitate a particular capital transaction” rule.⁵⁷⁸ Currently, deduction of overhead costs is inconsistent, however, with the full absorption line of cases exemplified by *Adolph Coors*.⁵⁷⁹ These cases, like *Idaho Power*, demonstrate a concern for the clear reflection of income with respect to direct and indirect costs, including overhead, of constructing tangibles or acquiring them for resale. For instance, in *PNC Bancorp*, the Third Circuit addressed the anti-distortion of income concern of *Idaho Power* with a rough justice approach insofar as the court stated that “[t]here need be no concern about a distortion of income because

Cir. 1979); *Cincinnati, New Orleans & Texas Pacific Railway Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970)).

⁵⁷⁴ See *supra* notes 241-49 and accompanying text; I.R.C. § 162(a).

⁵⁷⁵ Christine M. Turgeon, a senior tax law specialist in Treasury’s Office of Tax Policy . . . said the administration questions whether it makes sense to capitalize external employee compensation costs – external Counsel, for example – but not internal costs. The government recognizes it may be more burdensome to taxpayers to allocate those [internal] costs, she said, adding that simplifying these rules is under consideration.

Amy Hamilton, *Treasury Official Assesses INDOPCO Coalition Proposal*, 93 TAX NOTES 745, 747 (Nov. 5, 2001).

⁵⁷⁶ Evans & Gallagher, *supra* note 25, at 55. See *Transcript of Conference on Tax Legislative Process, Day Two, supra* note 34, ¶¶ 569-79 (comments of Joseph Mirkut) for an excellent counter argument.

⁵⁷⁷ See *supra* notes 117-33, 174-81 and accompanying text.

⁵⁷⁸ *Munson v. McGuiness*, 283 F.2d 333, 336 (3d Cir. 1960).

⁵⁷⁹ *Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976); see *supra* notes 227-29 and accompanying text.

of the regularity of these expenses.”⁵⁸⁰ Currently deducting overhead costs incurred in connection with an intangible ironically is less inconsistent with section 263A, the uniform capitalization rules whose

Thrust . . . was to require various producers of tangible property already capitalizing direct and some indirect costs to more comprehensively capitalize other indirect costs. Congress meant to exempt from the new uniform capitalization rules those taxpayers, or expenditures, that were already exempted under prior law from the general capitalization rules.⁵⁸¹

Further confirmation may be seen in the Congressional intention to exclude the costs of creating intangibles from section 263A.⁵⁸² The Treasury Proposals forming the basis for section 263A had excepted (without explanation) from the Uniform Capitalization Rules marketing, selling, and advertising expenses, and research and development costs unrelated to particular production activities.⁵⁸³ In this context, the Joint Committee Staff had read case law such as *Lincoln Savings* as adopting “a rule of reason approach to applying section 263, tacitly acknowledging the impracticality of requiring that

⁵⁸⁰ PNC Bancorp, Inc., v. Commissioner, 212 F.3d 822, 835 (3d Cir. 2000). The Seventh Circuit in *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137, 1146-47 (7th Cir. 2001), provides a much more sophisticated analysis of recurring. See *supra* text accompanying note 243.

⁵⁸¹ 134 CONG. REC. 9160 (1988) (extension of remarks of Rep. Thomas J. Downey, D-N.Y., member of House Ways & Means Committee).

⁵⁸² The Senate Finance Committee Report stated that the new provision was not intended to modify

present-law principles governing the determination of whether an expenditure results in a separate and distinct asset that has a useful life substantially beyond the taxable year. See Treas. Reg. sec. 1.263(a)-1, (a)-2; *Commissioner v. Lincoln Savings and Loan*, 403 U.S. 345 (1971). Thus, if the costs of producing an intangible item such as goodwill are deductible under current law, such costs will continue to be deductible under . . . [section 263A]. The uniform capitalization rules merely will prescribe which costs associated with an asset required to be capitalized must be included in its basis or otherwise capitalized.

TAX REFORM ACT OF 1986, S. REP. NO. 99-313, at 141 & n.38 (1986) (footnote combined with text).

⁵⁸³ See U.S. DEP'T OF THE TREASURY, 2 TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 207 (1984); U.S. DEP'T OF THE TREASURY, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 203 (1985).

every cost with some conceivable future benefit be capitalized.”⁵⁸⁴ This concept is the ultimate foundation for the Seventh Circuit’s adopting in *U.S. Freightways* a balancing of burdens and benefits test for determining whether to expense or capitalize a cost producing future benefits.⁵⁸⁵ The remainder of this article applies various rough justice balancing factors⁵⁸⁶ to the facts of the cases discussed above.⁵⁸⁷

B. Lack of Depreciation

A rough justice basis for the result in both *A.E. Staley* and *Wells Fargo* could be the unavailability of depreciation if the costs are capitalized to the nondepreciable corporate structure. A major difficulty with this analysis, although it certainly has the appeal of avoiding “perpetual capitalization,” is that logically it should apply to inside and outside transaction costs. Under the rationale of the unavailability of depreciation, the outside transaction costs in *INDOPCO* would be currently deductible or, better still, depreciable over sixty months. Abrogating either *INDOPCO* or section 197 in interpretative regulations is not advisable. Therefore, the “facilitate the transaction” gloss of *A.E. Staley* should be followed, as the Advance Notice contemplates.

⁵⁸⁴ STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., TAX REFORM PROPOSALS: ACCOUNTING ISSUES 50 (Joint Comm. Print 1985). Note the close parallel to the Bittker formulation:

This emphasis on the long-run consequences of the taxpayer’s accounting practice acknowledges that a rule of reason is essential. If every cost contributing to the profits of future periods were to be disallowed, it would be necessary to divide almost every salary and advertising expense between its immediate impact on the customer and its contribution to the company’s long-lived goodwill. Recognizing this, the Supreme Court 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.” . . . [E]ven the most routine repairs often have a long-term impact but are, nevertheless, classified as deductible expenses rather than as nondeductible capital expenditures.

1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 20.4.1, at 20-68 (2d ed. 1989) (quoting *Commissioner v. Lincoln Savings & Loan Ass’n*, 403 U.S. 354 (1971)).

⁵⁸⁵ *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137 (7th Cir. 2001), literally based its approach on *Encyclopaedia Britannica v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982), but the latter expressed just the same thought, probably also influenced by Bittker. See *supra* note 584.

⁵⁸⁶ See *supra* Part IV.

⁵⁸⁷ See *supra* Part V.

C. Insubstantial Expenditure

A rough justice rule that would apply to *Wells Fargo*, but not to *A.E. Staley* or, in all likelihood, to *PNC Bancorp*, is the current deduction of insubstantial costs notwithstanding future benefit. Indeed, a concurring opinion in *Wells Fargo* thought the record inadequate to show substantiality.⁵⁸⁸ Moreover, the Tax Court majority in *Lychuk* distinguished *Wells Fargo* on just that ground.⁵⁸⁹ The result in *Wells Fargo* is probably correct on the theory that the expenditure was not substantial, but incorrect on the theory that the salaries were deductible because they would be paid anyway as is customary. The reality, however, is that the Service apparently cannot administer a facts and circumstances substantiality test.⁵⁹⁰ For instance, Revenue Ruling 2001-4⁵⁹¹ turns current deduction of certain cyclical aircraft maintenance costs on undefined factors such as “significant portion,” “substantial structural part,” “major component,” or “material upgrade or addition,” which are not administrable in the field.⁵⁹² Further, an insubstantiality approach

⁵⁸⁸ [The Tax Court’s] finding does not address whether some officers at any particular period of time devoted substantial work to the acquisition or whether the officers during the period of time in question only incidentally worked on the acquisition while doing regular banking duties.

In order to determine whether an allocation of officers’ salaries to an acquisition-transaction such as made here qualifies as a deduction from income or should be capitalized, the taxing authorities should require the taxpayer to show officers’ time devoted to the acquisition as compared to time spent on regular work during a particular and relevant time period.

Wells Fargo & Co. v. Commissioner, 224 F.3d 874, 890 (8th Cir. 2000) (Bright, J., concurring) (the Service capitalized only \$150,000 of the nine executives’ and seventy-three other officers’ salaries).

⁵⁸⁹ *Lychuk v. Commissioner*, 116 T.C. 374, 404-05 (2001).

⁵⁹⁰ See *infra* note 592 and accompanying text.

⁵⁹¹ 2001-3 I.R.B. 295.

⁵⁹² Some of the terminology used in the ruling (i.e. “significant portion,” “substantial structural part,” “major component,” or “material upgrade or addition”) is undefined. Pending clarification of these terms, this document is intended to provide guidance to examiners on the efficient use of time and resources in the examination of this issue. Based on the ruling, the commitment of staffing to examine airframes, which underwent the first or second HMV, is usually not an effective utilization of those resources.

....

At the beginning of an examination, you should contact the Air Transportation Technical Advisor group and obtain a listing of the taxpayer’s fleet composition. . . . This list can be shared with the taxpayer and used to confirm the type and age of their fleet. From this, you will

does not address *PNC Bancorp* or *Lychuk*:

D. Recurring Expenditures with Short-Term Future Benefit

The *Lychuk* court, although it correctly rejected the reasoning of *PNC Bancorp*, was incorrect on the facts before the court. While the reasoning of *Lychuk* with respect to the salaries paid to its loan origination department employees is more consonant with *PNC Bancorp* than with *Idaho Power* on the facts, the capitalization of 40% of the employees' salaries is inconsistent with a balancing of the burdens and benefits of capitalization analysis.⁵⁹³ The costs were (1) recurring, (2) difficult to allocate to particular loans,⁵⁹⁴ (3) almost insubstantial insofar as only 38% of the loan applications were accepted, with the result that 62% of these costs and all the overhead was held currently deductible, and (4) most significantly, the accepted loans had an average life of less than two years since they were made to high credit risk car buyers.⁵⁹⁵ Under a balancing test, the rest of the salaries (and the overhead) should have been currently deducted. This answer, however, will not cover loans of longer length, such as residential mortgages with an average duration of seven years, or the average duration before the homeowner moves or refinances.⁵⁹⁶

In *PNC Bancorp*, the Third Circuit did not mention the length of the loans. I will assume, for purposes of this analysis, that the length

quickly see if the taxpayer has an aging fleet that would be subject to a third HMTV or a newer one that would not be subject to it. If they have few aircraft subject to a third HMTV, you should not spend significant resources on this issue.

2001 FSA LEXIS 195 (Sept. 28, 2001).

⁵⁹³ *Iowa-Des Moines* applied a balancing test in allowing a current deduction for purchased *credit information* which it emphasized was short lived and subject to sudden change, thereby precluding depreciation under the certainty requirement for intangibles. *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) ("Where the prospective benefit is very slight, capitalization is not easily supported.").

⁵⁹⁴ See *supra* note 358 and accompanying text.

⁵⁹⁵ The average lives of accepted car loans were 17.5 months and 19.5 months for the tax years at issue. *Lychuk v. Commissioner*, 116 T.C. 374, 420 n.1 (2001) (Swift, J., concurring mostly to show *PNC Bancorp* erred in its reasoning).

⁵⁹⁶ Scott Burns, *It's Balanced Budget Deja Vu All Over Again*, DALLAS MORNING NEWS, Jan. 7, 1996, at H-1; *Mortgages in 1990s: Faster, Cheaper, More Flexible*, ST. LOUIS POST-DISPATCH, Feb. 3, 1989, at 6F ("The 30-year fixed mortgage is a bit outmoded, says John E. Hemschoot, director of home-mortgage standards for Federal Home Loan Mortgage Corp. (Freddie Mac). That's because few borrowers buy a house and live in it for a lifetime; the average stay is seven years.").

of the loans was seven years. The short-term recurring factors will not produce an ordinary deduction in this case. Another rough justice factor should be used rather than *PNC Bancorp*'s definitional, result-oriented test, a "technical argument not articulated before,"⁵⁹⁷ as to the meaning of "create or enhance a separate and distinct asset."⁵⁹⁸ That factor is the difficulty of allocation of the costs to each loan.

E. The Difficulty of Allocation

The difficulty in allocating overhead or officers' salaries to particular assets, particularly to recurring costs as in *PNC Bancorp* and *Lychuk*, justifies a rough justice current deduction as a matter of administrative policy.⁵⁹⁹ Conventional wisdom presumes that capitalization or expensing in the taxpayer's book accounting lessens the taxpayer's burden of compliance sufficiently enough to require capitalization.⁶⁰⁰ *PNC Bancorp* reveals this logical fallacy. The capitalized book cost was not allocated to each loan as conceptual rigor would require; rather, an aggregate amount was amortized over a predetermined period.⁶⁰¹ If we are just going to guess, then a guess guided by tax principles is preferable to a guess based on accounting concepts, which have "vastly different objectives."⁶⁰²

There is a significant difference in administrability at the taxpayer level between outside and inside transaction costs, since outside transaction costs often are separately itemized while internal costs often are not separately accounted for.⁶⁰³ A broader rationale would take into account the difficulty of allocating costs to individual loans. Interestingly, when the Office of Chief Counsel characterized loan origination fees as acquisition costs of mortgage servicing contracts, its conclusion did not turn on the difficulty of allocating the costs, but rather on the speculative nature of such assets.⁶⁰⁴

⁵⁹⁷ See Massey, *supra* note 475 and accompanying text.

⁵⁹⁸ See *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822, 830 (3d Cir. 2000); *supra* note 476 and accompanying text.

⁵⁹⁹ See Gen. Couns. Mem. 33,968 (Nov. 18, 1968).

⁶⁰⁰ Lokken, *supra* note 35, at 1365; Evans & Gallagher, *supra* note 25, at 51.

⁶⁰¹ *PNC Bancorp*, 212 F.3d at 825 n.3, 432-33 n.16.

⁶⁰² *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542 (1979) (not surprisingly written by Justice Blackmun); *accord PNC Bancorp*, 212 F.3d at 832.

⁶⁰³ See *supra* note 575.

⁶⁰⁴ See Gen. Couns. Mem. 35,681 (Feb. 19, 1974).

F. Conclusion: How Should the Regulations Be Structured?

Hopefully, the proposed regulations on intangible expenditures will explicitly state the policy of minimal distortion of income as the basis for, and apply a burdens and benefits balancing standard to, their transaction costs rules.⁶⁰⁵ Most likely, it is now too late to provide a framework for the trier of fact or taxpayer actually to apply a case-by-case balancing test with the appropriate factors and method of allocation.⁶⁰⁶ The proposed regulations will probably take the form of either specific rules or even a list of capitalizable expenditures with unlisted costs being deductible⁶⁰⁷ for deducting and capitalizing specified expenses that create or enhance tangible assets.⁶⁰⁸ Even so, these rules should specifically apply a balancing test both in the

⁶⁰⁵ [A]n expenditure should not be capitalized in any case where the resulting enhancement of accuracy in the measurement of income is outweighed by the burden of separating capital from current items. If the expenditure directly creates or enhances a separate and distinct asset, this burden is seldom great, and capitalization should usually be required. If no separate or distinct asset is created or enhanced, or if the expenditure indirectly relates only to such an asset, compliance and administrative burdens should be considered explicitly. The Service might consider these burdens in formulating objective rules governing particular types of expenditures, rather than requiring case-by-case determinations, but the objective rules should be justified by evaluating and explaining the burdens involved with the costs affected by each rule.

Lokken, *supra* note 35, at 1369.

⁶⁰⁶ Treasury Regulation 1.355-2(d) comes to mind. See Lee, *Art of Regulation Drafting*, *supra* note 424, at 1032, 1039-41. I am proud that my scholarship played a role in those regulations. *Id.* at 1032 n.30. Mark L. Yecies once told me that he drafted the 1977 proposed revised version with a copy of my "Rafferty" article in front of him. Besides the new balancing approach of bail out potential appearing in both the regulations and my article, this is indirectly confirmed by General Counsel Memorandum 36,387 (Aug. 25, 1975) and General Counsel Memorandum 36,069 (Nov. 5, 1974). Even more transparent is my contribution to the "related function" rule of section 1.355-2(d)(2)(iv)(C), since the absence of an "impairment of equity" factor was my only criticism of the 1977 version (not then knowing of my role). See John Lee, *Proposed Regs. Under 355 Overhaul Device Test and Single-Business Divisions*, 46 J. TAX'N 194 (1977).

⁶⁰⁷ Sheryl Stratton, *Federal Bar Association – Tax Accounting Guidance Will Address New Jobs Law, Intangibles*, 94 TAX NOTES 1434 (Mar. 18, 2002) ("There will be a list for what should be capitalized, and if an item is not on the list, capitalization is not appropriate, [Heather] Maloy[, Service associate chief counsel (Income Tax & Accounting)] said.").

⁶⁰⁸ It would be possible, however, to provide a balancing test with the rough justice rules as safe harbors. Cf. Treas. Reg. § 1.355-2(d)(2), (d)(5) (as amended in 1992).

preamble and in the body of the proposed regulations introducing the transaction cost rules.⁶⁰⁹

VII. CONCLUSION

A decade ago, it was foreseeable from the ISP and GAO studies of the most common business audit issues that capitalization would become the biggest tax audit issue.⁶¹⁰ It was also foreseeable from the Service's experience with purchased intangibles leading up to section 197 that the litigation costs to both taxpayers and the government would be substantial.⁶¹¹ Based on the courts' experience with start-up costs prior to section 195 as well as the general plan of rehabilitation doctrine, it was also foreseeable that if auditors and litigators pushed for capitalization resulting in perpetual capitalization or too slow depreciation, some circuit opinions would permit a current deduction.⁶¹² This approach has had unintended consequences, and has generated conflicts with prior decisions. It was somewhat more surprising that (1) the audit levels dropped so precipitously⁶¹³ and (2) corporate tax shelters would become either the largest⁶¹⁴ or second largest tax issue.⁶¹⁵ With all these developments, the ideal regulations embodying the principles of "structured discretionary justice,"⁶¹⁶ and

⁶⁰⁹ Cf. § 1.355-2(d)(1).

⁶¹⁰ See 1993 House Hearings, *supra* note 37, at 1687-88.

⁶¹¹ *Id.*

⁶¹² See *supra* note 527 and accompanying text.

⁶¹³ See *supra* notes 105-16 and accompanying text.

⁶¹⁴ See *supra* note 132 and *infra* note 615 and accompanying text.

⁶¹⁵ [W]e identified four important areas of systematic non-compliance. They are misuse of devices such as trusts and passthroughs to hide or improperly reduce income; use of complex and abusive corporate tax shelters to reduce taxes improperly; failure to file and pay large accumulations of employment taxes; and erroneous refund claims. However, there is one common element in all four. These schemes are organized and actively promoted.

....

Abusive corporate tax shelters are the second major compliance problem.

CHARLES O. ROSSOTTI, COMMISSIONER OF INTERNAL REVENUE, PROGRESS REPORT (2001), reprinted in *IRS Releases December 2001 Progress Report*, TAX NOTES TODAY (Mar. 4, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 42-6, ¶¶ 129, 136).

⁶¹⁶ See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 200-02; Lee et al., *Rough Justice I*, *supra* note 17, at 688-89.

transparent “negotiated regulation”⁶¹⁷ are no longer feasible. The administrative costs to the Service are too great.

The answer now is a *principled* withdrawal by the Service and the Treasury Department from capitalizing costs that were traditionally deductible and that Congress obviously wanted to remain deductible. Nevertheless, Congress bet on the wrong horse: the no separate asset rule.⁶¹⁸ As a guiding principle, the Service and the Treasury Department should ask, with respect to self-created intangibles, whether the burdens of capitalizing to the taxpayer (and to the Service from the taxpayer currently deducting future benefit costs) outweigh the benefits. The Advance Notice takes some giant steps toward this goal. The proposed regulations should explicitly base the contemplated transaction costs rules on a burdens and benefits analysis. When these and other capitalization regulations are made final so that they become the revenue baseline, Congress should revisit the area and codify or modify these regulations as it sees fit.

⁶¹⁷ See Lee et al., *Capitalizing Aircraft Maintenance*, *supra* note 241, at 238-40.

⁶¹⁸ See *supra* notes 47-48 and accompanying text.