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THE REQUIREMENT THAT A CAPITAL EXPENDITURE CREATE OR ENHANCE AN ASSET

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The typical judicial opinion in an income tax case concerning capital expenditures consists of little more than a description of the expenditure in question and a conclusion that it is, or is not, capital. General agreement prevails that some costs must be capitalized because they are so closely related to the production of future years' income that a current deduction would not clearly reflect income.[1] But nearly every business expenditure has some impact on the future, and the cases distinguishing capital expenditures from "ordinary and necessary expenses" do not exhibit any easily-described pattern. The Board of Tax Appeals once observed that in capital expenditure cases "no court has ever yet attempted to make a definition that can apply to any case except the one under review."[2] The Second Circuit, finding that "the rulings and decisions are in a state of hopeless confusion,"[3] has suggested that prayer and fasting are in some way appropriate conduct for those faced with a capitalization problem.[4]

In *Commissioner v. Lincoln Savings & Loan Association,*[5] decided in 1971, the Supreme Court, noting that many deductible expenditures have some effect beyond the taxable year, justified

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[1] The necessity of capitalizing at least some expenditures is obvious only so long as one accepts the proposition that no tax deduction should be allowed for money saved, since most capital expenditures may be viewed as savings. For a discussion of the arguments for and against exempting savings from taxation, see N. Kaldor, An Expenditure Tax 79-101 (1955).

[2] American Seating Co., 4 B.T.A. 649, 658 (1926), acquiesced in part, nonacquiesced in part, VII-1 Cum. Bull. 2 (1928).

[3] Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 785 (2d Cir. 1973).

[4] Id.

[5] 403 U.S. 345 (1971) (Blackmun, J.).

capitalization of the expenditure in question by finding that it served "to create or enhance . . . what is essentially a separate and distinct additional asset."[6] Although the Second Circuit has said that this language "has brought about a radical shift in emphasis,"[7] nothing in the *Lincoln Savings & Loan* opinion suggests that the Court was doing anything more than describing the existing law on the subject. The regulations provide that expenditures that "[result] in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year" are not deductible.[8] The converse of this rule, that expenditures that do not result in the creation of an asset are currently deductible even though they relate to future years' income, was also reasonably well-established before *Lincoln Savings & Loan*; Judge Tannenwald's concurring opinion in *David J. Primuth*[9] describes the cases as limiting capitalization to "cases of acquisition of tangible assets or intangible assets, such as a license or goodwill of a going business, or preparation for engaging in a new field of endeavor."[10] The tendency of the courts to think of a capital expenditure as something associated with assets rather than as a guide to the proper determination of income may derive from the old emphasis on the balance sheet as the primary financial statement.[11] Thus, in *Wyoming National Bank,*[12] the Board of Tax Appeals held that excess "rental" payments made to induce a lessor to speed up construction of a building should not be capitalized because the payments gave the taxpayer no asset that it could show on its books.[13] The case is probably wrong in this respect,[14] but the

[6] Id. at 354. The significance of the requirement that the asset created or enhanced be a "separate and distinct additional" one is not clear. If capitalization were limited to costs that "create" an asset, "separate and distinct" might be viewed as reflecting the distinction drawn in the cases cited in note 68 infra. But the quoted phrase describes as capital expenditures those costs that "enhance" an existing asset as well; thus it cannot be read as limiting capital expenditures to costs that give the taxpayer some asset that he did not have before the expenditure was incurred. It is hard to conceive of a cost that creates or enhances an asset that is not "separate and distinct" from some other asset.

[7] *Briarcliff,* 475 F.2d at 782.

[8] Treas. Reg. § 1.461-1(a)(1) (1973) (cash method taxpayers); Treas. Reg. § 1.461-1(a)(2) (1973) (accrual method taxpayers).

[9] 54 T.C. 374 (1970).

[10] Id. at 381, 382 (concurring opinion).

[11] The tendency today is to regard the income statement as more significant than the balance sheet. Statement of the Accounting Principles Board, Oct. 1, 1970, CCH Accounting Princ. §§ 1022.04, 1026.36.

[12] 23 B.T.A. 408, acquiesced in, X-2 Cum. Bull. 78 (1931).

[13] 23 B.T.A. at 411.

[14] There is some authority for the deduction of payments for the early delivery of goods either as a business expense, O.D. 664, 3 Cum. Bull. 131 (1920), declared obsolete by Rev. Rul. 69-661, 1962-2 Cum. Bull. 111, or as depreciation, Frank & Seder Co. v. Commissioner, 44 F.2d 147 (3d Cir. 1930); Atwater Kent Mfg. Co. v. Commissioner, 43 F.2d 331 (3d Cir. 1930). However, the weight of authority is that such payments are merely part of the purchase price of the goods and must be capitalized. Sears Oil Co. v. Commissioner, 359 F.2d 191 (2d

Board's attention to the balance sheet is instructive. In any event, even if the limitation of the capital expenditure concept to the costs of producing or enhancing an asset did not originate with *Lincoln Savings & Loan,* the clear statement of the limitation in a Supreme Court opinion will undoubtedly increase the attention that is paid to the search for an asset in capitalization cases.

The term "asset" is usually used in tax cases as a synonym for "property," although as a matter of accounting theory an "asset" is nothing more than a capitalized cost,[15] which will be recognized as an expense through depreciation, amortization or depletion in whatever future accounting periods are appropriate.[16] The names on the asset side of a balance sheet are not the names of pieces of property; they are the names of costs. If capitalization were approached with this in mind, it would be inaccurate to say that a particular expenditure must be capitalized because it has produced an asset; one should say instead that there is an asset because a particular expenditure has been capitalized. While this view of capitalization has occasionally been recognized in tax cases,[17] the usual approach has been to base the decision whether to capitalize an expenditure upon the result of a determination that the expenditure has produced an asset. Since the word "asset" is used in everyday speech to mean a piece of property, it is perhaps not surprising that the peculiar use of that term in accounting parlance has been ignored. In most cases the distinction between asset as cost and asset as property is of no practical significance, since the typical capital expenditure does produce something that can be regarded as tangible or intangible property. Thus, in the typical case, there is no particular reason to take care to observe that when one says "asset" in connection with an expenditure one means the expenditure itself and not the thing acquired as a result of the expenditure. Recognition that the assets on a balance sheet are costs rather than pieces of property does not compel the conclusion that the rule limiting capital expenditures to costs associated with the production of property is unsound. The

Cir. 1966); Thalhimer Bros., Inc., 27 T.C. 733 (1957), acquiesced in, 1957-2 Cum. Bull. 7; W.P. Brown & Sons Lumber Co., 26 B.T.A. 1192 (1932), appeal dismissed, 68 F.2d 1022 (6th Cir. 1934); Robert Buedingen, 6 B.T.A. 335 (1927); Rev. Rul. 70-332, 1970-1 Cum. Bull. 31; cf. McCulley Ashlock, 18 T.C. 405 (1952). The denial of a deduction in these cases is attributable in part to a concern that allowing the deduction would encourage artificial characterization of part of the cost of assets as early delivery payments. *Sears,* supra, at 197.

[15] De Capriles, Modern Financial Accounting (pt. I), 37 N.Y.U.L. Rev. 1001, 1020-21 (1962).

[16] Alternatively, if the asset is the cost of an item that does not have a limited life, such as land or the purchased goodwill of a going business, it will be recognized in the period when the asset is sold.

[17] See Rev. Rul. 68-483, 1968-2 Cum. Bull. 91, which apparently treats the cost of periodic redredging of a slip rather than the slip itself as the asset in question.

limitation may be perfectly reasonable; but it is important to understand that it is a limitation, not something inherent in the nature of capitalization.

The distinction between asset as cost and asset as property may be helpful in determining the proper period for recovery of capitalized costs through depreciation or amortization. Two Tax Court cases[18] have denied depreciation of landscaping costs on the ground that the costs enhance an asset—land—that does not have a limited useful life. If landscaping must be repeated periodically, denial of depreciation in such a case results in taxing something more than net income. Unless landscaping is performed at least annually a current deduction would distort income, but recovery of the cost through depreciation over the period between landscapings should be permitted. Recognition that the "asset" in such cases is the cost itself, which might be called "deferred landscaping cost," rather than what is purchased with the cost, may help to avoid this kind of error.[19]

This article will examine several aspects of the capital expenditure problem with a view toward determining whether it is ever reasonable to permit a current deduction for expenditures having some future impact and whether such expenditures can reasonably be classified as capital or current on the basis of the connection between the expenditure and something that can be called an asset. Particular emphasis will be given to cases in which expenditures are held to be deductible notwithstanding their relation to the production of income in future years, because the result of the expenditure is not an asset. After brief discussion of the statutory provisions concerning capital expenditures and the problem of whether capitalization is a "method of accounting," three kinds of capital expenditure problems will be discussed. The capital nature of ground rent and insurance during the construction of a building will be examined in order to determine the nature of the relationship between a cost and an asset necessary to require capitalization of the

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[18] Herbert Shainberg, 33 T.C. 241 (1959), acquiesced in, 1960-1 Cum. Bull. 5; Algernon Blair, Inc., 29 T.C. 1205 (1958). But cf. Alabama-Georgia Syrup Co., 36 T.C. 747 (1961), acquiesced in, 1962-1 Cum. Bull. 3, rev'd on other grounds sub nom. Whitfield v. Commissioner, 311 F.2d 640 (5th Cir. 1962), where the Commissioner allowed depreciation of the costs of shrubbery.

[19] The problem here is not so much the allocation of the cost to the wrong asset as it is the failure to recognize that there is an asset distinct from the land. It may be possible to avoid this error without recourse to treating the cost itself as the asset if one is willing to regard some incidental product of the landscaping, such as shrubbery, as a separate depreciable asset, but this approach seems somewhat strained, and there are other situations where it is unsatisfactory. Thus, in Rev. Rul. 68-483, 1968-2 Cum. Bull. 91, depreciation of the cost of periodic redredging of a channel (though not of the cost of the initial dredging) was allowed. The dredging cost is described as an "intangible asset."

cost, and to determine whether the distinction between the treatment afforded ground rent and insurance can be explained on "production of an asset" grounds. The capital nature of educational expenditures will then be considered, in an effort to determine whether the nondeductibility of some educational expenditures can be explained on capital expenditure grounds and whether the educational expense cases are consistent with the limitation of capital expenditures to costs that produce an asset. Finally, the capital nature of the costs of expanding a business will be considered in order to determine whether the distinctions that are drawn in this area can be explained by classifying the results of those costs as "assets" or "not assets."[20]

[20] This selection of topics does not by any means exhaust the capital expenditure area. Some problems other than those listed here, such as the distinction between repairs and improvements, will be discussed briefly in connection with other matters. See text at notes 62-71 infra. There are many problems involving capitalization for which an analysis in terms of the creation or enhancement of an asset does not seem particularly helpful. For example, many cases deny a deduction under § 162 or § 212 for costs incurred in connection with the sale of property. For a recent example, see Great Lakes Pipe Line Co. v. United States, 352 F. Supp. 1159 (W.D. Mo. 1972). Although the denial of a deduction in such cases is explained by saying that the costs are "capital expenditures," these costs are quite different from those that are called capital expenditures because they are considered the costs of earning future years' income. The sale cases involve tax benefit problems rather than timing problems; the benefits of the costs of a sale are realized in the period in which they are incurred, but the costs are treated as offset to the sales proceeds so as to reduce capital gains or unrecognized gains rather than ordinary income. See Towanda Textiles, Inc. v. United States, 180 F. Supp. 373, 378 (Ct. Cl. 1960), where the court said: "Expenses necessarily incurred to realize a capital gain reduce the amount of that gain and partake of the nature of the gain to which they relate." Id., citing Arrowsmith v. Commissioner, 344 U.S. 6 (1952), a leading tax benefit rule case. The problem of capitalizing the costs of organizing or reorganizing a corporation is somewhat similar to that involved in the sale cases. Although the nondeductibility of such costs as those of issuing stock can be explained by saying that the costs create or alter the corporation's capital structure, an "intangible asset"—see, e.g., General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir.), cert. denied, 379 U.S. 832 (1964)—another explanation may be that costs related to a corporation's acquisition of capital should be nondeductible because the receipt of the capital is not taxable.

Cases involving the deductibility of litigation costs may raise tax benefit "capital expenditure" problems like those discussed above. See, e.g., Judge Hays' dissenting opinion in Commissioner v. Doering, 335 F.2d 738, 742 (2d Cir. 1964). They may also involve difficult problems of separating personal from business expenditures, a matter that is dealt with by determining whether the origin of the claim involved in the lawsuit was "personal." See, e.g., United States v. Gilmore, 372 U.S. 39 (1963). In Commissioner v. Tellier, 383 U.S. 687 (1966), the Court held that the costs of defending against criminal charges arising out of the taxpayer's securities business were not capital expenditures because "[t]hey were incurred in his defense against charges of past criminal conduct, not in the acquisition of a capital asset." Id. at 690. But the costs of litigation that is part of the process of acquiring property or of "defending or perfecting title or property" must be capitalized. Woodward v. Commissioner, 397 U.S. 572 (1970); Treas. Reg. §§ 1.263(a)-2(c), 1.212-1(k) (1973). For discussions of capital expenditure problems relating to legal fees, see generally Brookes, Litigation Expenses and the Income Tax, 12 Tax L. Rev. 241, 250-63 (1957); Note, The Deductibility of Attorneys' Fees, 74 Harv. L. Rev. 1409, 1409-21 (1961). The results of the litigation cases do not, for the most part, turn upon whether the subject of the litigation was an "asset," and to the extent that such an inquiry may be relevant, as in *Tellier,* the litigation cases do not seem to present any problems different in kind from cases not involving litigation.

I. Code Provisions Concerning Capital Expenditures

Section 263(a) of the Internal Revenue Code of 1954 provides that no deduction shall be allowed for amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[21] Sections 162 and 212 provide that the "ordinary and necessary expenses" of a trade or business or for the production of income are deductible, and both the word "ordinary"[22] and the word "expenses"[23] can be interpreted as denying a current deduction for capital expenditures. The Supreme Court's opinion in *Lincoln Savings & Loan* may be read as supporting both these explanations; the Court described the payments there as "capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) . . . ."[24] The only apparent function of section 263 in the statutory scheme is to provide a heading under which the tax services can list the capital expenditure cases. That section is both too narrow and too broad to explain satisfactorily all capitalization requirements—too narrow because its reference to "new buildings or . . . permanent improvements" suggests that capitalization is limited to the costs of new, tangible property, which is clearly not the case; too broad because there are costs, such as those for some repairs, which are represented by permanent improvements but which have always been considered deductible.[25] Sections 162 and 212 have no application to expenses not incurred in carrying on a trade or business or for the production of income, but such expenses must sometimes be classified as capital or current, in order to determine the basis of nonbusiness property. The Supreme Court has said that sections 263 and 162 are not all-inclusive, and that there are capital expenditures not listed in section 263, without identifying whatever other sections are relevant.[26] The Tax Court has said that costs not described in section 263 may be subject to capitalization on the ground that they are "acquisition" costs and thus part of the basis of property under

[21] Int. Rev. Code of 1954, § 263(a)(1). This language has remained virtually unchanged since the Revenue Act of 1913. Section 263(a)(2) requires capitalization of amounts paid to restore property or to make good the exhaustion of property for which a depreciation, amortization or depletion deduction has been taken.

All section references in this article are to the Internal Revenue Code of 1954 unless otherwise indicated.

[22] See Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Griswold, An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142, 1145 (1943).

[23] See 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 349 (1972).

[24] 403 U.S. at 354.

[25] See text at notes 62-63 infra.

[26] See Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 358 (1971).

section 1012.[27] Recent cases treating capitalization as a problem of determining whether the taxpayer's method of accounting clearly reflects income bring sections 446 and 461 into the picture.[28] To the extent that capitalized costs are associated with property having a limited useful life, sections 1012, 1016(a), 167 and 612 provide for their recovery through depreciation, amortization or depletion.[29]

Capitalization of particular items ranging from almond grove development costs to water conservation expenditures is governed by a multitude of code provisions.[30] Of these specific provisions,

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[27] George L. Schultz, 50 T.C. 688, 698 (1968), aff'd per curiam, 420 F.2d 490 (3d Cir. 1970).

[28] See, e.g., text at notes 37-51 infra.

[29] When a capital expenditure is associated with more than one asset, a choice of which property is to have its basis increased or an allocation of the expenditure between the properties must be made. In Stuart M. Hughes, 54 T.C. 1049 (1970), aff'd, 450 F.2d 980 (4th Cir. 1971), the Tax Court was faced with determining whether the cost of moving a house from one lot to another should have been added to the basis of the house or to the basis of the lot from which the house had been removed. The court upheld the Commissioner's allocation of the entire moving cost to the house because the taxpayer failed to prove that more than removal of the house from the lot was necessary to effect the sale or exchange of the lot or to demonstrate the relationship between the cost of moving the house to its new location and the cost of merely removing the house from the lot. The cost of moving a building from one lot to another has been held to be an added cost of the building, while the cost of removing a building from a lot has been held to increase the basis of the lot. See id. at 1056. The *Hughes* court apparently would have allocated to the lot so much of the cost of moving the house as did not exceed the cost of clearing the lot so that it could have been exchanged if the record had provided a basis for making such an allocation. See id. at 1057.

In Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), the taxpayer sought to amortize the costs of acquiring leasehold interests in land it owned over the unexpired term of the leases, while the Government argued that the costs should be added to the basis of the land and not amortized. The court ruled that the costs were "most closely related" to the construction of a new building on the land and allowed amortization over the useful life of the building.

[30] Section 263(b) denies a deduction for expenditures for advertising or promotion of goodwill if a corporation has elected to treat those expenditures as capital improvements for purposes of determining its excess profits tax credit. Section 263(c) permits a taxpayer to elect to deduct intangible drilling and development costs in the case of oil and gas wells. Section 263(e) permits a taxpayer to elect to expense the costs of rehabilitating certain railroad rolling stock if such rehabilitation expenditures in any given year do not exceed 20% of the basis of the property. Section 263(f), discussed in text at notes 72-74 infra, provides that the Secretary may by regulation permit taxpayers to elect to expense repairs and improvements to depreciable property to the extent of a prescribed "repair allowance." Section 173 provides for the deduction of expenditures to "establish, maintain, or increase" the circulation of a periodical unless the taxpayer elects to capitalize so much of such costs as are chargeable to capital account pursuant to Treas. Reg. § 1.173-1(c) (1973). The election does not apply to the costs of acquiring circulation through the purchase of any part of the business of another publisher. This exception appears to be an application of the principle that the purchase price of an asset is generally not deductible although the cost of developing a similar asset may be. In Triangle Publications, Inc., 54 T.C. 138 (1970), acquiesced in, 1972-2 Cum. Bull. 3, the Tax Court held that § 173 may apply to purchased circulation lists and to the purchase of the business of a company that is a mere "distributor" rather than a "creator," a very questionable interpretation of the statute. Section 174(a) permits a taxpayer to expense research or experimental expenditures in connection with a trade or business. Farmers may elect under §§ 175, 180 and 182 to expense certain costs of soil and water conservation, fertilizer and clearing land.

section 266, which permits a taxpayer to elect to capitalize certain taxes and carrying charges, is of particular interest, since the provision in the regulations under that section granting permission to capitalize items "otherwise deductible" that are "under sound accounting principles, chargeable to capital account,"[31] shows that the rules concerning capitalization, pervasive though they may be, allow some items that should be capitalized to be expensed.[32]

Recognition that capitalization is a basic principle of income taxation rather than a technical requirement imposed by specific statutory language may help to avoid the error of looking for the answers to close questions concerning capitalization in the words of the Code. Undue attention to the language of section 263 has led at least one court to permit expensing of an item that clearly should have been capitalized. In *Idaho Power Co. v. Commissioner,*[33] the

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Section 249 requires corporations to capitalize premiums paid on repurchase of convertible debt instruments to the extent the premiums are attributable to the conversion feature rather than to the cost of borrowing. Section 250 permits deduction of payments by railroads to the National Railroad Passenger Corporation if the railroad does not receive stock in connection with the payment. Section 266 permits a taxpayer to elect to capitalize taxes and carrying charges specified in the Regulations. Section 268 denies a deduction for the costs of unharvested crops sold by the taxpayer. Section 272 limits the deductibility of the costs of disposal of coal or iron ore under the circumstances described in § 631(c). Section 278 requires capitalization of certain costs of planting and developing citrus and almond groves. Section 616 provides for the deduction of the costs of developing a mine except to the extent the taxpayer elects otherwise. Section 617 permits a taxpayer to elect to deduct certain costs of exploring for minerals other than oil and gas. Section 1253(d) governs capitalization of amounts paid for franchises, trademarks and trade names.

Closely related to the provisions permitting the deduction of costs that would normally have to be capitalized are the provisions for recovery through depreciation or amortization of costs over a shorter period than would normally be the case, such as § 169 (cost of pollution control facilities), § 174(b) (research and experimental expenditures), § 177 (trademark and trade name expenditures), § 184 (railroad rolling stock), § 185 (railroad grading and tunnel bores), § 187 (coal mine safety equipment), § 188 (on-the-job training and child care facilities), § 248 (corporate organizational expenditures) and § 1253(d) (franchises).

[31] Treas. Reg. § 1.266-1(b)(1)(iv) (1973).

[32] Compare the Administration's proposal for a "Limitation on Artificial Accounting Losses" ("LAL"), which would in certain cases involving "tax shelters" defer deduction of certain items until the years in which income related to those items is realized. Since the function of tax accounting is primarily the determination of the proper year for reporting income and deductions, the very existence of losses that are "artificial" and that are attributable to accounting rules demonstrates that something is wrong with those rules. The Administration's general explanation of the proposed Limitation on Artificial Accounting Losses states that tax shelter devices "take advantage of basic tax accounting rules as well as intended tax incentives which contemplate some deferral of tax . . . ." CCH 1973 Stand. Fed. Tax Rep. No. 24 (pt. II), at 95 (May 2, 1973). For a criticism of § 1251, a recapture provision that is somewhat similar to the proposed LAL provisions in that it deals with items that should be capitalized not by requiring capitalization but by establishing a special account for the improper deductions, see Bittker, Objectives and Approaches to Tax Reform and Simplification, in Panel Discussions Before the House Comm. on Ways and Means (pt. I), 93d Cong., 1st Sess. 122, 127-28 (1973).

[33] 477 F.2d 688 (9th Cir. 1973), cert. granted, 42 U.S.L.W. 3270 (U.S. Nov. 5, 1973).

Ninth Circuit held that depreciation on equipment used to construct assets for use in the taxpayer's business did not have to be capitalized as part of the cost of those assets. The court reasoned that depreciation is not "paid out" within the meaning of section 263(a)(1). As an interpretation of the phrase "paid out" the *Idaho Power* decision is highly questionable, since depreciation deductions are, as a general rule, deductions for money spent by the taxpayer for the depreciable property, delayed until the proper period by the mechanics of the capitalization and depreciation provisions,[34] and so represent amounts that are no less "paid out" than any other business expense.[35] But the *Idaho Power* court erred not only in its interpretation of the statute but also in its assumption that the wording of section 263(a) was controlling. The capital expenditure requirement is broader than any one Code section.[36]

[34] See Announcement 71-76, 1971 Int. Rev. Bull. No. 1971-34, at 29: "The depreciation deduction is allowed in order that taxpayers may treat as an expense in determining taxable income an allocable part of the costs of business assets which have a limited life."

[35] There is some authority, however, for the view that depreciation is not "paid" for purposes of the medical expense and charitable contribution deductions. See Orr v. United States, 343 F.2d 553 (5th Cir. 1965); Clinton H. Mitchell, 42 T.C. 953 (1964); Maurice S. Gordon, 37 T.C. 986 (1962); Weary v. United States, 73-2 U.S. Tax Cas. ¶ 9646 (D. Kan. July 16, 1973); Rev. Proc. 70-24, 1970-2 Cum. Bull. 505; Rev. Rul. 58-279, 1958-1 Cum. Bull. 145. The argument of the taxpayer in *Orr* that the requirement of payment in § 170 was intended to affect timing of a deduction rather than the amount of the deduction seems sound.

[36] Another reason given for allowing the deduction in *Idaho Power* was that depreciation is allowable in order to permit the taxpayer to accumulate a reserve for replacement of the equipment that is depreciating. But the deduction for depreciation is not ultimately a deduction "for" a reserve or even "for" wear and tear; it is a deduction "for" the money that has been spent to acquire the asset being depreciated. As Judge Davis, dissenting in Chicago, Burlington & Quincy R.R. v. United States, 455 F.2d 993, 1023 (Ct. Cl. 1972), observed: "Depreciation reflects the cost of an existing capital asset, not the cost of a potential replacement." Id. at 1025 (dissenting opinion). The Supreme Court endorsed Judge Davis' reasoning in reversing this case, thus authoritatively laying to rest the "reserve" theory of depreciation in tax cases. See 412 U.S. 401, 415 (1973). Even under the "reserve" theory of depreciation, *Idaho Power* is wrong, since the reserve the taxpayer needs to replace assets used in his business would be adequately provided for by depreciation of the cost of the transmission and distribution facilities constructed with the equipment. It is these assets, not the construction equipment, that the taxpayer needs to replace to continue his business. Had the taxpayer in *Idaho Power* purchased its transmission and distribution facilities, their entire cost would have been capitalized, and there is no sound reason for requiring capitalization of less than that cost merely because the taxpayer chose to construct the facilities rather than to buy them intact. The Court of Claims and the Tax Court have required capitalization of depreciation on equipment used in constructing capital assets. Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969); Idaho Power Co., 29 CCH Tax Ct. Mem. 383 (1970), rev'd, 477 F.2d 688 (9th Cir.), cert. granted, 42 U.S.L.W. 3270 (U.S. Nov. 5, 1973). Great Northern Ry., 30 B.T.A. 691 (1934), which reached a contrary result, should no longer be regarded as authoritative. That case proceeded upon the theory that the deduction should be allowed because the depreciable equipment was used in the taxpayer's trade or business, an approach to capitalization that would seem to permit expensing of all the costs of capital assets so long as the taxpayer's business included constructing such assets. There is no apparent reason for trying to solve capitalization problems by determining the scope of the taxpayer's trade or business.

II. CAPITALIZATION AS A "METHOD OF ACCOUNTING": DEDUCTIBLE COSTS THAT PRODUCE ASSETS

The nondeductibility of the cost of an asset can be explained as a reflection of the requirement that a taxpayer account for income and deductions in a manner that clearly reflects his income. In many cases a current deduction for the cost of an asset would distort income because that cost should be matched with the income of the years in which the asset is used in the taxpayer's business. But there are instances in which even the costs of assets are deductible, provided the distortion in income as a result of the deduction is not serious. In effect, a determination of whether capitalization of an expenditure is necessary to clearly reflect income is substituted for the usual process of determining whether the expenditure produces an asset. One example is the purchase of small items, where the Court of Claims has expressly recognized the test of whether a deduction clearly reflects income as a substitute for the *Lincoln Savings & Loan* inquiry of whether the expenditure produces or enhances an asset. Another is the deductibility of the cost of repairs, though the inconsistency of the repairs deduction with the requirement that the costs of assets be capitalized has not been generally recognized. The legitimacy of the inquiry into clear reflection of income in these cases is based upon treatment of capitalization as a problem of determining the proper method of accounting for particular items.

The provisions in the regulations under section 446 defining "change in the method of accounting" in a way that includes a change in a practice of expensing the costs of a class of items[37] do not necessarily mean that capitalization questions are to be decided by considering, in a given case, whether capitalization is necessary in order to clearly reflect income,[38] or whether it will permit deduc-

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[37] Treas. Reg. § 1.446-1(e)(2)(ii)(a) (1973) defines "change in the method of accounting" to include a "change in the treatment of any material item." "Material item" is defined as "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." Id. Although some changes involving timing, such as adjustments to the useful lives of depreciable assets, are not treated as accounting method changes on the ground that such changes have "traditionally" been dealt with by adjustments in the year of change and future years, a change from consistent treatment of the cost of a class of assets as an expense to capitalization is said in Treas. Reg. § 1.446-1(e)(2)(ii)(b) (1973) to be a change in the method of accounting.

Treas. Reg. § 1.446-1(a)(4)(ii) (1973), which requires a taxpayer to classify expenditures between capital and expense, is a record-keeping requirement, not a rule requiring determination of capitalization questions as matters of clear reflection of income.

Treas. Reg. §§ 1.461-1(a)(1), -1(a)(2) (1973), providing that expenditures that "[result] in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year" are not deductible, are at best neutral on this point.

[38] Int. Rev. Code of 1954, § 446(b).

tions to be taken in the "proper taxable year."[39] Treatment of capitalization changes as accounting method changes to determine whether the Commissioner's consent to a change in practice is required[40] or whether errors for years barred by the statute of limitations are to be corrected by adjustments under section 481 rather than through the mitigation provisions of sections 1311-14[41] does not require resort to the general accounting method principles of sections 446 and 461 for all purposes if other Code provisions answer timing questions specifically. There are many situations where timing problems are dealt with specifically and exclusively by rules other than those of the accounting sections.[42] It is at least arguable that a capitalization practice is not a "method of accounting" when the issue is whether a particular item should be capitalized, even though the practice is a "method of accounting" when the issue involves the consequences of a change in the practice. Or it can be said that even though capitalization is a method of accounting, the general search for a clear definition of income must be conducted within the limits of section 263 and section 162 or 212.[43] What little authority there is on this question, however, supports the direct use of sections 446 and 461 in dealing with capitalization questions, at least in cases where an expenditure does produce an asset.

In *Fort Howard Paper Co.*[44] the taxpayer contended that its practice of allocating only direct costs to self-constructed assets was permissible because the method clearly reflected income and had been followed consistently for thirty-five years. The Tax Court rejected the Commissioner's contention that section 263 was "in and of itself dispositive of the issue,"[45] and, finding sections 263 and 446 "inextricably intertwined" and being unwilling to "encase the general provisions of section 263 with an inflexibility and sterility neither mandated to carry out the intent of Congress nor required for the effective discharge of respondent's revenue-collecting

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[39] Int. Rev. Code of 1954, § 461(a).

[40] Int. Rev. Code of 1954, § 446(e).

[41] See Oklahoma Gas & Elec. Co. v. United States, 464 F.2d 1188 (10th Cir. 1972); Rev. Rul. 64-74, 1964-1 Cum. Bull. pt. 1, at 314; Liles, Adjustments Dictated by Treasury Requirements: Statutory Relief Provisions; Correlative Adjustments; Effect of Adjustments on Future Years, N.Y.U. 26th Inst. on Fed. Tax. 595, 601 (1968).

[42] For example, § 214 in effect puts taxpayers on an accrual basis with a one-month accounting period for purposes of determining the monthly limitation on the dependency care deduction. Bittker, supra note 32, at 119. No one would contend that such specific rules as these can be overridden by the general language of §§ 446 and 461.

[43] Both of these arguments were advanced without success by the Government in Cincinnati, N.O. & Tex. Pac. Ry. v. United States, 424 F.2d 563 (Ct. Cl. 1970).

[44] 49 T.C. 275 (1967).

[45] Id. at 283.

responsibilities,"[46] treated the problem as one arising under section 446 and held that, under the particular circumstances of the case, the taxpayer's accounting method clearly reflected its income.[47]

The use of clear reflection of income principles in a case like *Fort Howard* is not necessarily inconsistent with viewing capitalization as a fixed requirement of section 263, since the issue in *Fort Howard* was one of what costs were to be allocated to what was clearly a capital asset, a problem not expressly covered by section 263, which, as the court observed, "begs the question"[48] by requiring capitalization of amounts paid out "for" new buildings or improvements. But in *Cincinnati, New Orleans & Texas Pacific Ry. v. United States*[49] the Court of Claims, faced with a clear choice between deciding a capitalization case under section 263 or under section 446, chose the latter. The taxpayer, whose financial statements were prepared in compliance with the Interstate Commerce Commission's "General Instructions of Accounting Classifications," followed the ICC's "minimum rule" of expensing all purchases of property costing less than $500 other than land, track and railroad cars.[50] The Commissioner disallowed expense deductions for items

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[46] Id. at 283-84.

[47] The result of *Fort Howard* may be attributable to some extent to the strong equities favoring the taxpayer, whose returns had been audited every year for 33 years without challenge to its accounting practice, and whose method of allocating costs had frequently been used by the examining agents themselves in computing allowable deductions. The Internal Revenue Service changed its position as a result of investigating alleged "irregularities" in the conduct of one of the revenue agents who had examined the taxpayer's returns. The investigation disclosed that no "irregularities" had in fact occurred, but the investigating agent proposed that the taxpayer's method of allocating costs to self-constructed assets be challenged. Id. at 279-80. The court's opinion carefully limits its holding to the particular facts of the case, including the application of the taxpayer's allocation method by the Commissioner in making adjustments to the taxpayer's income, "as distinguished from . . mere failure to object to its use by such taxpayer." Id. at 286. Several cases citing *Fort Howard* have, in the manner of the devil quoting scripture, adopted its reasoning while reaching results that are inconsistent with *Fort Howard* unless one is willing to accept rather tenuous distinctions. See Lincoln Elec. Co., 54 T.C. 926 (1970), aff'd, 444 F.2d 491 (6th Cir. 1971); All-Steel Equip., Inc., 54 T.C. 1749 (1970), rev'd in part on other grounds, 72-2 U.S. Tax Cas. ¶ 9660 (7th Cir. 1972); cf. Electric & Neon, Inc., 56 T.C. 1324 (1971); Alabama Coca-Cola Bottling Co., 28 CCH Tax Ct. Mem. 635 (1969).

The taxpayer in William K. Coors, 60 T.C. No. 44 (June 12, 1973), argued that *Fort Howard* authorized its practice of expensing or allocating to costs of goods sold certain indirect costs of constructing capital assets. The Tax Court distinguished *Fort Howard* on the basis of its finding in that case that the taxpayer's capital assets were constructed by employees in their spare time, so that the construction did not interfere with the employees' maintenance tasks, and the contribution of the employees to the costs of the assets was in effect zero, since no costs (other than direct costs) were incurred beyond those that would have been incurred had no construction taken place.

[48] 49 T.C. at 283.

[49] 424 F.2d 563 (Ct. Cl. 1970).

[50] The "minimum rule" also prohibited combining unrelated items to circumvent the requirement that small items be expensed, and dividing up large purchases to avoid capitalization. Id. at 56566.

costing more than $100 each. In upholding the taxpayer's practice, the court rejected the government's argument that the predecessor of section 263 was solely determinative, calling this "an argument for an inflexible objective, *ipso facto* approach" to capitalization.[51] Citing *Fort Howard* for the proposition that the accounting sections are "inextricably intertwined" with section 263, the court treated the question as one of clear reflection of income, and allowed a deduction for the cost of the "minimum rule" items. *Cincinnati Ry.* is thus one example of a case in which a cost that produces an asset is nevertheless deductible.

The problem of whether expensing small items distorts income may be approached either by considering whether the practice will, for taxpayers in general, be likely to distort income, or by considering whether the practice has, in the case of the particular taxpayer involved, distorted income. The *Cincinnati Ry.* opinion adopts both of these approaches to some extent. The court's finding that the "minimum rule" was acceptable to accountants and to the Interstate Commerce Commission[52] implies that the practice is acceptable per se. The court went on, however, to consider the amount of distortion involved for the particular taxpayer, a problem that involves two distinct views of the meaning of "clear reflection of income."

If one looks to a single purchase of a capital asset it is clear that expensing the purchase price distorts income to some extent, since the cost of an asset that will produce income for several years will be deducted only in the year of purchase. If, however, the taxpayer has a number of capital assets, which he replaces regularly, expensing the purchase price of those assets may lead to approximately the same deductions as capitalization and depreciation. Thus a taxpayer whose business requires the use of ten widgets, each costing $100 and having a useful life of five years, would, if he capitalized the purchase price of the widgets, take depreciation of $200 per year.[53] This is the same amount as the purchase price of two widgets, the number that would, on the average, have to be replaced each year. In this example, expensing the purchase price of the widgets leads to the same deduction as capitalization, so long as the number and cost of the widgets remains constant (a somewhat unrealistic assumption for an expanding business in an inflationary period).

Another approach to determining whether income is seriously distorted by expensing the cost of small items involves comparing the amount of the excess deduction obtained by expensing the item with the total amount of income involved. Thus a taxpayer who

[51] Id. at 567.
[52] Id. at 569-70.
[53] This figure represents straight-line depreciation and assumes no salvage value.

uses one widget of the kind described above and expenses its cost will have his income reduced by $100 in the year a widget is purchased and increased by $20 in each of the five years in which the widget is used. This is a distortion, but if the taxpayer's annual income is one million dollars, the distortion is not a very serious matter.

The Court of Claims' approach to the "clear reflection of income" problem in *Cincinnati Ry.* adopts both of the aforementioned views of the meaning of that phrase. The court found it "significant that, both on a year-to-year basis and on a 17-year overall basis," the expenses deductible under the "minimum rule" were "fairly similar" to the depreciation that would have been taken if the costs in question had been capitalized.[54] The comparison on a seventeen-year basis is not very meaningful, since it establishes only that depreciation over a substantial period of time will approach the cost of the assets being depreciated, a point that does not require proof by statistical comparisons.[55] The year-by-year similarity between depreciation and minimum rule expenses shows that the income figure produced under the minimum rule is close to the "true" income figure. The court went on to compare the expenses in question with the taxpayer's yearly operating expenses, its net income and its total investment, and, finding that the minimum rule expenses were relatively small and that the Commissioner's computations would have increased the taxpayer's income by a relatively small amount, allowed the deductions. This kind of comparison, unlike the comparison between the minimum rule expenses and the depreciation that would have been taken if minimum rule items had been capitalized, does not tend to show that the minimum rule produces no distortion in income, but rather shows that the distortion is small in relation to the total income involved. That is to say, a method of accounting is acceptable for tax purposes even though it distorts income, if the distortion is small in relation to the total amount of income.

The holding of *Cincinnati Ry.* is consistent with the regulatory provisions and administrative practices permitting deduction of the costs of small items of property which, strictly speaking, should be capitalized because the property has a useful life beyond the taxable year.[56] Thus farmers may deduct the cost of small tools,[57] professional persons may deduct the cost of "books, furniture, and profes-

[54] 424 F.2d at 571.

[55] The assets in question were assumed to have a useful life of about ten years.

[56] Indeed, the Internal Revenue Service had, in auditing the returns of the taxpayer in *Cincinnati Ry.*, allowed the deduction of purchases of less than $100, the limit of the ICC's minimum rule until 1940. 424 F.2d at 572.

[57] Treas. Reg. § 1.162-12 (1973).

sional instruments and equipment, the useful life of which is short,"[58] and those who have to wear uniforms may deduct their cost.[59] In none of these cases will a current deduction reflect income more clearly than would capitalization and depreciation, but the burden on the taxpayer of accounting for such costs through capitalization and depreciation would not justify the small increase in the accuracy of determining taxable income that would result from capitalization.[60] *Cincinnati Ry.* differs from the above situations only in that the determination that the inconvenience of requiring capitalization outweighs the accuracy in computing income is made by looking directly at the amount of the expense rather than by considering the nature of the assets purchased. The only serious problem with the *Cincinnati Ry.* rule may be in establishing its boundaries. A de minimis rule that can be applied only by a taxpayer who can support the practice by the preparation of a statistical analysis and the expert testimony of accountants is not likely to achieve convenience for either the taxpayer or the Internal Revenue Service. The *Cincinnati Ry.* opinion relies to such a great extent on the particular facts of that case that the case may not even hold that all taxpayers subject to the Interstate Commerce Commission's minimum rule may use that rule for tax purposes, and the case is certainly not authority for the expensing of costs of less than $500 by taxpayers who are not required to do so by a regulatory agency. The Court of Claims' suggestion that the Treasury adopt by regulation minimum rules for classes of taxpayers whose circumstances warrant such treatment[61] seems sound.

It is useful to consider the problem of distinguishing deductible repairs from nondeductible "improvements" in light of the *Cincinnati Ry.* approach to clear reflection of income. There have been hundreds of cases involving the "repairs vs. improvements" puzzle, but for the purposes of this discussion it is necessary to consider only one example. The cost of replacing a roof is a capital expenditure, while the cost of replacing a shingle is a repair.[62] This distinction is

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[58] Treas. Reg. § 1.162-6 (1973).

[59] Rev. Rul. 70-474, 1970-2 Cum. Bull. 35.

[60] "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." Cincinnati, N.O. & Tex. Pac. Ry. v. United States, 424 F.2d 563, 572 (Ct. Cl. 1970).

[61] Id. The American Law Institute, in ALI Fed. Income Tax Stat. § X166(b)(2) (Feb. 1954 Draft), provides for an election to expense "[a]ny aggregate expenditure the amount of which is $500 or less."

[62] The example is taken from Shugerman, Basic Criteria for Distinnguishing Revenue Charges from Capital Expenditures in Income Tax Computations, 49 Mich. L. Rev. 213, 231 (1950).

not attributable to any difference in kind between what is produced by the two kinds of expenditure. No distinction can be made by looking to the creation or enhancement of an asset, since the repair both produces one (the shingle) and enhances one (the roof).[63] Nor can a distinction be found by focusing upon the function of capitalization as a mechanism for deferral of costs that are properly considered to contribute to earning income in future years, since repairs and even maintenance are essential to preserving the asset involved so that it can earn that income. The only meaningful differences between the deductible repair and the nondeductible improvement are that the repair involves a small amount of money and is the kind of cost that will have to be repeated frequently, while the improvement involves a large amount of money and is not likely to be repeated on a more or less annual basis. Of these distinctions, the one involving the amount of the expenditure is perhaps the more significant; virtually no authority has been found allowing the expensing of the costs of what are normally considered improvements rather than repairs on the ground that improvements are made regularly.[64] Repairs, then, are deductible for the same reason the minimum rule expenses in *Cincinnati Ry.* were deductible: they involve relatively small amounts of money.

The regulations concerning repairs provide that "[t]he cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition" is deductible.[65] This language may be consistent with the view that repairs are deductible because they are inexpensive, if one focuses on the words "materially" and "appreciably." The regulations, however, emphasize the result of the repair

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[63] The view of capital expenditures as costs that produce an asset might suggest a distinction between maintenance and improvements, on the ground that maintenance does not produce anything new. But the line between deductibility and nondeductibility has always been drawn so as to allow a deduction for the cost of repairs.

[64] But cf. Great Northern Ry., 30 B.T.A. 691 (1934).

[65] Treas. Reg. § 1.162-4 (1973). In Illinois Merchant Trust Co., 4 B.T.A. 103, 106, acquiesced in, V-2 Cum. Bull. 2 (1926), the following language was used to distinguish repairs from "replacements":

> In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure is made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

or improvement rather than the amount of the expense. While some correlation between the two may be expected, it is not inevitable that an expensive undertaking will result in a significant increase in the value of the asset involved. One troublesome problem in the repair-improvement area is that of the major effort to achieve a minor result. For example, in *Oberman Manufacturing Co.*[66] the taxpayer had to remove a roof in order to replace an expansion joint and stop the roof from leaking. The Tax Court, finding that the work did not add materially to the value of the building, allowed the deduction. If the true distinction between repairs and improvements rests on the amount and the routine nature of the expenditure, *Oberman Manufacturing Co.* and similar cases[67] are wrong. A number of cases require capitalization of *Oberman*-type expenditures if the improvement adds a new and distinct asset to the building[68] or adapts the building to a new use.[69] It is not self-evident that this is a sensible distinction, though it is found throughout the capitalization area.[70] The ultimate issue is whether deferral of a deduction is

[66] 47 T.C. 471 (1967), acquiesced in, 1967-2 Cum. Bull. 3.

[67] E.g., United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968) (Government not entitled to directed verdict that $97,000 of work done on a building must be capitalized); Plainfield-Union Water Co., 39 T.C. 333 (1962), nonacquiesced in, 1964-2 Cum. Bull. 8; Regenstein v. Edwards, 121 F. Supp. 952 (M.D. Ga. 1954); Kansas City S. Ry. v. United States, 112 F. Supp. 164 (Ct. Cl. 1953); Midland Empire Packing Co., 14 T.C. 635 (1950), acquiesced in, 1950-2 Cum. Bull. 3; American Bemberg Corp., 10 T.C. 361 (1948), nonacquiesced in, 1948-2 Cum. Bull. 5, aff'd mem., 177 F.2d 200 (6th Cir. 1949); Rev. Rul. 54-356, 1954-2 Cum. Bull. 82.

[68] E.g., Woolrich Woolen Mills v. United States, 289 F.2d 444 (3d Cir. 1961) (cost of constructing a filtering plant; irrelevant that the plant does not help the taxpayer produce anything); Hotel Sulgrave, Inc., 21 T.C. 619 (1954) (cost of sprinkler system installed in hotel); Trenton-New Brunswick Theatres Co., 13 CCH Tax Ct. Mem. 550 (1954) (cost of constructing a fire passageway in a theater; taxpayer argued that the expenditure decreased the value of the theater).

[69] E.g., Coors Porcelain Co., 52 T.C. 682 (1969), aff'd, 429 F.2d 1 (10th Cir. 1970); Difco Laboratories, Inc., 10 T.C. 660 (1948), acquiesced in, 1948-2 Cum. Bull. 1; Rev. Rul. 71-469, 1971-2 Cum. Bull. 120 (cost of converting utility's customers' steam heating equipment to gas equipment held capital, although change did not increase the number of utility's customers).

[70] Thus Welch v. Helvering, 290 U.S. 111 (1933), which held that voluntary payment by an officer of a bankrupt corporation of the corporation's debts in order to "solidify his credit and standing" was not "ordinary," has been distinguished by a number of lower courts, which have allowed a deduction for similar payments upon a finding that the payments were made to protect rather than enhance the taxpayer's existing business or reputation. See, e.g., Allen v. Commissioner, 283 F.2d 785 (7th Cir. 1960); Lutz v. Commissioner, 282 F.2d 614 (5th Cir. 1960); Dunn & McCarthy, Inc. v. Commissioner, 139 F.2d 242 (2d Cir. 1943); Scruggs-Vandervoort-Barney, Inc., 7 T.C. 779 (1946); Edward J. Miller, 37 B.T.A. 830 (1938). Judge Raum's opinion in Carl Reimers Co., Inc., 19 T.C. 1235 (1953), aff'd, 211 F.2d 66 (2d Cir. 1954), may be read as suggesting that the distinction between these cases and *Welch* is unsound.

Similarly, until the enactment of the predecessor of § 173, the deductibility of payments relating to the circulation of a publication turned upon whether the payments were made to maintain existing circulation or to increase circulation. Willcuts v. Minnesota Tribune Co., 103 F.2d 947 (8th Cir.), cert. denied, 308 U.S. 577 (1939); Perkins Bros. Co. v. Commisdesirable as a matter of matching income with deductions. Whether a construction-type expense enables a taxpayer to earn future income in a new and different way rather than in the same way he has been earning income in the past seems irrelevant.[71] The distinction may stem from the use of the term "improvements," which has connotations of something new and different, to describe the costs that must be capitalized.

An approach somewhat similar to the "minimum rule" has been authorized by statute in the case of repairs. Section 263(f) authorizes regulations to permit a taxpayer to elect to deduct amounts paid for repairs, rehabilitation or improvements for a class of property to the extent such amounts do not exceed a "repair allowance" for that class.[72] The legislative history of section 263(f) indicates that costs that are "clearly of a capital nature" must be capitalized notwithstanding an election to use the repair allowance,[73] a rule that creates two categories of capital expenditures, "improvements," which have always been considered capital expenditures but which now may be expensed within the limits of the repair allowance, and "clearly capital" expenditures, which must be capitalized in any case. Some capital expenditures are thus more capital than others, though the distinction between the two classes is not readily apparent. Because the use of section 263(f) is elective, that provision's stated objective

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sioner, 78 F.2d 152 (8th Cir. 1935); Public Opinion Publishing Co. v. Jensen, 76 F.2d 494 (8th Cir. 1935); Meredith Publishing Co. v. Commissioner, 64 F.2d 890 (8th Cir.), cert. denied, 290 U.S. 646 (1933); News Publishing Co. v. Blair, 29 F.2d 955 (D.C. Cir. 1928); Journal of Living Publishing Corp., 3 T.C. 1058 (1944); Reuben H. Donnelley Corp., 26 B.T.A. 107 (1932); Walter S. Dickey, 14 B.T.A. 1295 (1929), acquiesced in, IX-1 Cum. Bull. 15 (1930).

Compare the regulations concerning the deductibility of educational expenditures ("an inseparable aggregate of personal and capital expenditures"), which allow a deduction for the costs of maintaining or improving skills required in an existing trade or business of the taxpayer, but not for the cost of qualifying the taxpayer for a new trade or business. Treas. Reg. § 1.162-5 (1973).

The search for "newness" may derive in part from the unfortunate tendency to confuse the question whether an expenditure is a capital expenditure with the question whether an expenditure is incurred in carrying on a trade or business. See text at notes 174-82 infra.

[71] Some support can be found for requiring capitalization of only those costs that increase the taxpayer's earning capacity. See, e.g., Marsh Fork Coal Co. v. Lucas, 42 F.2d 83 (4th Cir. 1930), and the excellent discussion of that case in Note, Income Tax Accounting: Business Expense or Capital Outlay, 47 Harv. L. Rev. 669 (1934). Although the comments to the capital expenditure provisions of the American Law Institute's Federal Income Tax Statute indicate acceptance of the theory of the *Marsh Fork* case—see ALI Fed. Income Tax Stat. § X166(b), comment 3 at 287-88 (Feb. 1954 Draft)—that principle is not uniformly followed, nor should it be. See Note, supra, at 675-77.

[72] Treas. Reg. § 1.167(a)-11(d)(2) (1973). For a criticism of the Treasury's issuance of the Asset Depreciation Range System, of which the repair allowance system is a part, without specific statutory authority, see Bittker, Treasury Authority to Issue the Proposed "Asset Depreciation Range System" Regulations, 49 Taxes 265 (1971). Repair allowances for some classes of property have been established by Rev. Proc. 72-10, 1972 Int. Rev. Bull. No. 8, at 13.

[73] S. Rep. No. 92-437, 92d Cong., 1st Sess. 51 (1971).

of resolving disputes is achieved only by conceding a class of close cases to taxpayers, and no simplification in bookkeeping is likely to result, since a taxpayer will have to determine whether his expenditures are repairs or improvements or "clearly capital" improvements in order to determine whether election to use the repair allowance system is desirable. The provision as it presently exists thus achieves no readily apparent desirable goal, though a mandatory guideline allowance for repairs could achieve considerable simplification,[74] and would be consistent with the policies underlying the deductibility of repairs.

Although no other case has gone so far as *Cincinnati Ry.* in substituting a search for clear reflection of income for consideration of whether an expenditure produces an "improvement or betterment," there is an evident tendency in the recent cases to discuss capitalization questions in accounting method language. Thus, in *Electric & Neon, Inc.*,[75] the taxpayer defended its practice of currently deducting the cost of signs it built and leased on the ground that its practice had been consistently followed and clearly reflected income. The Tax Court met the clear reflection of income argument directly and held for the Commissioner because the taxpayer's practice "demonstrably produced serious inaccuracies in the year-by-year computation of income"[76] and was contrary to industry practice and to the method which the Accounting Principles Board had said was generally used by lessors.[77] That the inquiry into whether the cost of the signs had to be capitalized was one involving the choice of an acceptable accounting method was not questioned. In *Alabama Coca-Cola Bottling Co.*,[78] the Commissioner conceded that requiring the taxpayer to capitalize the cost of self-constructed signs effected a change in accounting method, and the court's decision in favor of the Commissioner was based on the necessity of capitalization in order to reflect clearly the taxpayer's income. In *Mountain Fuel Supply Co. v. United States*,[79] a case involving the classification of the costs of rehabilitation of a pipeline as repairs or improvements, the Tenth Circuit seems to have accepted the taxpayer's contention that requiring capitalization would amount to changing its method of accounting, while upholding the Government's contention that the change was required. And in *William K. Coors*,[80] the Tax Court

[74] See 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 356 (1972) [hereinafter cited as S. Surrey].

[75] 56 T.C. 1324 (1971).

[76] Id. at 1333.

[77] Id.

[78] 28 CCH Tax Ct. Mem. 635 (1969).

[79] 449 F.2d 816 (10th Cir. 1971), cert. denied, 405 U.S. 989 (1972).

[80] 60 T.C. No. 44 (June 12, 1973).

treated the choice of a method of allocating overhead costs to self-constructed assets as a problem of clear reflection of income.

That there is an increasing tendency to regard capitalization questions as clear reflection of income problems seems evident. Whether this trend is desirable depends upon the use the courts make of the flexibility that the accounting method approach gives. "Flexibility" is the sort of thing that sounds desirable, particularly if the alternative is described as "sterile,"[81] "rigid,"[82] "ipso facto"[83] or "arbitrary."[84] Still, the major part of the Internal Revenue Code consists of specific rules that deny flexibility to the courts, suggesting that Congress, at least, does not always consider flexibility a virtue.[85] The results of the capitalization cases discussed above are acceptable, at least if *Fort Howard* is limited to its peculiar facts, as the Tax Court's opinion suggests it will be.[86] Attempts by taxpayers to justify expensing a variety of capital expenditures on the ground that they have always done so and thus are practicing the accounting virtue of "consistency" have been rejected;[87] "consistency," the Tax Court has said, "is not a substitute for correctness."[88] There are some disturbing hints in the recent cases, however, of a tendency to defer unduly to the opinions of accountants in capitalization cases. Although the Supreme Court has pointed out that financial accounting rules are not necessarily applicable in tax cases, even when the

[81] See Fort Howard Paper Co., 49 T.C. 275, 283 (1967).

[82] See Cincinnati, N.O. & Tex. Pac. Ry. v. United States, 424 F.2d 563, 569 (Ct. Cl. 1970).

[83] See id. at 567.

[84] See United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968).

[85] Much of this detail, of course, is a congressional response not to excessive flexibility on the part of the courts, but rather to the failure of the courts to be flexible in applying the provisions of earlier, less intricate statutes. Cf. Judge Simpson's concurring opinion in International Trading Co., 57 T.C. 455, 463 (1971), rev'd, 73-2 U.S. Tax Cas. ¶ 9582 (7th Cir. 1973). The intricacies of the corporate reorganization provisions—§§ 306 and 341, and much of the estate and gift tax provisions—illustrate the congressional approach. In other areas, attempts at judicial flexibility have led to the enactment of inflexible Code provisions, even where Congress has approved the basic thrust of the court's approach, as in the "Clifford trust" provisions. See generally Brown, The Growing "Common Law" of Taxation, U. So. Cal. 1961 Tax Inst. 1; Lowndes, Federal Taxation and the Supreme Court, 1960 S. Ct. Rev. 222.

[86] 49 T.C. at 286-87.

[87] See cases discussed in text at notes 75-80 supra.

[88] Electric & Neon, Inc., 56 T.C. 1324, 1333 (1971) (Simpson, J.). For financial accounting purposes, consistency may at times be at least as important as correctness, since it is important that current financial data be comparable to earlier years' data so that users of the data may be able to determine whether the company's position is improving, declining or remaining the same. Therefore, at least in cases where it is questionable what the "best" rule is, it may be better for a company to apply an unsatisfactory rule consistently than to improve the accuracy of current financial statements at the cost of making comparison between those statements and earlier statements impossible. But there is no corresponding reason for failure to correct errors for tax purposes in order to achieve consistency.

rules are imposed upon a taxpayer by a regulatory agency,[89] the courts in both *Fort Howard* and *Cincinnati Ry.* relied to a considerable extent upon the evidence of accounting texts and the expert testimony of accountants. In *Cincinnati Ry.* the Court of Claims brushed aside the Supreme Court's holdings in *Schlude v. Commissioner*[90] and *American Automobile Association v. United States*[91] that the taxpayers' accounting methods, though in accordance with "generally accepted accounting principles," were unacceptable for tax purposes, by saying that the rule of those cases is applicable in "the limited context of the accounting for received but unearned income."[92] It is true that the prepaid income cases like *Schlude* and *American Automobile Association* involve problems that suggest the need for a different accounting rule for tax purposes than is proper for financial accounting purposes,[93] while no similar need for separate approaches is apparent in the capitalization area.[94] But even where it is reasonable to use the same rules for financial accounting purposes as for tax purposes it is neither necessary nor desirable that the courts abdicate their responsibility for seeing to it that the rules are sound by leaving the matter to the accountants. For one thing, it is probably undesirable to expose the accountants to the stresses of devising accounting rules with one eye on potential tax savings for their clients. One may suspect that the pressures of

[89] Old Colony R.R. v. Commissioner, 284 U.S. 552 (1932).

[90] 372 U.S. 128 (1963).

[91] 367 U.S. 687 (1961).

[92] 424 F.2d at 570.

[93] It may be desirable that the income tax be imposed when the taxpayer has the money to pay the tax, rather than in some later year when the money may have been spent. Cf. W. Andrews, Federal Income Taxation ¶ 41.23(c) (1969). For a contrary view, see Nolan, The Merit in Conformity of Tax to Financial Accounting, 50 Taxes 761, 768 (1972). The Regulations now permit accrual basis taxpayers to report advance income from the sale of goods when the income is considered earned for financial accounting purposes, Treas. Reg. § 1.451-5 (1973), and advance income for services performed in the following year may be reported in the year of performance, Rev. Proc. 71-21, 1971-2 Cum. Bull. 549. Generally speaking, a tax accounting rule that says that a taxpayer has not received income even though the transaction in question has given him substantial amounts of money seems somewhat out of touch with reality, just as the operation of the well-known real estate tax shelter, where depreciation on mortgaged property places the taxpayer in the happy position of having both losses and cash, is generally regarded as a loophole. Deferral of income until it is earned may be perfectly reasonable as a matter of financial accounting, but it does not necessarily follow that the tax accounting rule should be the same. The distinction between tax accounting and financial accounting in prepaid income cases was recognized in Curtis R. Andrews, 23 T.C. 1026, 1032-33 (1955).

[94] The existence of the income tax provides considerable pressure for expensing as much as possible, while non-tax considerations encourage capitalization. If the income tax requirement of capitalization were tied to flexible financial accounting principles, the result would undoubtedly be an increase in the tax burdens of taxpayers sensitive to pressures from shareholders and creditors, and a decrease in the tax burden of those who have no great need to present impressive financial statements.

the income tax have occasionally led to the acceptance of accounting rules having no obvious intrinsic merit, such as the LIFO method of accounting for inventories.[95] For the most part, the courts have done reasonably well in the accounting area, a circumstance that may explain the absence of detailed statutory rules concerning timing of income and deductions. While it is no doubt of some benefit to consider what accountants have to say about capitalization, the responsibility for devising the rules is, and should remain, upon the courts.

One illustration of the unfortunate consequences of uncritical acceptance of accounting theory is the distinction that seems to be developing between the rules for determining the cost of an asset when the issue is capitalization and the rules for determining the cost of an asset when that asset is an inventory item. It is well established that the prime cost method, which does not take into account overhead costs, is not acceptable for inventory accounting, either for tax purposes or for financial accounting purposes.[96] But in *Fort Howard* the Tax Court, in permitting the taxpayer to use a capitalization method that allocated no part of overhead to self-constructed capital assets, relied to a considerable extent on expert accounting testimony and accounting literature as establishing that failure to allocate part of overhead to the asset in question may be acceptable for assets other than inventory, though such a practice is erroneous in the case of inventory.[97] *Fort Howard* may well be distinguishable from the cases prohibiting prime costing of inventory (as well as from other capital expenditure cases) because of the peculiar facts of that case,[98] but it is unsound to base the distinction upon the asset's being inventory rather than something else, except perhaps to the extent that the regulations expressly require allocation of some overhead to inventory. In both cases the problem is the determination of the cost of an asset, and in both cases the reason for the importance of an accurate cost determination is that the cost is to be given effect for tax purposes in a period later than that in which it is incurred. There is no reason to apply different standards merely because the method of deferral is inventory accounting on the one hand and capitalization on the other. The apparent willingness of accountants to accept the distinction does not justify the courts' doing the same, particularly when the accountants have not

95 T. Fiflis & H. Kripke, Accounting for Business Lawyers 264 (1971).

96 See All-Steel Equip., Inc., 54 T.C. 1749 (1970), and authorities cited therein, id. at 1752-53.

97 49 T.C. at 285-86.

98 The Tax Court's finding in *Fort Howard* that the taxpayer's employees constructed capital assets only in their spare time in effect makes the prime cost method the same as the incremental cost method for that taxpayer. Id. at 283 n.4.

expressly required the application of different rules but rather have selected the proper practice for inventory accounting and have left the question open for capitalization.[99]

Since the accounting method provisions of the Code contain no specific rules applicable to capitalization, but merely urge the selection of practices that will "clearly reflect income," the importance of the courts' acceptance of capitalization as an accounting problem is more in the nature of the creation of attitudes toward capitalization than in any direct result that is required by the accounting method approach. Even the "flexibility" that the Court of Claims and the Tax Court have found to be a desirable consequence of treating capitalization as an accounting problem has been approved in cases approaching capitalization as a section 263 problem.[100] And there is no inherent lack of logic in treating capitalization as a method of accounting while limiting the application of capitalization to costs that produce or enhance an asset.

All of the cases discussed above involve the deductibility of expenditures that clearly produced assets. The converse of this situation, capitalization of costs that do not produce assets, has not yet been dealt with as an accounting method problem, though it is conceivable that continued treatment of capitalization as an accounting problem may someday lead to the creation of a climate of opinion in which the search for an asset in capitalization cases is replaced by consideration of whether capitalization is necessary to clearly reflect income. Another possibility, which will be examined below, is that the determination of whether particular expenses produce assets will, in close cases, turn upon clear reflection of income considerations.

III. CONSTRUCTION PERIOD EXPENSES

An examination of the treatment of construction period insurance and ground rent during construction may help to clarify the

[99] Another distinction between costing for inventory purposes and costing for capitalization purposes involves the treatment of storage charges for whiskey during the aging process. In George L. Schultz, 50 T.C. 688 (1968), aff'd, 420 F.2d 490 (3d Cir. 1970), the Tax Court required capitalization of such costs in the case of a taxpayer who purchased bulk whiskey as an investment, while the Court of Claims, in Heaven Hill Distilleries, Inc. v. United States, 476 F.2d 1327 (Ct. Cl. 1973), and the Seventh Circuit, in Van Pickerill & Sons, Inc. v. United States, 445 F.2d 918 (7th Cir. 1971), have held that such charges may be deducted currently where the whiskey was the taxpayer's inventory. Although the Seventh Circuit in *Van Pickerill* found *Schultz* "readily distinguishable," id. at 921, the opinions suggest that the "distinction" is attributable to the failure of the Seventh Circuit and the Court of Claims to accept the Tax Court's reasoning. Another consideration may be that the problem in the case of a speculator like the taxpayer in *Schultz* has overtones of reduction of capital gain by the taking of ordinary deductions, a factor that is not determinative but which, as Judge Tannenwald observed, "may erect a yellow caution signal on [the] road to decision." 50 T.C. at 694. These cases are discussed in text at notes 142-44 infra.

[100] E.g., American Seating Co., 4 B.T.A. 649 (1926).

relationship between the requirement that a cost be capitalized and the contribution of that cost to the production or enhancement of an asset. The "asset" requirement in capital expenditure cases has previously been described as a requirement that the costs "of producing" or "of enhancing" an asset be capitalized. But the cases discussed in this section establish that at least some costs associated with the construction of assets are capital expenditures even though those costs do not in and of themselves produce or enhance any asset. As a matter of clear reflection of income such costs as insurance during construction and ground rent should be capitalized. Capitalization of these costs is consistent with the asset theory of capital expenditures so long as the relationship between costs and assets necessary to support capitalization is broader than one of cause and effect. The cases support the capitalization of construction period insurance, but ground rent during construction is, for no apparent reason, deductible.

A. *Insurance*

A few cases have treated the capitalization of insurance during construction as one aspect of the broader problem of selecting and applying the proper overall cost accounting method of accounting for self-constructed assets,[101] but the usual approach has been to determine whether a particular insurance cost was a capital expenditure. Most of the authorities require capitalization of premiums for both liability and indemnity insurance during construction,[102]

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[101] See William K. Coors, 60 T.C. No. 44 (June 12, 1973); Fort Howard Paper Co., 49 T.C. 275 (1967); Ben Perlmutter, 44 T.C. 382 (1965), aff'd, 373 F.2d 45 (10th Cir. 1967).

[102] See, e.g., Herbert Shainberg, 33 T.C. 241 (1959), acquiesced in on other issues, 1960-1 Cum. Bull. 5; W.P. Brown & Sons Lumber Co., 26 B.T.A. 1192 (1932); Columbia Theatre Co., 3 B.T.A. 622 (1926), acquiesced in, VI-1 Cum. Bull. 2 (1927); Rev. Rul. 66-373, 1966-2 Cum. Bull. 103; cf. Maxwell R. Lenington, 25 CCH Tax Ct. Mem. 1350 (1966) (insurance premiums on buildings held for sale a capital expenditure). In Churchill Farms, Inc., 28 CCH Tax Ct. Mem. 990 (1969), rev'd in part on other grounds sub nom. Bayou Verret Land Co. v. Commissioner, 450 F.2d 850 (5th Cir. 1971), the Commissioner argued that liability insurance was necessitated by construction activities and hence should have been capitalized, but the court, noting that the insurance provided broader coverage than construction liability, and that it was in force even in years when no construction took place, allowed the deduction under § 162. In his dissenting opinion in George L. Schultz, 50 T.C. 688, 702 (1968), Judge Featherston argued that the taxpayer in *Shainberg* was required to capitalize insurance premiums and certain other costs because they were part of the contract price (under a cost-plus contract) for a completed shopping center, and thus were "an integral part of the cost of acquiring the asset intended to be purchased." Id. Thus *Shainberg* is read not as authority for capitalizing insurance premiums but rather as holding that the particular "premiums" in that case were acquisition costs. As to the cost of liability and property damage insurance paid by the taxpayer to the contractor this view is certainly correct; while the payments were measured by the contractor's insurance cost they were, to the taxpayer, merely part of the purchase price of an asset. But the premium in issue in *Shainberg* was paid for fire insurance, and was paid to the insurance company rather than to the contractor. While the *Shainberg* opinion is not as clear on this issue as it might have been, the primary reason for

though some of them have noted that the cost in question did not add anything to the value of the asset in question.[103] As a matter of clear reflection of income, insurance during construction should probably be capitalized, though the matter is not very clear. Construction period insurance may be thought of as a cost of earning income in the period in which the asset being constructed is used in the taxpayer's business. This fact does not compel capitalization, since there is no general requirement that deductions be postponed until the income corresponding to those deductions is earned.[104] But a deduction for the direct costs of constructing a capital asset is deferred until the asset is "placed in service."[105] This rule seems to be largely a matter of convenience; there is no apparent reason apart from some computational difficulties why depreciation should not begin as soon as construction begins. Given the generally accepted practice of postponing deductions for direct construction costs until completion of the asset, some degree of consistency may be achieved by postponing deductions for indirect costs like insurance as well. That is to say, the rule requiring capitalization of direct construction costs together with the rule that depreciation does not begin until the asset is placed in service mean that most construction period expenses are not deductible until the asset is completed. Since this is so, deductions for indirect construction costs like insurance might as well be postponed like any other cost of acquiring that asset. The cost of insurance during construction is, as a practical matter, a necessary cost of erecting a building, and there is no apparent reason for treating it differently from other construction costs. What must be capitalized is the "cost" of a building, a term which should include all costs necessarily incurred in construction. It is artificial to view cost in such a case as merely the sum of labor and materials.[106]

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nondeductibility seems to have been simply that the insurance "was on the buildings during the process of construction." 33 T.C. at 251. The Internal Revenue Service has interpreted *Shainberg* as requiring capitalization of insurance during construction. See Rev. Rul. 66-373, supra.

[103] See, e.g., W.P. Brown & Sons Lumber Co., 26 B.T.A. 1192 (1932); cf. Donald B. Jones, 40 T.C. 249 (1963), remanded on other grounds, 64-1 U.S. Tax Cas. ¶ 9379 (3d Cir. 1964) (insurance on lives of remaindermen treated as cost of remainder interests in determining gain on sale).

[104] Cf. Treas. Reg. § 1.162-1(a) (1973) ("The full amount of the allowable deduction for ordinary and necessary expenses in carryingg on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business."); Treas. Reg. § 1.212-1(b) (1973) (income for purpose of § 212 not limited to income of the taxable year in which deduction is taken).

[105] Treas. Reg. § 1.167(a)-10(b) (1973). For the meaning of "placed in service," see, e.g., Sears Oil Co. v. Commissioner, 359 F.2d 191 (2d Cir. 1966); Batman v. Commissioner, 189 F.2d 107 (5th Cir.), cert. denied, 342 U.S. 877 (1951); George S. Jephson, 37 B.T.A. 1117 (1938).

[106] This point may be clarified by comparing the amount that must be capitalized when a

A strict view of the requirement that a capital expenditure produce or enhance an asset would suggest that insurance during construction should be deductible, since it is not an expense that results directly in the production or enhancement of anything. Reconciliation of the rule requiring capitalization of construction insurance with the "asset" theory of capitalization requires that the relationship between cost and asset necessary for capitalization be viewed as broader than one of cause and effect. The Tax Court has described the costs that must be capitalized as those incurred "in connection with" the acquisition of a capital asset;[107] this formulation of the relationship seems broad enough to include indirect costs like insurance among the costs that must be capitalized, while preserving the requirement that some relationship between a cost and an asset exist if the cost is to be considered a capital expenditure.

In *George L. Schultz,*[108] the Tax Court described the expenditures that must be capitalized as "essential ingredients of the cost of acquiring property."[109] The taxpayer in *Schultz* had purchased bulk whiskey as an investment, and sought to deduct insurance, storage charges, and estimated ad valorem taxes paid during the period when the whiskey was being aged. Conceding that such expenditures did not themselves add to the value of the whiskey, and that similar expenditures in connection with investment property are normally deductible, the court nevertheless required capitalization because the whiskey in question was, during the storage period, going through an aging process that would turn it into four-year-old whiskey, the product the taxpayer was seeking to acquire. In a similar case involving whiskey held as inventory, the Court of Claims allowed a deduction, since it considered the storage in question to be part of the "sales phase" of the taxpayer's operations rather than part of the manufacturing process.[110] Both of these cases support the capitalization of indirect costs incurred during construc-

building is purchased with the amount that must be capitalized when a building is constructed. Except for actual savings due to self-construction of capital assets, the amount capitalized should be the same in both cases. The cost of a purchased building will normally reflect all of the seller's costs of constructing the building, including construction insurance. The cost of constructing a building should, therefore, include such indirect costs. This kind of comparison is harder to apply to the ground rent problem; because of the immobility of buildings they are not often built on leased land and then sold. But if it were possible to engage in that kind of dealings with buildings, the seller would undoubtedly regard ground rent during construction as a cost of the building, which he would have to recover in order to make a profit.

[107] Ben Perlmutter, 44 T.C. at 403.

[108] 50 T.C. 688 (1968).

[109] Id. at 696.

[110] Heaven Hill Distilleries, Inc. v. United States, 476 F.2d 1327, 1335 (Ct. Cl. 1973).

tion, though the opinions seem to differ as to the amount of activity that constitutes construction.[111]

B. *Ground Rent*

Insurance during construction is only one example of the indirect costs that must be capitalized because they are incurred "in connection with" the construction of a capital asset. Interest on construction financing and taxes would be others, but for the specific provisions in the Code allowing their deductibility.[112] The Tax Court's opinion in *Herbert Shainberg*[113] has been read as requiring capitalization of accounting costs and cleaning services during construction,[114] although *Shainberg* involved a taxpayer who paid for those items under a cost-plus contract for a completed shopping center, a circumstance that might mean that the costs were capitalized not because they were incidental to construction but because they were part of a purchase price.[115] But ground rent during construction, unlike other construction period expenditures, appears to be currently deductible. The Board of Tax Appeals held in *Columbia Theatre Co.*[116] that ground rent during construction was a current expense for excess profits tax purposes,[117] and in *Ernest A. Jackson*[118] the Tax Court held that ground rent during construction was a "carrying charge" subject to capitalization unless

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[111] See also Van Pickerill & Sons, Inc. v. United States, 445 F.2d 918 (7th Cir. 1971).

[112] Int. Rev. Code of 1954, §§ 163, 164. When tax payments are not deductible under § 164 they must be capitalized or expensed like any other expenditure. See, e.g., George L. Schultz, 50 T.C. 688 (1968), aff'd, 420 F.2d 490 (3d Cir. 1970). It is not at all clear why § 263 should not override §§ 163 and 164 to require capitalization of interest and taxes paid in connection with the construction of assets, but it seems to be generally accepted that it does not. See, e.g., Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969); Treas. Reg. § 1.163-1(a) (1973); 1 S. Surrey, supra note 74, at 409; Hamovit, Construction Period Expenses, N.Y.U. 29th Inst. on Fed. Tax. (pt. 2) 1075, 1080 (1971); cf. United States v. Mississippi Chem. Corp., 405 U.S. 298 (1972). Asimow, Principle and Prepaid Interest, 16 U.C.L.A.L. Rev. 36, 58-68 (1968), sets forth a number of arguments for the position that prepaid interest is a capital expenditure; all of Professor Asimow's arguments would apply with equal force to construction period interest that is not prepaid. The problem with capitalizing interest and taxes may be that interest and taxes are deductible even when paid for purely personal purposes, and it may seem anomalous to disallow a deduction when interest and taxes relate to the production of income in future years while allowing a deduction when they do not relate to any income at all. A deduction important enough to override § 262 may be regarded as important enough to override § 263 as well. It is difficult to fit these provisions into a rational pattern in the absence of a sound reason for the deductibility of personal interest and many of the taxes enumerated in § 164.

[113] 33 T.C. 241 (1959). See also Cohn v. United States, 57-1 U.S. Tax Cas. ¶ 9457 (W.D. Tenn. 1957), aff'd, 259 F.2d 371 (6th Cir. 1958).

[114] See Ben Perlmutter, 44 T.C. at 404.

[115] See note 102 supra.

[116] 3 B.T.A. 622 (1926), acquiesced in, VI-1 Cum. Bull. 2 (1927).

[117] Id.

[118] 9 T.C. 307 (1947), aff'd, 172 F.2d 605 (7th Cir.), cert. denied, 338 U.S. 816 (1949).

the taxpayer elected a deduction.[119] In 1969 the Secretary of the Treasury recommended to the Senate Finance Committee that "the excess of . . . rent over receipts (if any) from unimproved real property during the period of construction of improvements" should be a tax preference item for purposes of the ten percent minimum tax.[120] None of these authorities gives any reason for the deductibility of ground rent during construction. A secondary source lists ground rent during construction as a "statutorily-authorized" deduction like interest and taxes,[121] citing section 162 and the Regulations. Section 162 alone does not support this position. The mere listing of a category of expense in that section does not mean that such an expense need never be capitalized, for all the items listed in section 162 are deductible only if they are noncapital. For instance, section 162 mentions salaries, which clearly must be capitalized if they are paid to employees constructing capital assets.[122] The Regulations provide modest support for the deductibility of rent during construction by discussing the requirement that a lessee capitalize the cost of erecting a building on leased land without mentioning any need to capitalize rent.[123]

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[119] Regulations 69, art. 1561 (1926); cf. Int. Rev. Code of 1954, § 266.

In Rev. Rul. 55-118, 1955-1 Cum. Bull. 320, the Internal Revenue Service ruled that delay rentals on oil and gas leases are carrying charges, which may be deducted unless the taxpayer elects capitalization under § 266. This ruling does not support the deductibility of ground rent during construction because delay rentals, unlike such ground rent, are not payable during "construction" or during activities equivalent to construction under an oil or gas lease; indeed, delay rentals are ordinarily paid because of the lessee's failure to develop the property, and may be avoided by development. Treas. Reg. § 1.612-3(c)(1) (1973).

[120] Statement of the Honorable David M. Kennedy, Secretary of the Treasury, 91st Cong., 1st Sess. 49 (Sept. 4, 1969).

[121] Hamovit, Construction Period Expenses (pt. 2), N.Y.U. 29th Inst. on Fed. Tax. 1075, 1083 (1971). Redeemable ground rents, defined in § 1055(c), are mortgages, and rentals are deductible as interest under § 163(c). The discussion in the text concerns only ground rents that are not redeemable.

[122] See, e.g., Acer Realty Co. v. Commissioner, 132 F.2d 512 (8th Cir. 1942).

[123] Treas. Reg. § 1.162-11 (1973).

In Flambeau Plastics Corp., 22 CCH Tax Ct. Mem. 112 (1963), the taxpayer sought to deduct rentals paid on leased land during the construction of a building. The Commissioner apparently did not argue that the rents should be capitalized, but rather contended that part of the "rents" were in fact paid for something other than the use of the land, and that the taxpayer did not show that it had possession or use of the property, so as to meet the requirement of § 162(a)(3).

There is language in *Flambeau Plastics* to the effect that rents do not have to be incurred "in carrying on" a trade or business:

> To hold [for the Commissioner], would be to say that a taxpayer who acquires a right to eventually use land by virtue of a lease arrangement must use it in the course of the carrying on of a trade or business before he may be said to have the use thereof under the statute. The words of section 162(a)(3) are broader in their scope. The phrase "for purposes of the trade or business" of the taxpayer evidences a clear congressional intent that such use or possession need not be limited to the *carrying on* of a trade or business, but falls within the statutory intendment if the use or possession is for the *purposes* thereof. Certainly petitioner was using the premises

The distinction between ground rent and insurance as capital expenditures cannot be explained on clear reflection of income grounds. Nor does consideration of whether such costs produce or enhance an asset explain the distinction, since neither expense produces an asset in the sense of causation, while both are incurred "in connection with" the production of an asset. The deductibility of ground rent may derive from viewing the asset to which ground rent relates as being the land rather than the building. Separate determination of the cost of a building and the cost of the land on which it is constructed is normally required because the building is depreciable while the land is not. Ground rent cannot be capitalized as part of the cost of land, since the taxpayer is not taking title to the land,[124] and it may be thought to follow therefrom that it cannot be capitalized at all. This process of allocating costs between building and land and capitalizing only those costs allocated to an asset that is being acquired seems somewhat artificial; a taxpayer who rented construction equipment to erect a building would clearly have to capitalize the rent paid, and ground rent during construction is as much a cost of that construction as the rental of space in which capital assets are built, or of equipment used to construct capital assets, is a cost of those assets.[125] No such distinction is drawn in the cases involving construction period insurance.[126] If construction

> within the statutory meaning[;] immediately it began to oversee and supervise the construction of the building which construction clearly had no other purpose than to house the petitioner's business. It had a clear right under the lease to oust anyone (other than those engaged in construction of the building) including Realty, the lessor. We find it also had statutory possession upon the execution of the lease.

22 CCH Tax Ct. Mem. at 115 (emphasis by the court).

Similar reasoning might be used to support the position that rents are a unique kind of deduction not subject to the requirement of "ordinariness." But the least strained reading of § 162 is that the "purposes thereof" language stressed by the court merely denies a deduction for rent paid on nonbusiness property. The "carrying on" requirement, as well as the "ordinary and necessary" requirement, applies to *all* § 162(a) deductions, one of which is rent. The legislative history of § 162 does not support the court's view of the "clear congressional intent." The addition of a specific reference to rent and of the "purposes thereof" phrase to the predecessor of § 162 was intended to allow "the same deductions from gross income as under existing law." H.R. Rep. No. 767, 65th Cong., 2d Sess. 10 (1918). The "existing law" referred to was comparable to the first paragraph of § 162(a), including the "carrying on" requirement.

[124] Int. Rev. Code of 1954, § 162(a)(3).

[125] That there is no corresponding cost when a building is constructed on land the taxpayer owns is due to the nondepreciability of land, not to the necessity of allocating costs between land and building. If there were such a thing as depreciable land, as might be the case if a taxpayer were constructing improvements on an island that was being washed away by the sea, it would seem proper to allocate depreciation during construction to the cost of the building.

[126] Similar reasoning in the case of construction insurance would permit deductibility on the grounds that the asset purchased with an insurance premium is insurance, which lasts only for the period for which the premium is paid.

Compare the cases holding that the cost of such assets as roads, water systems and sewage disposal systems constructed by a developer may be capitalized as part of the basis of period insurance costs are capital expenditures, ground rent during construction should also be a capital expenditure.

IV. Educational Expenditures

A few cases,[127] and more than a few commentators,[128] have explained the nondeductibility of the costs of some kinds of education on capital expenditure grounds. The Regulations describe nondeductible educational expenditures (those required to meet the minimum educational requirements of a trade or business and those that qualify the taxpayer for a new trade or business) as "personal expenditures or . . . an inseparable aggregate of personal and capital expenditures."[129] This area is worth examining, not only because educational expenditures constitute an important and much-litigated area, but also because of the light the educational expenditure cases may shed on the limitation of capital expenditures to costs that produce or enhance an asset. If an education is not an asset, the educational expenditure cases must be explained on some basis other than that of capitalization, unless a major exception to the normal rules regarding capitalization is recognized. If an education is an asset, or if educational expenditures are capital expenditures even

the lots they were constructed to serve: Willow Terrace Dev. Co. v. Commissioner, 345 F.2d 933 (5th Cir.), cert. denied, 382 U.S. 938 (1965); Commissioner v. Offutt, 336 F.2d 483 (4th Cir. 1964); Cambria Dev. Co., 34 B.T.A. 1155 (1936), acquiesced in part, nonacquiesced in part, 1937-1 Cum. Bull. 4, 31. If a cost that enhances asset *A* can be capitalized as part of the cost of asset *B*, a fortiori a cost that does not enhance asset *A* may be treated as part of the cost of asset *B* even though it relates to asset *A* as well as to asset *B*. Cf. note 29 supra.

127 Welch v. Helvering, 290 U.S. 111 (1933) (dictum); Knut F. Larson, 15 T.C. 956 (1950) (alternative holding); James M. Osborn, 3 T.C. 603 (1944) (alternative holding); Richard Henry Lampkin, 11 CCH Tax Ct. Mem. 576 (1952) ("might be"). See also Arthur M. Jungreis, 55 T.C. 581 (1970).

128 Wolfman, Professors and the "Ordinary and Necessary" Business Expense, 112 U. Pa. L. Rev. 1089 (1964), does not examine in any detail the question of whether educational expenditures can in themselves be capital, and at one point even seems to suggest the opposite by pointing out that research expenditures that do produce an "asset" such as a marketable book may have to be capitalized. Id. at 1090-91 n.9, 1112. Professor Wolfman goes on, however, to describe a professional education as an "intangible capital asset." Id. at 1093, 1112. Shaw, Education as an Ordinary and Necessary Expense in Carrying on a Trade or Business, 19 Tax L. Rev. 1 (1963), argues that some educational expenditures are capital, as does Comment, The Deductibility of Educational Expenses: Administrative Construction of Statute, 17 Buffalo L. Rev. 182 (1968). See also R. Goode, The Individual Income Tax 82-93 (1964), a discussion which seems to be colored to a considerable extent by the author's view that "it is good social policy to resolve doubts in favor of more liberal writeoffs." Id. at 92. The American Law Institute in its Federal Income Tax Statute defines capital expenditures as including expenditures for the acquisition, development, or improvement of "an asset, interest, or income-producing status" having a useful life beyond the close of the taxable year. ALI Fed. Income Tax Stat. § X166(a) (Feb. 1954 Draft). The comments indicate that this wording, which is "not meant to deviate from the general trend of the existing cases," is intended to apply to educational expenditures.

129 Treas. Reg. § 1.162-5(b)-1 (1973).

though they do not produce an asset, the existing rule denying depreciation of educational costs is unsound.

Determination of whether educational expenditures are capital is necessary only in the case of expenditures having some connection with the taxpayer's trade or business. Expenditures not so connected, such as expenditures undertaken for education unrelated to the taxpayer's business, are personal, and so are nondeductible under section 262 whether or not they create or enhance an asset. Thus a lawyer's expenses in learning to play the piano or fly airplanes would ordinarily be nondeductible as personal expenses, making consideration of whether they are capital expenditures unnecessary.

An education is probably not an asset. No entirely satisfactory definition of an "asset" or of "property," which is probably the same thing, seems possible, and in capitalization cases the courts have, for the most part, prudently refrained from attempting to define "asset." But it is reasonably clear that what we call "property" has two characteristics distinguishing it from what we do not call property: property is subject to ownership, and hence to being transferred from one person to another,[130] and property involves some degree of legal protection against interference by others.[131] Thus things everyone would agree are property, such as land or copyrights, are both transferable and subject to a considerable amount of protection by the law; things that are perhaps less clearly property, such as licenses to engage in particular businesses, are frequently nontransferable and may not be assured of the same degree of legal protection as are land or copyrights. A few forms of knowledge have been treated as property for one purpose or another; thus in *International News Service v. Associated Press,*[132] the Supreme Court upheld an injunction against publishing news that had been gathered by the plaintiff. Justice Brandeis dissented, believing that the knowledge in question was not something the law had previously considered property and that, while a legislature might want to make it property, with appropriate safeguards against abuse of that status, the court

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[130] Not all specific items of property are transferable, of course, but the nontransferability of a liquor license, for example, is something imposed upon the holder of that property by the state because it is thought to be convenient to do so, while the nontransferability of an education is more or less inherent in its nature.

[131] See, e.g., Reich, The New Property, 73 Yale L.J. 733, 771 (1964). Most of the definitions of "property" in Black's Law Dictionary (4th ed. 1951) refer to "rights" of one sort or another; most of the definitions of "asset" refer to "property." For an interesting discussion of what contract rights can be "assets" for purposes of applying the capital gains provisions, see Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), where the court treats as assets those rights that would be protected in equity.

[132] 248 U.S. 215 (1918).

should not.[133] Novel ideas not properly the subject of patent or copyright have sometimes been protected against exploitation,[134] and even for tax purposes it is recognized that "know-how" can be an asset.[135] But all of these exceptions involve knowledge that is both unique and of some immediate practical use; the kind of knowledge attained by spending money in a nondeductible way, for example, the knowledge gained as a result of a legal education, is not protected by the Government in any way that can be said to give that knowledge the status of property. Indeed, there is no need for such protection; no one can steal someone else's education.

Education, then, is unlike most things that are considered assets. And it is difficult to see how the scope of the asset concept can be extended to education without rendering meaningless the statement that production or enhancement of an asset is what distinguishes capital expenditures yielding benefits in future years from currently deductible expenditures yielding such benefits. For if an education is an asset, why is not any other benefit such as reputation, or health, or good relations with customers, or public knowledge of the benefits of using a particular product?

The earliest cases and rulings disallowing deductions for the costs of learning state that such costs are not deductible because they are "personal."[136] Both the cases and the rulings are so cryptic that one must extract general principles from them with some hesitation, but their failure to examine the particular circumstances of the educations involved at least suggests that the Internal Revenue Service and the Board of Tax Appeals felt that any acquisition of knowledge was necessarily personal. The early rule of nondeductibility of the costs of acquiring knowledge was never absolute; costs of attending professional meetings were held deductible,[137] and college professors were sometimes permitted to deduct the costs of engaging in research related to their teaching,[138] though as recently

[133] Id. at 248, 250-51 (dissenting opinion).

[134] See, e.g., Belt v. Hamilton Nat'l Bank, 108 F. Supp. 689 (D.D.C. 1952), aff'd, 210 F.2d 706 (D.C. Cir. 1953).

[135] See, e.g., Taylor-Winfield Corp., 57 T.C. 205 (1971), aff'd mem., 467 F.2d 483 (6th Cir. 1972); United States Mineral Prods. Co., 52 T.C. 177 (1969), acquiesced in, 1969-2 Cum. Bull. xxv; Heil Co., 38 T.C. 989 (1962), acquiesced in, 1963-1 Cum. Bull. 4. But see Rev. Rul. 64-56, 1964-1 Cum. Bull. 133.

[136] T.F. Driscoll, 4 B.T.A. 1008 (1926) (cost of music lessons "in anticipation of vocal engagements in a professional capacity"); Jay N. Darling, 4 B.T.A. 499 (1926), acquiesced in, VI-1 Cum. Bull. 2 (1927) (cartoonist's expenses in connection with work undertaken in order to become a sculptor); O.D. 984, 5 Cum. Bull. 171 (1921) (costs of doctors' taking post-graduate courses); O.D. 892, 4 Cum. Bull. 209 (1921), revoked, I.T. 4044, 1951-1 Cum. Bull. 16 (expenses of teacher attending summer school).

[137] Alexander Silverman, 6 B.T.A. 1328, acquiesced in, VI-2 Cum. Bull. 6 (1927).

[138] I.T. 1520, I-2 Cum. Bull. 145 (1922), revoked, I.T. 2688, XII-1 Cum. Bull. 251 (1933), held that such expenses were "personal," but G.C.M. 11,654, XII-1 Cum. Bull. 250

as 1962 the Tax Court denied a deduction for such costs in the case of a tenured faculty member, reasoning that the expenses were not "necessary."[139] Not until 1950 was a taxpayer allowed to deduct the costs of formal classroom instruction.[140] In 1958 detailed regulations governing the deduction of educational expenditures were issued. These regulations provided that the costs of education undertaken "primarily for the purpose of" maintaining or improving skills required by the taxpayer's business or meeting the conditions of the taxpayer's continued employment were deductible.[141] The cost of obtaining education for the purpose of securing a new or better position or of "fulfilling the general educational aspirations or other personal purposes of the taxpayer" was expressly ruled nondeductible.[142] The Regulations were revised in 1967 to eliminate the necessity of determining a taxpayer's purpose in acquiring an education; the tests today are whether the education maintains or improves employment skills or meets the express requirements of employment, and does not meet minimum educational requirements of a business or qualify the taxpayer for a new trade or business.[143]

The idea that the cost of obtaining an education can be a capital expenditure derives from dictum in *Welch v. Helvering,*[144] where Justice Cardozò said that "[r]eputation and learning are akin to capital assets, like the good will of an old partnership. . . . For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business."[145] This statement does not necessarily mean that educational expenditures are or indeed can ever be capital. The Court's expressed concern in *Welch v. Helvering* was with the statutory requirement that deductible expenses be "ordinary," and while much in the opinion suggests that "ordinary" means "noncapital," there are indications too that it means more than that, and that "unique" or "unusual" expenditures are nondeductible irrespective

(1933), held to the contrary after the Commissioner had lost a number of cases involving more or less similar expenses. G.C.M. 11,654 stated that the costs of research by a college professor may be deductible depending on whether they are capital expenditures, a position that was reaffirmed in Rev. Rul. 63-275, 1963-2 Cum. Bull. 85.

[139] Harold H. Davis, 38 T.C. 175 (1962) (remanded pursuant to agreement of the parties in the Ninth Circuit, 1964). For a discussion of the *Davis* case, see Wolfman, supra note 128, at 1089-91, 1104-05.

[140] Hill v. Commissioner, 181 F.2d 906 (4th Cir. 1950).

[141] Treas. Reg. § 1.162-5 (1958), amended by T.D. 6918, 1967-1 Cum. Bull. 36 (1967).

[142] Id.

[143] Treas. Reg. § 1.162-5 (1967). The validity of the 1967 regulations was upheld by the Tax Court in Ronald F. Weiszmann, 52 T.C. 1106 (1969), aff'd, 443 F.2d 29 (9th Cir. 1971).

[144] 290 U.S. 111 (1933).

[145] Id. at 115-16.

of whether they are capital, with uniqueness determined by looking to the practice of the industry, rather than the particular taxpayer.

Apart from *Welch v. Helvering* there is very little support in the cases for the view that educational expenses are ever capital. No case has ever held that a nonpersonal educational expenditure not related to some asset other than the education itself[146] was nondeductible solely because it was a capital expenditure. Perhaps the closest approach to such a finding is *James M. Osborn,*[147] in which the Tax Court described the research expenses of a scholar who sought to develop a reputation so that he could obtain a teaching position as being "in essence the cost of the capital structure from which his future income is to be derived;"[148] but in *Osborn* the primary reason given for nondeductibility was that the taxpayer was not engaged in a trade or business.[149] In *Knut F. Larson,*[150] the Tax Court found it unnecessary to decide whether a mechanic's expenses in obtaining an engineering degree were capital or personal since they were clearly one or the other and were nondeductible in either case.[151] In *Richard Henry Lampkin,*[152] the Tax Court suggested that a scholar's expectation of some reimbursement for his outlays "might" make capitalization proper, and went on to hold that the

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[146] Acceptance of the view that an education is not an asset for capitalization purposes does not compel the conclusion that no expenditure that produces knowledge can be a capital expenditure. If the product of an expenditure is knowledge relating to some asset other than the knowledge itself, the expenditure should be capitalized. Thus in Louisiana Land & Exploration Co., 7 T.C. 507 (1946), aff'd, 161 F.2d 842 (5th Cir. 1947), the cost of conducting geophysical surveys on land leased to the taxpayer for oil drilling was held to be a capital expenditure. I.T. 4006, 1950-1 Cum. Bull. 48, sets forth a method of allocation of the costs of such surveys to specific properties. See also Hart-Bartlett-Sturtevant Grain Co., 12 T.C. 760 (1949), aff'd, 182 F.2d 153 (8th Cir. 1950); Red Star Yeast & Prods. Co., 25 T.C. 321 (1955). It is apparently these kinds of research expenditures (i.e., those leading to the production of some asset other than knowledge) that are meant to be excluded from deductibility on capital expenditure grounds in Rev. Rul. 63-275, 1963-2 Cum. Bull. 85, and in G.C.M. 11,654, XII-1 Cum. Bull. 250 (1933). Cf. Edward R. Godfrey, 22 CCH Tax Ct. Mem. 1, 7 (1963), aff'd, 335 F.2d 82 (6th Cir. 1964), cert. denied, 379 U.S. 966 (1965) (costs of unsuccessful attempt to have property rezoned and of survey to determine best use of property held capital expenditures).

In Rev. Rul. 56-600, 1956-2 Cum. Bull. 171, the cost of acquiring and developing air routes was held a capital expenditure. While many of the costs involved may have produced assets, such as a license to use a particular route, or maps, these assets account for less than the entire cost of a route. What was produced seems to be, essentially, knowledge. While as a general rule knowledge seems an unsatisfactory kind of asset, an exception might be made for the acquisition of specific practical information of use for no purpose other than the conduct of a taxpayer's business. This kind of knowledge is much like the "know-how" that is a recognized asset for purposes of §§ 1021 and 1031.

[147] 3 T.C. 603 (1944).

[148] Id. at 605.

[149] Id.

[150] 15 T.C. 956 (1950).

[151] Id. at 958.

[152] 11 CCH Tax Ct. Mem. 576 (1952).

expenses in question were "personal" and so nondeductible.[153] Courts allowing a deduction for educational expenditures have from time to time taken the trouble to hold that they are noncapital, as in *Coughlin v. Commissioner,*[154] where the Second Circuit, after holding that a lawyer's expenses in attending a tax institute were nonpersonal, observed that "the rather evanescent character of that for which the [taxpayer] spent his money deprives it of the sort of permanency [the capital asset] concept embraces."[155] The case for the capital nature of educational expenditures thus rests upon dicta, inferences from findings that particular educational expenditures were noncapital, and an occasional alternative holding. Such authorities might be persuasive if there were nothing on the other side, but that is not the case. The nondepreciability of educational expenditures, the nature of the distinctions drawn in both the current Regulations and the 1958 Regulations between deductible and nondeductible educational expenditures, and the abundance of authority for disallowing deductions for the kinds of education thought to be capital on the ground that such education is personal (or at least not incurred in carrying on a trade or business) all suggest that capital expenditure concepts need play no part in the educational expense area.

If the costs of obtaining an education are in fact capital expenditures a taxpayer who uses his education in his trade or business should be able to recover those costs through depreciation or amortization. But the four cases in which this issue was presented have denied the deduction. One case denies a deduction for amortization on the sole ground that there is no authority for allowing such a deduction,[156] another denies a deduction on the ground that the cost of education to qualify for a new trade or business is a personal expense,[157] and the remaining two cases rely solely on stare decisis.[158] Commentators who argue that educational expenditures are capital explain their nondepreciability by saying that such expenditures do not have an ascertainable useful life.[159] There is no authority to support this explanation,[160] and amortization of such intangible assets as a franchise and the right to practice medicine in

[153] Id. at 577.

[154] 203 F.2d 307 (2d Cir. 1953).

[155] Id. at 310.

[156] Huene v. United States, 247 F. Supp. 564 (S.D.N.Y. 1965).

[157] Nathaniel A. Denman, 48 T.C. 439 (1967), acquiesced in, 1968-1 Cum. Bull. 2.

[158] David N. Bodley, 56 T.C. 1357 (1971); Walter F. Maxwell, 29 CCH Tax Ct. Mem. 1356 (1970).

[159] Wolfman, supra note 128, at 1093; Shaw, supra note 128, at 29-30; Comment, supra note 128, at 209.

[160] It is only fair to point out that all of these articles were published before there was any case law denying depreciation of educational expenditures.

a hospital has been allowed when the utility of the asset is limited to the life of the taxpayer.[161] A taxpayer's life expectancy is at least as predictable as most other useful lives. The nondepreciability of educational expenditures can be justified only if the disallowance of a deduction for such expenditures is based on some ground other than capitalization.

The nature of the distinctions drawn by the Regulations between deductible and nondeductible educational expenditures cannot be satisfactorily explained by the use of capital expenditure concepts. The Regulations do allow a deduction for the costs of "maintaining" existing skills, while denying a deduction for the costs of developing new skills. This distinction is analogous to that made between repair and maintenance expenditures, which are deductible, and the costs of building new equipment, which are capital. But the analogy breaks down when the intermediate class of education expenditures is considered, for the costs of "improving" business skills are deductible, while the costs of "improvements" in general are expressly made capital by section 263.[162] A strong argument for the noncapital nature of educational expenses can be made by considering the kinds of educational expenditures that are deductible. Consider, for example, a secondary school teacher who obtains a master's degree and who accordingly is entitled to receive, for the rest of his working life, a higher salary than his less well-educated colleagues. Quite apart from any benefits such a person may derive from picking up new knowledge, his degree itself will provide him with substantial, measurable benefits for many years to come. No clearer example of an educational expenditure that is related to the production of future years' income can be found than this, yet the expenditure is currently deductible.[163] If an education, or even a degree, can be an asset, expenses like these should be nondeductible. If, on the other hand, an education or a degree is not an asset, the deductibility of such expenses can be explained as an application of

[161] See Hampton Pontiac, Inc. v. United States, 294 F. Supp. 1073 (D.S.C. 1969) (payments to acquire an automobile dealership amortized over life expectancy of dealer where dealer's franchise unlikely to be renewed after his death); Glenn L. Heigerick, 45 T.C. 475 (1966) (medical staff fee held capital expenditure; Commissioner allowed amortization over doctor's life expectancy); Stephen J. Thiel, 25 CCH Tax Ct. Mem. 212 (1966) (same); Robert C. Hill, 25 CCH Tax Ct. Mem. 213 (1966) (same); Leon G. Hunter, 25 CCH Tax Ct. Mem. 214 (1966) (same); Edward M. Slowik, 25 CCH Tax Ct. Mem. 214 (1966) (same); E. Vance Walters, 25 CCH Tax Ct. Mem. 215 (1966), aff'd, 383 F.2d 922 (6th Cir. 1967) (same); Rev. Rul. 70-171, 1970-1 Cum. Bull. 55 (same); cf. Wells-Lee v. Commissioner, 360 F.2d 665 (8th Cir. 1966) (medical staff fee amortized over life of hospital).

[162] The 1958 Regulations, as first proposed, would have allowed a deduction only for expenditures to "maintain" existing skills as opposed to "improving" them. Shaw, supra note 128, at 6 n.32.

[163] Treas. Reg. § 1.162-5(b)(2)(iii), example 1 (1973).

the limitation of capital expenditures to costs that produce or enhance an asset.

The costs of obtaining an education enabling a taxpayer to meet the minimum educational requirements of his profession or to qualify for a new trade or business are the nondeductible educational costs that seem most like capital expenditures. The nondeductibility of these costs can, however, be satisfactorily explained on grounds other than that of their capital nature. In the first place, most costs such as these relate to a trade or business other than that in which the taxpayer was engaged at the time he incurred them, and thus do not satisfy the requirement that deductible expenses be incurred "in carrying on any trade or business," or in carrying on equivalent activities under section 212.[164] This justification for nondeductibility clearly covers all the educational expenses that were expressly ruled nondeductible under the 1958 Regulations. While the new Regulations may disallow some expenses that are incurred for purposes related to an existing trade or business of the taxpayer, this change in practice is probably better explained as an attempt at achieving administrative convenience and avoiding the difficulties of proving a taxpayer's "purpose" in undertaking education than as reflecting the acceptance of capital expenditure principles. Furthermore, it is not unreasonable to regard the costs of obtaining the kinds of learning that qualify a taxpayer for a new trade or business as "personal" in the sense that they are consumption rather than (or as well as) the costs of earning income. The costs of obtaining high school and undergraduate educations, at least, surely provide personal satisfactions to so great an extent that they should be nondeductible under section 262. Some people undoubtedly incur even these costs primarily for business reasons, but any attempt to reward those oblivious to the nonfinancial benefits of learning by letting them deduct the costs of their general education would be an administrative horror at best,[165] and many costs are treated as "personal" even

[164] Int. Rev. Code of 1954, § 162; see notes 174-82 infra and accompanying text. Expenditures that are outside the scope of § 162 and § 212 because the taxpayer is not carrying on a trade or business are sometimes referred to as "capital expenditures." If this is all that is meant by the reference in the regulations to "capital expenditures," then it is unimportant whether an education is an asset or not, except with regard to depreciation or amortization. But the authorities cited in note 128 supra appear to be using "capital expenditure" in the sense of "improvements" under § 263. See also Arthur M. Jungreis, 55 T.C. 581 (1970), discussing whether the taxpayer, a university teaching assistant, was engaged in a trade or business, but also citing § 263. Much of the language in the educational expenditure regulations seems to be adapted from the kinds of language normally used in connection with tangible property. Compare the references to "maintaining" and "improving" skills in the educational expenditure regulations, Treas. Reg. § 1.162-5 (1973), with the references to "conservation" and "maintenance" of tangible property, Treas. Reg. § 1.212-1 (1973).

[165] R. Goode, supra note 128, at 84-89, proposes a plan for allowing amortization of the costs of any course creditable toward earning a college degree, vocational training at "recog-

though some may incur them solely for profit.[166] Much the same sort of argument can be made, though perhaps with less force, for the "personal" nature of the costs of attending graduate or professional schools. While the conduct of a business is regarded as a nonpersonal activity, the choice of the business or profession that a man will enter can be thought of as a personal choice. The day-to-day decisions that a lawyer makes, for example, may be regarded as business decisions in a sense in which the decision to become a lawyer in the first place was not. If this is so, it is perhaps sound to treat the costs of becoming a lawyer as personal expenses even though those costs will someday help to earn income. In *United States v. Gilmore,*[167] Justice Harlan described Congress as regarding an individual as having, for tax purposes, two personalities, one seeking profit, the other satisfying human needs.[168] The costs of becoming a member of a profession, however closely related to a man's profit-seeking personality, may well be even more strongly associated with the "human needs" side of his nature. To quote Professor Blum out of context, these costs "go to the individual as a whole person rather than to him as merely a businessman."[169] There is at least as much support in the cases for this view of nondeductible educational expenditures as there is for the position that such expenditures are capital,[170] and this explanation is consistent with denial of amortization of educational expenditures.

nized" trade schools, refresher courses and correspondence courses. He would allow the amortization deduction to be taken only against earned income. He proposes that students be allowed to amortize the cost of an education paid for by parents, relatives and friends, but not the cost of an education paid for by universities or governments. The reason given for denying a deduction to the parents who actually pay educational expenditures is that such a deduction "could not be justified as a refinement in the measurement of the parents' earnings." Id. at 92. This is perfectly true, but Goode apparently fails to recognize that allowing the deduction to the students in such a case cannot be justified as a refinement in the measurement of their incomes either, since it would allow them deductions for costs they have not incurred. Any "unfairness" involved in denying a student a deduction for the cost of his education seems to be more than outweighed by the allowance of tax-free scholarships, fellowships and gifts.

166 Some commuting expenses, costs of clothing purchased for business reasons but suitable for nonbusiness wear, and the cost of a large residence purchased and maintained in order to impress clients are a few examples.

167 372 U.S. 39 (1963).

168 Id. at 44.

169 Blum, Motive, Intent, and Purpose in Federal Income Taxation, 34 U. Chi. L. Rev. 485, 527 (1967).

170 For example, in David J. Primuth, 54 T.C. 374 (1970), the court, in rejecting the contention that fees paid to secure employment were personal, described the fees as "paid for the *limited* purpose of securing employment at a particular time . . . . There was no element . . . of qualifying for a new trade or business or better preparing oneself to take advantage of any number of unknown opportunities or of making life more enjoyable generally." 54 T.C. at 381 (emphasis in the original). The inference is clearly that the costs of qualifying for a new trade or business are personal. In Harold H. Davis, 38 T.C. 175 (1962), the court described the expenses in question as personal, since they were incurred to increase the taxpayer's

What has been said above about educational expenditures applies with equal force to several similar problems. In particular, employment agency fees and other costs of obtaining a better job clearly relate to future years' income, yet they do not always produce or enhance an "asset," and a Tax Court concurring opinion has said that they are not capital expenditures for that reason.[171] The costs of enhancing one's reputation for integrity, on the other hand, are generally treated as capital expenditures,[172] though the leading case, *Welch v. Helvering*, can and perhaps should be interpreted otherwise.[173]

V. Business Expansion Costs

Many of the normal expenses of a going business make some contribution toward earning income in years other than the year in which the expenses are incurred. Advertising costs, the costs of training personnel and the costs of devising and implementing improved business practices are some examples. A strict view of capitalization might require deferral of part of such costs on the theory that income is distorted by allowing a current deduction for

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prestige. The holding that the particular expenses involved were personal seems questionable, but the suggestion that there can be a personal element in acquiring prestige seems sound. I.T. 4044, 1951-1 Cum. Bull. 16, states that "expenses incurred for the purpose of obtaining a teaching position, or qualifying for permanent status, a higher position, . . . are . . . personal expenses." Id. at 17. See also Manoel Cardozo, 17 T.C. 3 (1951). Wolfman, supra note 128, at 1100-01, argues that the *Cardozo* court's conclusion that expenses to create advancement, professional prestige and reputation are "personal" is erroneous, citing *Welch* and *Osborn.* There is considerably more authority for calling these expenses personal than for calling them capital. The 1958 Regulations did not mention capital expenditures at all; the present Regulations refer to nondeductible educational expenditures as "personal expenditures or . . . an inseparable aggregate of personal and capital expenditures." Treas. Reg. § 1.162-5(b)(1) (1973). As a practical matter, the only direct significance of the classification of educational expenditures as personal or capital concerns depreciability; and all the cases involving that issue deny depreciation. See notes 156-58 supra.

[171] See David J. Primuth, 54 T.C. at 381-82 (Tannenwald, J., concurring). Judge Tannenwald goes on to state, however, that the capital expenditure concept includes "preparation for engaging in a new field of endeavor." Id. at 382. Since the cost of preparation for engaging in a new field of endeavor will always be nondeductible because not an expense of an existing trade or business, it seems to make little practical difference whether such costs are or are not capital expenditures, so long as amortization of such costs is not allowed.

[172] See note 70 supra.

[173] I do not mean to suggest that the word "ordinary" in § 162 should be construed to disallow any expenditures other than capital expenditures. I am merely suggesting that the expenditures involved in *Welch* were not capital expenditures, and that it is more satisfactory to interpret *Welch* as holding merely that the expenditures in question were not ordinary, even if that interpretation required interpreting "ordinary" as more broad than "noncapital," than to read *Welch* as a capital expenditure case. The distinction drawn in the cases cited in note 70 supra, which strikes me as being unsound, appears to derive from the view that *Welch* involved capital expenditures. For a case holding that "ordinary" means more than "noncapital," see, e.g., Consumers Water Co. v. United States, 74-1 U.S. Tax Cas. ¶ 9189 (D. Me. 1974).

costs attributable to earning future years' income. Ordinarily, the regular recurrence of costs such as these, the likelihood that most of the contribution of such costs toward earning income takes place in or near the year in which the costs are incurred, and the impossibility of making a rational allocation of such costs between current and future years justify current deductibility. A more difficult question is presented when a taxpayer incurs an unusually large cost of this sort under circumstances indicating that some long-range benefit was the primary reason for incurring the cost, as when a company spends large sums to advertise a new product, or to train its employees to operate new equipment, or to obtain a new group of customers. Whether costs such as these should be capitalized cannot yet be considered as settled.

This section will examine the question whether the costs described above are capital expenditures. This inquiry requires consideration not only of whether such costs produce assets but also of whether capitalization of such costs is necessary to clearly reflect income. Even if capitalization is regarded simply as a problem of determining whether a cost has produced an asset, consideration of whether capitalization of that cost clearly reflects income is necessary in order to determine whether viewing the results of particular expenditures as "assets" or as "not assets" is desirable. That is to say, clear reflection of income may be used as a standard for judging whether the "asset" theory of capital expenditures produces satisfactory results. But clear reflection of income considerations may also provide an alternative to the search for an asset; in the case of de minimis asset-producing expenditures, a current deduction for costs that did produce assets was permitted on clear reflection of income grounds in *Cincinnati Ry.*, and a similar approach may be useful in the case of business expansion costs.

It is worth noting that the problem of whether the costs of extensive advertising, employee training or expansion of a business into new lines of endeavor must be capitalized is distinct from the problem of whether such costs are nondeductible because they are not incurred "in carrying on any trade or business."[174] The costs of investigating new business opportunities and developing a new business are nondeductible under section 162 when incurred prior to the time the taxpayer's activities reach the level of a trade or business.[175] Nor are such costs deductible as expenses for the pro-

[174] Int. Rev. Code of 1954, § 162.

[175] The leading case is Morton Frank, 20 T.C. 511 (1953). Cf. Charles T. Parker, 1 T.C. 709 (1943). Such expenditures may sometimes be deducted as a loss on a transaction entered into for profit, Int. Rev. Code of 1954, § 165(c)(2), provided the taxpayer's activities go beyond "investigation." See Rev. Rul. 57-418, 1957-2 Cum. Bull. 143, attempting to distin-

duction of income under section 212; although that section contains no reference to a trade or business and appears, on its face, broad enough to encompass nonpersonal investigatory and start-up expenses, the Supreme Court has held that the predecessor of section 212 merely extended the concept that only net income is to bé taxed to *income* from activities that cannot be characterized as a trade or business.[176] Deductions under section 212 are thus "coextensive with the business deductions allowed by [section 162],"[177] and are "subject to the same limitations and restrictions that are applicable to those allowable under [section 162]."[178] In short, there is a "carrying on" limitation to deductions under section 212 as well as to deductions under section 162, though what must be "carried on" under section 212 may be investment rather than a business. The limitation of deductions for costs incurred in profit-seeking activities to costs incurred in carrying on a trade or business (or section 212's equivalent of a trade or business) has been criticized,[179] as has the courts' unnecessarily restrictive application of the "carrying on" requirement in particular cases.[180] The point here is that, notwithstanding the tendency of the courts to confuse the two issues,[181] the nondeductibility of costs because they do not meet the "carrying on" requirement has nothing to do with the nondeductibility of capital expenditures. Expenditures outside the scope of sections 162 or 212 are nondeductible irrespective of whether they are capital expenditures, and expenditures that are capital are nondeductible irrespective of whether they are incurred in carrying on a trade or business. That many expenditures may be nondeductible for both reasons[182] does not mean that the reasons are the same.

guish *Frank* from *Parker*. In Theodore R. Price, 30 CCH Tax Ct. Mem. 1405-3 (1971), the Tax Court held that the expenses in question were deductible under § 165 because they could have been capitalized if the project had been successful. See generally Fleischer, The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment, 14 Tax L. Rev. 567 (1959).

[176] McDonald v. Commissioner, 323 U.S. 57 (1944).

[177] Trust of Bingham v. Commissioner, 325 U.S. 365, 374 (1945).

[178] United States v. Gilmore, 372 U.S. 39, 45 (1963).

[179] See Griswold, An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142, 1145-47 (1943); Fleischer, supra note 175.

[180] See, e.g., Erbacher, Start-Up Costs: Are They Deductible by a Corporation for Federal Income Tax Purposes?, 48 Taxes 488 (1970).

[181] For example, the court in Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir.), vacated and remanded on other grounds, 382 U.S. 68 (1965), said that "expenses incurred prior to and for the purpose of reaching a decision whether to establish a business are indisputably capital expenditures." 345 F.2d at 905 n.4. The court went on, however, to treat the "carrying on" requirement and the capitalization question as separate issues.

[182] See Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965), for a case where most of the expenses in question were held nondeductible both because they were incurred before the taxpayer's activities constituted a trade or business and because they were capital expenditures.

Current deductibility of advertising expenses is well-established.[183] An early Court of Claims case held that the cost of a nationwide advertising campaign necessary to induce manufacturers and retailers to enter into valuable contracts with the taxpayer could be capitalized for income tax and excess profits tax purposes.[184] There is language in some early opinions of the Board of Tax Appeals to the effect that part of the costs of extensive advertising campaigns could be capitalized if evidence to establish a reasonable allocation were available, but the cases sustain the Commissioner's determination that none of the costs are capital because of failure to introduce such evidence.[185] By World War II, however, the deductibility of advertising costs was so well-established that even the advertising of taxpayers engaged in war production, made to maintain goodwill until the taxpayers' return to peacetime production, was held to be an ordinary and necessary expense if reasonable in amount.[186] Even the costs of influencing proposed legislation, which might be considered advertising expenses of a sort, are currently deductible to the extent they are allowable at all, though most such expenses seem as much a cost of future years' income as of current income.[187] There are, however, two well-established exceptions to the noncapital treatment of advertising costs: (1) the cost of advertising to increase the circulation of a periodical is a capital expenditure (though this issue is now largely mooted by section 173, which permits a taxpayer to expense such costs); and (2) the cost of advertising that involves the purchase or construction of tangible assets is a capital expenditure.

The circulation expense cases proceed on the theory that the circulation structure of a publication is an "intangible asset," and that the cost of improving such an asset is, by analogy to the cost of improving physical property, a capital expenditure, while the cost of

[183] Treas. Reg. § 1.162-20(a)(2) (1973) provides that institutional advertising costs are "generally" deductible "provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future."

[184] United Profit-Sharing Corp. v. United States, 1 U.S. Tax Cas. ¶ 319 (Ct. Cl. 1928).

[185] Colonial Ice Cream Co., 7 B.T.A. 154 (1927); Richmond Hosiery Mills, 6 B.T.A. 1247 (1927), aff'd, 29 F.2d 262 (5th Cir. 1928), cert. denied, 279 U.S. 844 (1929); Northwestern Yeast Co., 5 B.T.A. 232 (1926), acquiesced in, VI-2 Cum. Bull. 5 (1927). In all of these cases it was the taxpayer who sought capitalization, which would have increased "invested capital" for excess profits tax purposes.

[186] I.T. 3581, 1942-2 Cum. Bull. 88, declared obsolete, Rev. Rul. 68-100, 1968-1 Cum. Bull. 572. It is hard to think of a clearer example than this of advertising costs related to future years' rather than to current year's income.

[187] The rules governing the deductibility of lobbying and other political expenses are spelled out in Treas. Reg. § 1.162-20 (1973). See generally Cooper, The Tax Treatment of Business Grassroots Lobbying: Defining and Attaining the Public Policy Objectives, 68 Colum. L. Rev. 801 (1968).

maintaining the structure at its existing level is a current expense.[188] The application of the distinction between "maintaining" and "improving" circulation proved difficult, and Congress enacted section 173 in order to reduce uncertainty by permitting all such expenditures to be expensed.[189] The circulation expense cases are inconsistent with the general rule that advertising expenses are currently deductible. Most advertising is aimed at increasing the number of customers of a business, and there is no apparent reason to require capitalization merely because the taxpayer is a publisher, or because the existence of customers can be given a name like "circulation structure," which sounds like the name of an asset.

The reasoning of the circulation expense cases has occasionally been applied in cases involving taxpayers who are not publishers. In *Houston Natural Gas Corp. v. Commissioner,*[190] for example, the court held that the salaries and expenses of solicitors who persuaded gas users to become customers of the taxpayer, rather than its rival, were capital expenditures because the taxpayer acquired "something of permanent use or value in the business" in the form of "new customers," "good will" and "elimination of competition."[191]

The cost of advertising accomplished through the purchase or construction of tangible property must be capitalized and written off over the life of the property. Thus the cost of advertising signs and similar property must be capitalized and depreciated over the life of the signs.[192]

Where the taxpayer's relations with its customers take the form of leases, the Internal Revenue Service has ruled that salesmen's commissions and bonuses must be capitalized as part of the cost of the lease,[193] though another ruling on similar facts holds that adver-

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188 See cases listed in note 70 supra.

189 S. Rep. No. 2375, 81st Cong., 2d Sess., 1950-2 Cum. Bull. 483, 529.

190 90 F.2d 814 (4th Cir.), cert. denied, 302 U.S. 722 (1937).

191 90 F.2d at 816. A rather cryptic ruling holds that payments for unspecified "activities necessary in the promotion and advertising of the taxpayer's products in connection with an exhibit at a fair" are capital expenditures amortizable over "the periods during which the fair was in operation." Rev. Rul. 68-283, 1968-1 Cum. Bull. 63, 64. The ruling may be merely an application of the rule requiring deferral of the prepaid cost of services until the period in which the services are performed.

192 See, e.g., Alabama Coca-Cola Bottling Co., 28 CCH Tax Ct. Mem. 635 (1969) (signs, clocks and athletic field scoreboards); Liberty Ins. Bank, 14 B.T.A. 1428 (1929), rev'd on other grounds, 59 F.2d 320 (6th Cir. 1932) (novelty savings banks distributed to bank's customers); Rev. Rul. 66-277, 1966-2 Cum. Bull. 42 (payments by a professional sports club to finance construction of a "hall of fame"). But see E.H. Sheldon & Co. v. Commissioner, 214 F.2d 655 (6th Cir. 1954) (catalogues). In all of these cases the asset in question was not owned by the taxpayer. Utility of the asset in the taxpayer's business rather than ownership by the taxpayer is determinative for capitalization purposes.

193 Rev. Rul. 69-331, 1969-1 Cum. Bull. 87.

tising and salary expenses are currently deductible.[194] The distinction is said to be that the expenses held deductible "were found to be less directly and significantly productive of assets having a value extending beyond the taxable year in which paid or incurred than is true in [the case of expenses which had to be capitalized]."[195] The rulings do not explain what factual differences, if any, make the expenses in the one case "more directly and significantly productive" than those in the other.

The costs of training employees to perform tasks in future years are probably not capital expenditures, although one case, *Cohn v. United States,*[196] held that World War II flying schools' expenses for training flight instructors were properly capitalized and written off over the life of the schools. In *Richmond Television Corp. v. United States*[197] a deduction for the taxpayer's expenses for training employees in the techniques of television broadcasting was disallowed on the ground that the taxpayer was not carrying on a television broadcasting business during the years in question, but in discussing the capital nature of the training expenses the court observed that they "might" have been deductible under section 162 had they been incurred after the taxpayer's television business had begun.[198]

The deductibility of business expansion expenses was put squarely in issue in *Briarcliff Candy Corp. v. Commissioner.*[199] The taxpayer (Loft), a manufacturer and seller of candy, experienced a substantial loss of business in the late 1950's, when many of its customers moved from the cities where Loft's stores were located to the suburbs. When Loft's suburban stores proved unprofitable it undertook a program of selling its candy through independent drugstores and other retailers. Loft established a franchise division to induce suburban stores to sell Loft candy, to enter into franchise contracts with the stores and to provide services and merchandise to the stores. The franchise division commenced an intensive advertising campaign, directed toward retailers rather than consumers of

194 Rev. Rul. 68-561, 1968-2 Cum. Bull. 117.

195 Rev. Rul. 69-331, 1969-1 Cum. Bull. 87.

196 57-1 U.S. Tax Cas. ¶ 9457 (W.D. Tenn. 1957), aff'd, 259 F.2d 371 (6th Cir. 1958).

197 345 F.2d 901 (4th Cir.), vacated and remanded on other grounds, 382 U.S. 68 (1965).

198 345 F.2d at 904. Strictly speaking, the amount in question was paid to another company, Larus, for training personnel who were actually Larus' employees. Before these costs were incurred, Larus dismissed its own application for a television permit and subscribed to 60% of the taxpayer's voting stock. The training program was thereafter conducted "for the benefit and convenience of" the taxpayer. Id. In addition to these training expenses, the taxpayer paid Larus some $25,000 as "reimbursement" for costs previously incurred in its training program. This latter amount was held to be a capital expenditure, the "asset" involved apparently being the trained staff. The distinction between the two kinds of payment is similar to the distinction made between the cost of purchased goodwill, which must be capitalized, and the cost of developing goodwill, which is an expense. See note 213 infra.

199 31 CCH Tax Ct. Mem. 171 (1972), rev'd, 475 F.2d 775 (2d Cir. 1973).

candy, consisting of advertising in magazines, mailing of circulars, telephone solicitations and personal visits by salesmen. Retailers who entered into franchise contracts with Loft agreed to install a certain kind of display case, to permit Loft to inspect their displays and to use their "best efforts" to sell Loft candies. In exchange, Loft paid the retailers a commission on candy sales, gave certain training and advertising advice, and agreed not to permit others to sell Loft candy within a specified area around the stores. The Commissioner disallowed deductions for approximately two-thirds of the expenses of Loft's franchise division, including all the division's advertising expenses, salaries of salesmen, and travel expenses, and portions of such items as telephone expenses, postage and printing.

The Tax Court sustained the Commissioner's determination that a major part of the expenses of Loft's franchise division were capital expenditures.[200] Finding that benefits to be enjoyed in future years were the reason for incurring the costs in question, the court held that those costs should be capitalized as the costs of "contracts which provided a channel of marketing distribution."[201] The court conceded that the cost of advertising "directed toward current sales" is currently deductible, but ruled that Loft's advertising was directed not at "promotion of its product" but at "establishing new channels of distribution for that product."[202] While much of the Tax Court's opinion indicates that the assets produced by the expenditures were the contracts, there is support also in the opinion for viewing the "channel of distribution" as an asset separate from particular contracts.[203]

On appeal, the Second Circuit held that the expenses of Loft's franchise division were deductible under section 162. Sweeping language in *Houston Natural Gas,*[204] to the effect that "an intensive campaign to get new customers at any time gives rise to capital expenditures,"[205] was said to be unacceptable "as an unqualified general rule."[206] The court turned its attention to the search for an

[200] Id.

[201] 31 CCH Tax Ct. Mem. at 176.

[202] Id.

[203] See id. at 177. The Tax Court relied to a considerable extent upon Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir.), cert. denied, 302 U.S. 722 (1937), upon several cases holding that costs incurred in connection with the construction of buildings were capital expenditures, and upon Manhattan Co., 50 T.C. 78 (1968), which involved the cost of purchasing customer lists.

[204] 90 F.2d 814 (4th Cir.), cert. denied, 302 U.S. 722 (1937).

[205] 90 F.2d at 817.

[206] 475 F.2d at 782. The court purported to distinguish *Houston Natural Gas* on the ground that the efforts of the taxpayer in that case succeeded in giving it an "asset" in the form of a monopoly of the gas business in Houston, since the taxpayer's competitor was driven into receivership. This distinction, which amounts to making the ordinary and necessary character of an expense turn on the success of the taxpayer in achieving the goal for which the

asset created or enhanced by Loft's franchise division, and was unable to find one with enough substance to support capitalization of the franchise division's costs. The franchise division itself was not such an asset since, despite some changes in its internal organization, Loft was doing no more than carrying on its old business in a more intensive way. The undefined "intangible asset" said in some opinions and rulings to be produced by an intensive solicitation campaign was found to be insufficient, at least in the absence of some "clear standards and guidelines" by legislation or regulation to specify which "intangible assets" are deductible and which are not. The court was unimpressed with the contracts with retailers, which the Tax Court had viewed as constituting a "channel of marketing distribution."[207] The contracts gave Loft no property interest in the space used to sell its candy, did not require the retailers to sell any minimum amount of candy, and gave Loft "little more than an expectation or hope of future sales."[208] Nor was a satisfactory asset to be found in the "innumerable new suburban customers, . . . good will . . . and assurance of a suburban market"[209] which the Commissioner argued Loft had obtained by entering into the franchise contracts. These benefits, said the court, were "no different from what a number of good commission-paid salesmen in the same territory would have achieved and such commissions are clearly deductible under § 162."[210]

One of the most interesting aspects of *Briarcliff* is that the case stands virtually alone. Except, perhaps, for *Houston Natural Gas,* the circulation structure cases and certain cases involving research and development costs,[211] there appears to be no other case in which the Commissioner has argued that mere business expansion

expense was incurred, is not very satisfactory. As a general rule, although in some circumstances an unsuccessful capital expenditure is deductible as a loss, the distinction between capital expenditures and ordinary and necessary business expenses should not turn on the success of the endeavor. See Note, Income Tax Accounting: Business Expense or Capital Outlay, 47 Harv. L. Rev. 669, 677 (1934); Edward R. Godfrey, 22 CCH Tax Ct. Mem. 1 (1963), aff'd, 335 F.2d 82 (6th Cir. 1964), cert. denied, 379 U.S. 966 (1965) (cost of unsuccessful attempt to have property rezoned held capital).

[207] 31 CCH Tax Ct. Mem. at 176.

[208] 475 F.2d at 786 n.5.

[209] Id. at 785.

[210] Id. at 787.

[211] E.g., Red Star Yeast & Prods. Co., 25 T.C. 321 (1955); Hart-Bartlett-Sturtevant Grain Co., 12 T.C. 760 (1949), aff'd, 182 F.2d 153 (8th Cir. 1950). These cases may be distinguishable from *Briarcliff* on the ground that laboratory research is usually directed toward developing something that is clearly an asset, such as a patent. Thus in *Hart-Bartlett-Sturtevant* the court said that early research costs, successful and unsuccessful, should be capitalized as the cost of whatever asset is ultimately developed by the project. Section 174 now permits a taxpayer to expense research and experimental expenditures or to deduct them ratably over a period of up to five years (except to the extent they are chargeable to depreciable or depletable property).

costs should be capitalized. The rule that amounts paid for goodwill in connection with the purchase of a going business are capital expenditures[212] does not require capitalization of expenditures incurred to develop goodwill. The distinction between the tax treatment of purchased goodwill and that of developed goodwill is well-established,[213] though the distinction is perhaps attributable more to the statutory language used to describe capital expenditures than to any apparent policy considerations. In close cases, capitalization is determined by balancing the nature of the expense as a contribution to an "improvement" under section 263 with its "ordinary" character under section 162. That a benefit is obtained by purchase does not make it more of an "improvement," but may make it less "ordinary."[214] Although goodwill is treated as an asset when it is transferred as part of the sale of a going business,[215] it is not satisfactory to regard self-developed goodwill as an asset sufficient to support capitalization, for any benefit that a taxpayer's activities generate could be called goodwill. If goodwill in the sense of "assurance of a market" or "new channels of distribution" is to be regarded as an "asset" as that term was used in *Lincoln Savings & Loan,* the search for an asset in capitalization cases will become merely a test of the Commissioner's ingenuity in putting names to whatever benefits a taxpayer's activities have created. Accordingly, the meaning of "asset" in capitalization cases must be limited at least to recognized kinds of property, such as tangible assets, stock, patents, copyrights, contracts and licenses. But acceptance of this limitation does not solve problems like that of *Briarcliff,* since the expenses in issue in that case did relate to contracts. It is clear that at least some contract rights are assets for capitalization purposes. Indeed, *Lincoln Savings & Loan* itself involved payments that gave the taxpayer something quite similar to contract rights.[216] As a practical matter, the search for rules regarding the extent to which business expansion costs must be capitalized reduces itself to a search for rules concerning the capital nature of payments relating to contracts and licenses,[217] for the circulation expense and research

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[212] Treas. Reg. § 1.263(a)-2(h) (1973).

[213] See Note, Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill, 81 Harv. L. Rev. 859 (1968).

[214] It may be easier to regard the costs of expansion through intensification of past activities as "ordinary" expenditures than to say that the cost of purchasing an entire business is an ordinary expense. And it is easier to regard something as an asset when a taxpayer has purchased it than when it is built up gradually.

[215] In essence, goodwill is whatever is transferred other than specific assets to which a portion of the purchase price has been allocated.

[216] See text at note 229 infra.

[217] Licenses are not contracts, but for capital expenditure purposes the two seem sufficiently similar to be treated together.

and experimental expense problems have now been largely mooted by statute, and payments that give the taxpayer something less substantial than the contracts in *Briarcliff* seem clearly noncapital.[218] Classification of expenditures made in connection with contract rights as capital or current turns on two factors: the relation of the payment to the contract, and the nature of the contract.

Amounts paid directly for a contract, license or similar right (in the sense that they constitute consideration for the creation of the right or for its assignment to the taxpayer) have generally been held to be capital expenditures.[219] These authorities suggest that if the

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[218] There are, however, some odd situations involving expenditures that probably should be capitalized, but which are not readily characterized as expenditures that produce an asset. For example, in L.M. Brown Abstract Co., 1 CCH Tax Ct. Mem. 509 (1943), the taxpayer purchased a set of title abstracts in order to prevent their falling into the hands of a competitor, and destroyed the records. *Lincoln Savings & Loan* seems to undermine the court's statement that the cost of eliminating competition is a capital expenditure. Capitalization in such a case may perhaps be based on the abstracts themselves being the necessary asset. Under the peculiar circumstances of the case the cost of the abstracts (though not the abstracts themselves) may be viewed as having continued utility in the taxpayer's business throughout the period when a competitor could have used the records. Had the taxpayer achieved its goal by paying the original owner to destroy his records, the necessary asset might be found in the owner's contractual agreement.

A similar problem arises in connection with payments to release the taxpayer from an onerous contract. Such payments have generally been held deductible as ordinary and necessary business expenses. See, e.g., Capitol Indem. Ins. Co. v. Commissioner, 237 F.2d 901 (7th Cir. 1956); Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948) (lessee purchased fee to be rid of onerous lease; excess of purchase price over value of property deductible); Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935) (purchase of stock); Metropolitan Co. v. United States, 176 F. Supp. 195 (S.D. Ohio 1959); Montana Power Co. v. United States, 171 F. Supp. 943 (Ct. Cl. 1959); Olympia Harbor Lumber Co., 30 B.T.A. 114 (1934), aff'd on other issues, 79 F.2d 394 (9th Cir. 1935); Denholm & McKay Co., 2 B.T.A. 444, acquiesced in, IV-2 Cum. Bull. 2 (1925); Pressed Steel Car Co., 20 T.C. 198 (1953), acquiesced in, 1956-2 Cum. Bull. 8 (purchase of stock); Stuart Co., 9 CCH Tax Ct. Mem. 585 (1950), aff'd, 195 F.2d 176 (9th Cir. 1952). But in the similar situation where a corporation pays a call premium to retire stock in order to obtain new financing at better terms, the call premium is a capital expenditure. See H. & G. Indus., Inc., 60 T.C. No. 20 (April 30, 1973). In Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494 (4th Cir.), cert. denied, 393 U.S. 962 (1968), the taxpayer made payments to its supplier (Coca-Cola) to induce the supplier to purchase and dissolve a company (Croswell) through which the taxpayer's dealings with Coca-Cola had been conducted. After the dissolution of Croswell, the taxpayer entered into contracts of indefinite duration with Coca-Cola. The court rejected the district court's ruling that payments to be relieved of an onerous contract are per se capital expenditures, but required capitalization because the taxpayer received a "positive business benefit" in the form of its contracts with Coca-Cola. The distinction thus drawn between *Darlington-Hartsville* and the other cases cited above does not seem particularly desirable as a matter of policy, but it is consistent with the limitation of capital expenditures to costs that produce or enhance an asset.

Another expenditure related to future years' business activities but not productive of an asset is the cost of a management survey. See, e.g., Goodwyn Crockery Co., 37 T.C. 355 (1961), aff'd, 315 F.2d 110 (6th Cir. 1963) (deductible).

[219] See, e.g., Vermont Transit Co. v. Commissioner, 218 F.2d 468 (2d Cir.), cert. denied, 349 U.S. 945 (1955) (franchise to operate bus line); Hampton Pontiac, Inc. v. United

taxpayer in *Briarcliff* had paid lump sums to the retailers with whom it dealt in order to induce them to enter into agency contracts, the payments might have been capital expenditures notwithstanding the meagerness of the rights the taxpayer obtained.[220] The opinion is not very clear on this point, but the court's repeated reference to the difficulties of classifying "intangible contributions" to "intangible assets" suggests a recognition of this distinction. As in the case of payments to acquire goodwill, the classification of payments to acquire contract rights as capital or current may turn not only on what the taxpayer acquires, but on how he acquires it. But the *Briarcliff* court's primary emphasis was upon the meagerness of the rights obtained by the taxpayer's contracts rather than upon the indirect way in which the costs in question contributed to the acquisition of those rights. Indirect contract costs such as payments to brokers for negotiating contracts and legal and other fees paid in connection with a license application have been held to be capital expenditures.[221] *Briarcliff* can be reconciled with these cases only if

States, 294 F. Supp. 1073 (D.S.C. 1969) (automobile dealership franchise); Darrell D. Hudgins, 55 T.C. 534 (1970) (payment to employer to get a promotion); George Wynn Smith, 55 T.C. 133 (1970) (payment to obtain "upland cotton acreage allotments"); Arthur E. Ryman, Jr., 51 T.C. 799 (1969) (payment by law professor to become member of a second state's bar); Mercantile Nat'l Bank, 30 T.C. 84 (1958), aff'd, 276 F.2d 58 (5th Cir. 1960) (club membership); Tube Bar, Inc., 15 T.C. 922 (1950) (liquor license); Morris Nachman, 12 T.C. 1204 (1949), aff'd, 191 F.2d 934 (5th Cir. 1951) (same); American Seating Co., 4 B.T.A. 649 (1926) (right to use unpatented inventions); Rev. Rul. 71-137, 1971-1 Cum. Bull. 104 (contract of professional athlete); Rev. Rul. 67-379, 1967-2 Cum. Bull. 127 (same); Rev. Rul. 66-58, 1966-1 Cum. Bull. 186 (cotton acreage allotment); Rev. Rul. 65-228, 1965-2 Cum. Bull. 43 (milk base). Payments for franchises, trademarks and trade names have been the subject of statutory tinkering; under § 1253(d) amounts paid for a franchise, trademark or trade name are deductible if they are contingent on productivity or use; other payments for such assets are in certain circumstances deductible in the year of payment or ratably over the life of the agreement or a ten-year period, under § 1253(d)(2).

[220] In Van Iderstine Co. v. Commissioner, 261 F.2d 211 (2d Cir. 1958), a current deduction was allowed for payments by the taxpayer for the right to purchase, for an unstated period, its requirements of raw materials at prices to be agreed upon in the future. Deductibility was based upon the fact that no enforceable contract was created by the payment; the taxpayer received only "an expectation or hope that it would be preferred over other possible purchasers." Id. at 213. Although the Second Circuit cited *Van Iderstine* as supporting its decision in *Briarcliff*, the contracts in the latter case at least required the retailers to use their "best efforts" to sell the taxpayer's candy, and thus could not be said to be without consideration. See Wood v. Lucy, Lady Duff-Gordon, 222 N.Y. 88, 188 N.E. 214 (1917).

[221] See, e.g., Griffiths v. Commissioner, 70 F.2d 946 (7th Cir. 1934) (attorney's fees and commissions for negotiating lease); Central Bank Block Ass'n v. Commissioner, 57 F.2d 5 (5th Cir. 1932) (commission for negotiating lease); KWTX Broadcasting Co., Inc., 31 T.C. 952, aff'd, 272 F.2d 406 (5th Cir. 1959) (legal fees and other costs of applying for a television broadcasting license); Radio Station WBIR, Inc., 31 T.C. 803 (1959) (same); George W. Knipe, 24 CCH Tax Ct. Mem. 668 (1965), aff'd on other issues sub nom. Equitable Publishing Co. v. Commissioner, 356 F.2d 514 (3d Cir.), cert. denied, 385 U.S. 822 (1966) (same); Rev. Rul. 67-113, 1967-1 Cum. Bull. 55 (cost of airline's acquisition of certification of public convenience from CAB); Rev. Rul. 56-520, 1956-2 Cum. Bull. 170 (television license). But see All States Freight, Inc. v. United States, 72 F. Supp. 673 (N.D. Ohio 1947), where the costs of a hearing before the Interstate Commerce Commission were ruled deductible because the

some distinction can be found in the nature of the contract rights involved. Considerations of clear reflection of income may suggest a basis for such distinctions.

The real problem in matching expenses with income in a case like *Briarcliff* is not capitalization; it is the lack of a satisfactory mechanism for recovering costs once they have been capitalized. Ideally, the costs of a special advertising campaign, or of training employees in new techniques, or of obtaining new customers should be capitalized and amortized over whatever period results in matching those costs against the revenues they were incurred to produce. But it is inconceivable that amortization of such costs would be allowed. The Commissioner argued in *Briarcliff* that the "asset" representing the taxpayer's expenditures had an indefinite useful life and could not be amortized;[222] the Tax Court was not sure the issue had been raised, but noted its agreement with the Commissioner's position.[223] Even where it is reasonably clear that an intangible benefit decreases in utility over the years the courts have been reluctant to allow amortization.[224] In the absence of a feasible method of amortizing costs like those in *Briarcliff*, a current deduction may be preferable to capitalization as a method of clearly reflecting income. A deduction will at least result in the taxation of only net income, while capitalization may deny or unduly postpone any tax effect in the case of costs that should at most be deferred for a relatively short period. The effect of capitalization will be to give the costs tax effect only in the year when the business is sold or terminated; if the costs are rightly thought of as the costs of earning

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taxpayer would have received a license without a hearing if other carriers had not filed a petition to stay its issuance. The court ruled that the expenditures were deductible because they were incurred to protect an existing business rather than to obtain a new one.

222 31 CCH Tax Ct. Mem. at 177.

223 Id.

224 In the case of purchased customer lists, for example, where the declining utility of the list can readily be measured by the number of customers who cease to deal with the taxpayer, amortization has been denied on the theory that the acquisition of the list gave the taxpayer goodwill or some such asset above and beyond the opportunity to deal with particular customers. See, e.g., Wikle v. United States, 65-1 U.S. Tax Cas. ¶ 9403 (N.D. Ala. 1965); Thrifticheck Serv. Corp., 33 T.C. 1038 (1960), aff'd, 287 F.2d 1 (2d Cir. 1961); Anchor Cleaning Serv., Inc., 22 T.C. 1029 (1954). The Tax Court has, rather grudgingly, allowed amortization of 75% of the cost of a customer list; four judges would have allowed amortization of the entire cost. Manhattan Co., 50 T.C. 78 (1968). The Fifth Circuit has recently allowed amortization of the entire cost of a customer list where the taxpayer established through the testimony of its officers and employees, and through evidence of market conditions, that the list had an ascertainable value apart from goodwill and an ascertainable useful life. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973). Many of the costs in the nature of "business expansion costs" produce benefits whose declining utility is even less measurable than that of customer lists. An advertising campaign, for example, is likely to have effects that fall off rapidly with time. While precise determination of the decrease in utility is impossible, everyone would agree that it is present.

income in years close to that in which they are incurred, such a postponement would seem to distort income more than a current deduction would.

The inability of the taxpayer to recover captialized costs in a case like *Briarcliff* may justify allowing the current deduction of such costs, but there are many cases in which costs associated with contract rights and similar assets should be capitalized. The clearest kind of case involves prepaid expenses. Cash basis taxpayers have frequently been denied a deduction for amounts paid for future years' interest, insurance, rent or services,[225] though there is some authority to the contrary.[226] Since such costs, once capitalized, may be written off in the period in which the services are performed, capitalization is an entirely satisfactory way of matching expenses with the appropriate income. The prepaid expense cases are sometimes explained solely on the ground that postponement of a deduction is necessary in order clearly to reflect income, without mention of capital expenditure principles. This rationale is not very satisfactory, since "clear reflection of income" is generally thought of as a standard for judging the adequacy of an accounting method, rather than as an accounting method in and of itself. The present state of affairs involving prepaid expenses is that some kinds of prepaid expenses are currently deductible, some are not, and some are treated on a case-by-case basis, with the determining factor in close cases being the Commissioner's concern over whether taxpayers are "abusing" prepayment.[227] Recognition that the prepaid expense cases involve capital expenditures, and consistent application of the requirement of capitalization, would bring uniformity to this area of the law, which one authority has described as a "jumble."[228] The prepaid expense cases present the best possible case for capitalization of costs relating to contract rights. Capitalization of prepaid expenses leads to the clearest possible reflection of income, and the contract rights in question are an entirely satisfactory kind of asset, since the period in which the benefits of the expense are realized can be determined with accuracy.

Closely related to the prepaid expense cases are cases in which the taxpayer obtains contract or other rights providing precisely ascertainable benefits in future years and in which the rights do not

[225] The leading case is Commissioner v. Boylston Market Ass'n, 131 F.2d 966 (1st Cir. 1942), involving prepaid insurance. See generally Asimow, Principle and Prepaid Interest, 16 U.C.L.A.L. Rev. 36 (1968).

[226] See, e.g., Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); Gaddis v. United States, 330 F. Supp. 741 (S.D. Miss. 1971); John Ernst, 32 T.C. 181 (1959), acquiesced in, 1959-2 Cum. Bull. 4; Rev. Rul. 71-252, 1971-1 Cum. Bull. 146.

[227] See Rev. Rul. 68-643, 1968-2 Cum. Bull. 76.

[228] See Asimow, supra note 225, at 74.

diminish in value. This was the case in *Lincoln Savings & Loan,* where the "additional premiums" in issue gave the taxpayer a share in the "Secondary Reserve" of the Federal Savings and Loan Insurance Corporation, which share was to be used to discharge the taxpayer's obligation to pay insurance premiums under certain defined circumstances and was returnable to the taxpayer if it ceased to be insured or upon liquidation. If this was not a prepaid insurance case, it was at least very similar.[229]

From the point of view of clear reflection of income, the cases involving capitalization of the costs of licenses are not as satisfactory as the prepaid income cases since the effect of capitalization is to give a cost of engaging in business over many years tax effect only in the year the license is lost or the business is terminated. In the case of a license that is not transferable this is certainly a distortion of income, but the cost is clearly capital and there seems to be no reasonable way to spread it over more than one business year under current law. The comparable problem of the organizational costs of a business has been solved by allowing amortization over a five year period.[230]

As a matter of clear reflection of income, the contract rights cases thus range from those in which capitalization is clearly desirable (the prepaid expense cases) to those in which capitalization is demonstrably unsatisfactory (*Briarcliff*). In all of these cases, the desirability of capitalization turns upon the possibility of recovering costs once they have been capitalized. The factors that caused the *Briarcliff* court to regard the contracts in that case as something other than assets are the same factors that make depreciation of the costs of those contracts impossible. This parallelism justifies tying the capitalization rules to the depreciation rules by saying that a benefit is not an asset for capitalization purposes if it is so immeasurable and nebulous that its useful life, while known to be short, cannot be determined with sufficient accuracy to allow

[229] The taxpayer argued in *Lincoln Savings & Loan* that the reserve might be consumed by losses of the FSLIC, a circumstance that is not present in the typical prepaid insurance case. But, as the Court noted, the possibility of such a loss exists with any investment in a bank or insurance company and does not make such an investment noncapital. 403 U.S. at 357.

[230] See Int. Rev. Code of 1954, § 248. The nondepreciability of organization costs or nontransferable licenses results from the impossibility of predicting the useful life of the taxpayer's business, while the nondepreciability of advertising costs is due to the impossibility of estimating the useful life of the cost itself, irrespective of the measurability of the life of the business. Unlike advertising costs, organizational costs and the cost of licenses cannot be regarded as wasting "assets." Therefore, *Briarcliff* does not support the deductibility of the cost of licenses. Where a cost, such as that of a license, does not provide benefits that decrease with time, *Lincoln Savings & Loan* clearly bars a deduction, even though that result may be more or less (depending on the actual duration of the business) unfortunate as a matter of taxation of only net income.

depreciation.[231] Another possible approach is suggested by *Cincinnati Ry.*[232] Just as the costs in that case were currently deductible even though they produced assets, where a deduction was shown to be satisfactory on clear reflection of income grounds, costs relating to contract rights might be viewed as always producing assets but still deductible whenever the cost can be shown to be both short-lived and nondepreciable. It is sometimes said that capitalization questions should be decided without regard to depreciation, that capitalization and depreciation are separate issues, and that if the depreciation rules for intangibles are inadequate the solution is for Congress to improve those rules.[233] But there is no reason to think that the depreciation situation will soon change, and until it does whatever flexibility exists with regard to capitalization should be exercised in such a way as to produce the best possible income figure, a process that requires coordination of the capitalization rules with the depreciation rules. "It is no bad thing that the law of the land should here and there conform with the known facts of everyday experience."[234]

Although defining contract rights like those in *Briarcliff* as something other than assets serves to increase the likelihood that only net income will be taxed in the case of taxpayers who are expanding existing businesses, taxpayers who incur similar expenses in connection with new businesses may run afoul of the requirement that expenses be incurred "in carrying on [a] trade or business" to be deductible under section 162. The tax benefit of expenditures not productive of assets will frequently be lost to such taxpayers because the expenditures, even if nonpersonal and currently deductible under *Lincoln Savings & Loan,* are not deductible when incurred

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[231] The writer understands that revenue agents have taken the position that the costs of employee training programs are capital expenditures. As in the case of the expenditures discussed in the text, the desirability of capitalizing these costs depends upon the possibility of amortization. Richmond Television Corp. v. United States, 354 F.2d 410 (4th Cir. 1965), denied amortization of the costs of training the taxpayer's employees over the period for which its broadcasting license was issued on the ground that the license had an indefinite useful life. If a taxpayer can establish "from experience or other factors," Treas. Reg. § 1.167(a)-3 (1973), that its trained employees can be expected, on the average, to work for some reasonably ascertainable period, or that their training will become obsolete at a foreseeable time, amortization should be allowed. At the very least, a deduction for an appropriate portion of the cost of a training program should be allowed whenever a trained employee stops working. If amortization of training costs is permitted, there should be no reasonable objection to capitalizing those costs. The necessary asset may be found in the employment contracts of the trained staff. But cf. David J. Primuth, 54 T.C. 374 (1970), where the court's allowance of a deduction for an employment agency fee implies that the fee is not part of the cost of the taxpayer's employment contract or that the contract is not an asset for capitalization purposes.

[232] See text at notes 49-52 supra.

[233] See, e.g., Asimow, supra note 225, at 61; Note, An Inquiry Into the Nature of Goodwill, 53 Colum. L. Rev. 660, 719 (1953).

[234] A. Herbert, The Reasonable Man, in Uncommon Law 1, 6 (1969).

because of the wording of section 162, and not deductible after the trade or business is begun because of the lack of a depreciable or amortizable asset. It is anomalous that business-related expenditures like these should be nondeductible under a system based on taxation of net income. This anomaly, which is aggravated by restrictive definitions of "trade or business," is not caused by capital expenditure rules, and the occasional tendency to describe non-trade or business investigatory expenses as "capital expenditures" should be discouraged, for that description engenders confusion and gives the nondeductibility of such expenditures an undeserved aura of legitimacy by describing the expenditures in language usually indicative of a sound reason for nondeductibility.

CONCLUSION

If the restriction of the requirement of capitalization to costs that produce or enhance an asset serves any useful function, it is the separation of costs like those in *Briarcliff* from those producing more precisely ascertainable benefits. If the asset produced by an expenditure is tangible property, or a measurable kind of intangible property like a contract for services to be performed in a particular future period, there is no reason to be restrictive about the costs that must be capitalized, since those costs will be matched with the income they help generate through depreciation or amortization. But in cases like *Briarcliff*, or in cases involving many educational expenditures or the costs of obtaining a new job, the nebulous and short-lived character of the benefits purchased by the expenditure, together with the lack of a reasonable method of giving the costs tax effect other than by a current deduction, may justify deductibility. Query whether limiting capitalization to costs that "produce or enhance . . . a separate and distinct additional asset" will explain satisfactorily the kind of distinctions that seem desirable in this area. In the case of contract rights, refinements based on distinctions between direct and indirect payments for a contract and upon the nature of the rights granted by the contract seem necessary.

The need for classifying rights or benefits as "property" is not confined to the capital expenditure area. The benefits of capital gains taxation, for example, are limited to gains from the sale of "property,"[235] and only "property" can be transferred tax-free to a controlled corporation or partnership.[236] Unfortunately, close cases in these areas sometimes seem to be decided by a process of labeling the rights in question as "property" or "not property" rather than by

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[235] Int. Rev. Code of 1954, §§ 1021, 1031.
[236] Int. Rev. Code of 1954, §§ 351, 721.

analysis of the interests involved.[237] It is to be hoped that the limitation of capital expenditures to costs that produce or enhance an asset will not be viewed as a license to engage in a mechanical process of labeling benefits as "an asset" or "not an asset."

A danger more subtle than that of decision by labeling is that of attempting to devise all-inclusive definitions of concepts such as "property" or "asset." Attempts at such definitions have not been successful even in the capital gains area,[238] where a wealth of decided cases might have been expected to provide the data from which a general definition could be drawn or to serve as standards for testing the adequacy of proposed definitions. Two definitions of "asset" for capital expenditure purposes are suggested by recent cases. Neither is very satisfactory. In *United States v. Mississippi Chemical Corp.*,[239] the Supreme Court held that the cost of purchasing Class C stock in a bank for cooperatives established by the Farm Credit Act of 1933 was a capital expenditure. The Court's opinion refers to the stock's being "a capital asset within the meaning of § 1221."[240] The policy considerations underlying the taxation of capital gains have no apparent relation to those involved in disallowing a deduction for capital expenditures, and it is to be hoped that *Mississippi Chemical* will not be read as approving the application of capital gains learning to capital expenditure problems.

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[237] See, e.g., Estate of John F. Shea, 57 T.C. 15 (1971), where gain on the sale of a charter party (a contract giving the owner the right to earn income by transporting goods by sea) was held taxable at capital gain rates because the charter party was "property." A more sophisticated approach to this kind of problem is presented in Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958), where the proceeds of the sale of carved-out oil production payments were taxed as ordinary income, notwithstanding that the production payments were property under non-tax principles.

A comparable problem under § 351 involves the transfer of accounts receivable to a controlled corporation. Section 351 makes tax-free the transfer of property, but not of services, to a controlled corporation in exchange for stock. Although accounts receivable are certainly property as that term is normally used, it is not self-evident that the accounts receivable of a cash-basis taxpayer should be treated as property for purposes of § 351, since to do so and to hold that collection of the receivables is taxable to the transferee seems to contravene the "first principle of income taxation: that income must be taxed to him who earns it." Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949). But see Hempt Bros., Inc. v. United States, 74-1 U.S. Tax Cas. ¶ 9188 (3d Cir. 1974).

[238] See, e.g., Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), where the court's scholarly analysis of whether the contracts in question were property may be criticized as not responsive to the issue of whether the payments for the contracts were so closely a substitute for ordinary income earned by the taxpayer's own efforts that they should have been taxed as ordinary income.

[239] 405 U.S. 298 (1972).

[240] Id. at 310. The Syllabus states that "[t]he Government contended that the stock is a capital asset as defined by . . . § 1221, and is non-deductible," but the Government's brief pointed out, in response to the taxpayers' contention that the *Corn Products* doctrine helped their case, that "the issue is whether the stock purchased is an asset, not whether it is a capital asset." Brief for Petitioner at 37 n.33, United States v. Mississippi Chem. Corp., 405 U.S. 298 (1972). See Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46 (1955).

In *Briarcliff* the Second Circuit stated that the product of an expenditure is a capital asset (for purposes of section 263) "if at the time it is furnished to the company, it has an ascertainable and measurable value—that is, a value in money or a fair market value."[241] This definition seems inadequate as a means of resolving any but the clearest cases. Many expenditures clearly capital—the cost of a nontransferable license, or stock in a closely-held corporation, for example—produce benefits no more susceptible to precise valuation[242] than benefits that are not assets. Measurability of the benefits of an expenditure in terms of time may be relevant in capitalization cases,[243] but there is no reason why measurability in terms of dollar value should determine whether a cost must be capitalized.[244]

[241] 475 F.2d at 784.

[242] It will not do to say that the amount spent is a measure of the value of the asset, since this would make everything an asset, which is clearly not what the court intended.

[243] See text at notes 230-31 supra.

[244] An expenditure is not currently deductible even in part merely because the asset it produces is worth less than the amount of the expenditure. United States v. Mississippi Chem. Corp., 405 U.S. 298 (1972).