Distinguishing Between Capital Expenditures and Ordinary Business Expenses: A Proposal for a Universal Standard

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DISTINGUISHING BETWEEN CAPITAL EXPENDITURES AND ORDINARY BUSINESS EXPENSES: A PROPOSAL FOR A UNIVERSAL STANDARD

The Internal Revenue Code draws a distinction between ordinary and necessary business expenses, which are currently deductible from gross income, and capital expenditures, which, if deductible at all, must be amortized over the useful life of the particular asset. Code section 162 allows a taxpayer to deduct expenses paid or incurred during the taxable year in carrying on any trade or business. To qualify as a section 162 deduction, the expense must be both "ordinary" and "necessary" and must bear a direct relation to the specific business. The principal function of the term "ordinary" is to clarify the distinction between those expenses that are currently deductible and those that are in the nature of capital expenditures. Code section 263 specifically applies to capital expenditures and denies a current deduction for expenses incurred in the acquisition or improve-

1. Title 26 of the United States Code. Unless otherwise indicated, all citations are to the Internal Revenue Code (I.R.C.) of 1954, as amended.
3. I.R.C. § 162(a) provides in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."
4. See, e.g., Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971); Commissioner v. Heininger, 320 U.S. 467, 470 (1943), superseded by statute as stated in Raymond Bertolini Trucking Co. v. Commissioner, 736 F.2d 1120, 1122 n.5 (6th Cir. 1984); Commissioner v. Polk, 276 F.2d 601, 602-03 (10th Cir. 1960); Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950).
6. I.R.C. § 263(a) provides in part: "No deduction shall be allowed for— (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

Section 263 represents a specific exception to the set of deductions authorized by § 162. See I.R.C. § 161 ("In computing taxable income, . . . there shall be allowed as deductions the items specified in this part [sections 161 to 196], subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible."). See also Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974); Blitzer v. United States, 684 F.2d 874, 892-93 (Ct. Cl. 1982); Southland Royalty Co. v. United States, 582 F.2d 604, 606 (Ct. Cl. 1978), cert. denied, 441 U.S. 905 (1979).
ment of a capital asset. As the Supreme Court has explained, section 263 "serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."

Distinguishing ordinary and necessary business expenses from capital expenditures has proven to be a difficult task for the courts. Although a variety of line-drawing criteria have developed to deal with the problem, the circuit courts have yet to apply a common standard. In Commissioner v. Lincoln Savings & Loan Association, the Supreme Court declared that any expenditure that, in addition to providing a future benefit beyond the taxable year, creates or enhances a separate and distinct additional asset must be capitalized. The circuits, however, have used this standard as a mere threshold before applying additional criteria. Furthermore, several circuits have split in their

7. Examples of capital expenditures include:
   (a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.
   (b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments.
   (c) The cost of defending or perfecting title to property.
   (h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.


12. See, e.g., Raymond Bertolini Trucking Co. v. Commissioner, 736 F.2d 1120, 1124 (6th Cir. 1984) ("Whether an expenditure is 'normal' or 'habitual' is a criterion to be used in determining whether it is currently deductible, or whether it must be capitalized."); Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 217 (7th Cir. 1982) ("The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be."); NCNB Corp. v. United States, 684 F.2d 285, 290, 292-93 (4th Cir. 1982) (en banc) (expenditures for the continuation or expansion of an existing business are currently deductible; the taxpayer's
application of line-drawing criteria to particular expenditures.\textsuperscript{13} It is apparent from an examination of the various court decisions that there is no single, common standard used to distinguish between capital expenditures and ordinary business expenses. The courts are not completely to blame for this situation, however, because the Internal Revenue Code provides little guidance on the capital/ordinary distinction.\textsuperscript{14} This Note proposes an amendment to the Tax Code that would provide courts with a universal standard to apply in differentiating between the two types of expenditures and that best reflects the general purpose of the Code in matching income with its related expenses.\textsuperscript{15} Part I analyzes the historical development of the capital/ordinary distinction and the various line-drawing tests that are currently applied by the courts. Part II proposes a Tax Code framework for distinguishing between capital and ordinary expenditures. Part III applies this framework to two instances in which courts have disagreed about the deductibility of certain method of accounting is controlling if it clearly reflects income); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) ("We find no statutory, regulatory, or decisional test which is dispositive. The issue must be determined on the facts presented in the novel situation before us.").

In Bonaire Dev. Co. v. Commissioner, 679 F.2d 159, 161 (9th Cir. 1982), the court ignored the "separate and distinct asset" standard of Lincoln Savings and applied only a future benefit test.

13. Compare NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (holding that a national bank's expenditures in connection with its establishment of a state-wide network of branch banks are currently deductible), with Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181 (5th Cir. 1984) (holding that expenditures made in investigating and establishing new branches of a savings and loan association must be capitalized); compare Snyder v. United States, 674 F.2d 1359 (10th Cir. 1982) and Faura v. Commissioner, 73 T.C. 849 (1980) (holding that expenditures made by taxpayer in his trade or business of being an author, in connection with the writing of a book, are currently deductible as ordinary and necessary business expenses), with Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982) (holding that payments made by an encyclopedia company to another company to do all necessary research work and to prepare and edit a natural science dictionary must be capitalized as expenditures for the acquisition of an asset).


15. \textit{See supra} note 8 and accompanying text. One might argue that a universal standard would be inappropriate because the capital/business expense distinction is typically very fact-sensitive. \textit{See} Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974). This Note contends, however, that a universal standard for classifying an expense as either capital or ordinary is clearly feasible and could be applied to any corporate expenditure. Furthermore, the need for consistency among the circuits weighs heavily in favor of a single standard. \textit{See infra} notes 132-38 and accompanying text. Factual considerations will, of course, be important in the application of any standard.
expenditures: prepublication expenses of authors and publish- ers\textsuperscript{16} and bank branching expenses.\textsuperscript{17}

I. HISTORICAL DEVELOPMENT OF THE CAPITAL/ORDINARY DISTINCTION

Section 263 of the Internal Revenue Code of 1954\textsuperscript{18} disallows a current deduction for any expenditure related to the creation, acquisition, or improvement of a capital asset.\textsuperscript{19} The nondeductibility of capital expenditures can be traced back to the income tax provisions enacted by Congress during the United States Civil War;\textsuperscript{20} similar provisions have been adopted in every major income tax statute since that time.\textsuperscript{21} Inevitably, the courts developed various line-drawing criteria to determine whether a specific expenditure should be classified as a currently deductible business expense or as a nondeductible capital expense.

A. "Ordinary and Necessary" Business Expenses

The distinction between capital and ordinary expenditures can be based on either the definition of "business expense" or on the definition of "capital expense."\textsuperscript{22} In Welch v. Helvering,\textsuperscript{23}

\begin{footnotes}
\item[16] Section 905 of the Tax Reform Act of 1985, H.R. 3838, 99th Cong., 1st Sess. (1985) [hereinafter cited as Tax Reform Act of 1985], could settle the dispute over prepublication expenses. Yet nothing in the Act addresses or changes the general thesis of this Note. See infra note 179.
\item[17] See supra note 13 and accompanying text.
\item[18] See supra note 6.
\item[19] I.R.C. § 263(a)(1)(A)-(H) notes several exceptions to this general rule. I.R.C. § 1221 defines "capital asset." Note, however, that an expenditure need not be described as a capital asset in § 1221 to be classified as a capital expenditure. Georator Corp. v. United States, 485 F.2d 283, 285 (4th Cir. 1973), cert. denied, 417 U.S. 945 (1974), superseded, NCNB Corp v. United States, 684 F.2d 285 (4th Cir. 1982). See also Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 786 (2d Cir. 1973) ("[T]he words ['capital asset'] must be taken in their usual and customary business sense as items of ownership of a permanent or fixed nature which are convertible into cash.").
\item[20] Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281-82 (1864): "[N]o deduction shall be made for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate.
\item[22] See Note, supra note 8, at 540-49. Thus, a court can apply either I.R.C. § 162 or § 263 to classify an expenditure. Classification under one of these provisions precludes classification under the other. A court would, however, have to apply both provisions to an expenditure having dual purposes (both capital and current). See Blitzer v. United States, 684 F.2d 874, 893 (Ct. Cl. 1982).
\item[23] 290 U.S. 111 (1933).
\end{footnotes}
the Supreme Court ruled that payments of a bankrupt corporation's debts, made by a former officer to strengthen his own standing and credit, were in the nature of nondeductible capital expenditures. The Court applied the "ordinary and necessary" expense standard of section 162 (formerly section 23) to conclude that the particular expenditures were not currently deductible. In achieving this result, Justice Cardozo defined a "necessary" expense as one that is "appropriate and helpful" to the development of the taxpayer's business. The definition of "ordinary" posed greater difficulties for the Court. Nevertheless, in Deputy v. du Pont, "ordinary" was defined as invoking

24. Id. at 112, 115.
25. Id. at 115.
26. Id. at 113; see also Commissioner v. Tellier, 383 U.S. 687, 689 (1966). To determine what is "appropriate and helpful," courts will generally defer to the business judgment of the taxpayer. Welch v. Helvering, 290 U.S. at 113 ("[W]e should be slow to override [the businessman's] judgment."); see also Note, supra note 8, at 541 n.28.

Note that the characterization of an expense as "necessary" does not end the inquiry: "Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary." Welch v. Helvering, 290 U.S. at 113 (emphasis added); see also Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971).

27. Justice Cardozo wrote at length on the elusiveness of the term "ordinary" as contained in I.R.C. § 162:

Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. . . . [T]he expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. . . . The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

. . . Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.


Neither I.R.C. § 162 nor the accompanying Treasury regulations provide a definition for "ordinary and necessary" business expenses. However, in Internal Revenue Service, Publication 535—Business Expenses 23,351 (Rev. Dec. 1985), the Department of the Treasury declared: "An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your trade, business, or profession. An expense does not have to be indispensable to be considered necessary." (emphasis in original).

"the connotation of normal, usual, or customary." The Court held that the carrying charges on short sales of stock made by a stockholder (taxpayer) to assist his corporation and preserve his investment in it were not ordinary and necessary expenses of his business. In reaching this conclusion, Justice Douglas, writing for the majority, set forth a general standard for determining whether an expense is "ordinary" within the meaning of section 162: "[A]n expense may be ordinary though it happen but once in the taxpayer's lifetime. . . . Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved."

The "recurrent in the industry" approach of du Pont was utilized forty years later in Encyclopaedia Britannica, Inc. v. Commissioner, a case dealing with the deductibility of prepublication expenditures. Judge Posner defined an "ordinary" expense as one that is "normally incurred in the type of business in which the taxpayer is engaged." However, the court also followed the trend of modern cases by using the word "ordinary" to clarify the distinction between currently deductible and capital expenditures. The continued ambiguity that resulted by shifting the standard from "ordinary" to "recurrent" or "normal," and the judicial inclination to define section 162 expenses by contrasting the definition of section 263 capital expenditures,

29. Id. at 495. After reciting Justice Cardozo's statement in Welch that what is ordinary is "a variable affected by time and place and circumstance," see supra note 27, the Court declared: "One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. . . . It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling." 308 U.S. at 496 (emphasis added).

30. Id. at 488, 490-93. In addition, the Court concluded that the expenditures were not incurred in connection with the taxpayer's alleged business of "conserving and enhancing his estate." The Court did not rule, however, on whether conserving and enhancing his estate constituted a "trade or business" within the meaning of I.R.C. § 162 (formerly § 23). Because the carrying charges were found not to be an "ordinary" expense—even assuming the activities of the taxpayer constituted a business—no such ruling was required. Id. at 493-94.

31. Id. at 495 (emphasis added). Although the Court ruled that the expenditures were not "ordinary," it declined to decide what treatment would be appropriate. Id. at 498-99. Thus, it cannot be concluded that the carrying charges were capital expenditures within the meaning of I.R.C. § 263.

32. See Note, supra note 8, at 541.
33. 685 F.2d 212 (7th Cir. 1982).
34. See infra notes 179-89 and accompanying text.
35. 685 F.2d at 216.
36. See Note, supra note 8, at 541 n.31.
37. 685 F.2d at 216; see also Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966).
led courts to apply line-drawing criteria based solely on the meaning of the term "capital expenditure."  

B. The Future Benefit or One-Year Test

In general, the future benefit or one-year test requires the capitalization of any expenditure that results in the creation of an asset having a useful life substantially beyond the close of the taxable year.\(^{39}\) This standard finds support in both the Treasury regulations\(^{40}\) and in the decisions of various circuit courts.\(^{41}\) Although several early court decisions applied a future benefit test in classifying corporate expenditures,\(^{42}\) \textit{United States v. Akin}\(^{43}\) is the case credited with first establishing the one-year test. In \textit{Akin}, the Tenth Circuit held that an expenditure should be treated as capital in nature "if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year."\(^{44}\) Although the one-year rule was valuable in eliminating from capital treatment those expenditures that

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38. See Note, supra note 8, at 541-43.
39. Treas. Reg. § 1.461-1(a)(1), T.D. 6282, 1958-1 C.B. 215, 218. An expenditure that does not create an asset, but does secure for the taxpayer a like advantage that has a life of more than one year, is also considered a capital expense within the standard. See Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950). The underlying objective of the future benefit test is to match revenue against the particular expenses made to produce that revenue. See supra note 8.
40. See supra note 39. The federal income tax regulations are the official Treasury Department interpretation of the Internal Revenue Code and follow the number sequence of the Code sections. 1 INCOME TAX REGULATIONS—FINAL AND PROPOSED AS OF JUNE 3, 1985 (CCH) 30,000.
41. See, e.g., Bonaire Dev. Co. v. Commissioner, 679 F.2d 159 (9th Cir. 1982); American Dispenser Co. v. Commissioner, 396 F.2d 137 (2d Cir. 1968); Sears Oil Co. v. Commissioner, 359 F.2d 191 (2d Cir. 1966); Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir.); vacated and remanded on other grounds, 382 U.S. 68, original holding on this issue reaff'd, 354 F.2d 410 (4th Cir. 1965), overruled, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982).
42. See, e.g., P. Dougherty Co. v. Commissioner, 159 F.2d 257, 258 (3d Cir. 1946) ("The benefits to petitioner were to last over a period of several years ....") , cert. denied, 331 U.S. 838 (1947); Clark Thread Co. v. Commissioner, 100 F.2d 257, 258 (3d Cir. 1938) ("The benefits derived from this [asset] cannot be confined to the year in which [it] was acquired ....").
43. 248 F.2d 742 (10th Cir. 1957), cert. denied, 355 U.S. 956 (1958).
44. See Note, supra note 9, at 1135.
45. 248 F.2d at 744 (citation omitted); see Note, supra note 9, at 1135. The expenditures at issue in \textit{Akin} were annual assessments paid by taxpayers to two mutual ditch companies that supplied water for the irrigation of the taxpayers' farms and were used by the companies to retire long-term indebtedness and to purchase a right of way. The court held these expenditures to be nondeductible capital contributions. The Tenth Circuit had previously delineated the one-year rule in Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950).
clearly provided no future benefits to the taxpayer,\footnote{46} the fact that many concededly deductible expenses have prospective effect beyond the taxable year led the Supreme Court to develop additional criteria for distinguishing capital expenditures from ordinary business expenses.\footnote{47}

C. The Separate and Distinct Asset Test

In \textit{Commissioner v. Lincoln Savings & Loan Association},\footnote{48} the Supreme Court held that the controlling consideration in classifying an expenditure as capital or ordinary is whether the “payment serves to create or enhance . . . what is essentially a separate and distinct additional asset.”\footnote{49} The expenditure at issue in \textit{Lincoln Savings} was a mandatory “additional premium” paid by a state-chartered savings and loan association into a Federal Savings and Loan Insurance Corporation (FSLIC) Secondary Reserve.\footnote{50} The Court concluded that the premium payment represented a nondeductible capital expenditure because it created a separate and distinct asset for the savings and loan

\footnote{46. \textit{See} \textit{Jack's Cookie Co. v. United States}, 597 F.2d 395, 405 (4th Cir.) (“The one-year rule is useful because it serves to segregate from all business costs those which cannot possibly be considered capital in nature because of their transitory utility to the taxpayer.”), \textit{cert. denied}, 444 U.S. 899 (1979).

47. \textit{See} \textit{Commissioner v. Lincoln Sav. & Loan Ass'n}, 403 U.S. 345, 354 (1971); NCNB Corp. v. United States, 684 F.2d 285, 289 (4th Cir. 1982) (“One need not consider further than the case of the corporate executive who spends a significant, though indeterminable, amount of his time on future planning to realize that universal application of the one year rule is impossible and that it has not been so applied in such cases.”); \textit{see also} infra notes 48-83 and accompanying text.


49. \textit{Id.} at 354. Justice Blackmun, writing for the majority, declared:

\[\text{[T]}\text{he presence of an ensuing benefit that may have some future aspect is not controlling; many expenses conceded deductible have prospective effect beyond the taxable year.}\]

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

\textit{Id.}


50. 403 U.S. at 345, 349.
Although the premium payment provided a future benefit to the taxpayer, and thus could be classified as a capital expenditure under the one-year rule, the Court held that this fact was not controlling.

Since the Lincoln Savings decision, most courts have held the future benefit aspect of an expenditure to be merely a factor for consideration rather than a dispositive characteristic. Accordingly, the "separate and distinct asset" test has gained wide acceptance. In Briarcliff Candy Corp. v. Commissioner, the Second Circuit concluded that promotional expenses incurred by the taxpayer in developing a new channel of distribution for its products did not create or enhance a separate and distinct capital asset. Thus, the expenditures were currently deductible as

51. Id. at 354. The Court cited two criteria supporting the existence of a separate and distinct capital asset: (1) the taxpayer had a recognized property interest in the Secondary Reserve; and (2) the taxpayer accounted for the payments as an asset on its balance sheet. Id. at 355-56. See also Southland Royalty Co. v. United States, 582 F.2d 604, 611 (Ct. Cl. 1978) (holding that litigation expenses allocable to future income were deductible because no property interest was at stake); see infra notes 118-28 and accompanying text.

52. See supra notes 39-46 and accompanying text.

53. See supra notes 39-46 and accompanying text.

54. See, e.g., Jack's Cookie Co. v. United States, 597 F.2d 395, 404-05 (4th Cir.), cert. denied, 444 U.S. 899 (1979); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1191-92 (10th Cir. 1974); cf. Bonaire Dev. Co. v. Commissioner, 679 F.2d 159, 161 (9th Cir. 1982) ("Under the 'one-year rule' . . . an expenditure creating an asset with a useful life beyond the taxable year of more than one year generally must be amortized.") (citations omitted).

As the Fourth Circuit noted in Jack's Cookie Co., the "separate and distinct asset" test of Lincoln Savings necessarily incorporates the one-year rule because "one integral characteristic of the 'separate and distinct' asset which is 'created or enhanced' by the outlay, is that it will serve the taxpayer in subsequent years." 597 F.2d at 405 (footnote omitted).

55. See infra notes 56-83 and accompanying text.

56. 475 F.2d 775 (2d Cir. 1973).

57. The Briarcliff Candy Corp., formerly known as Loft Candy Corp., had engaged in the manufacture and sale of confectionary products since the late 19th century. It made over 80% of its sales through its own retail stores located in the thickly populated urban centers of the Northeast. Yet the large shift in population from urban centers to the suburbs which occurred in the 1950's severely affected Briarcliff's sales. The "promotional expenses" incurred by the taxpayer were made in order to persuade suburban storekeepers to display and sell its products (in the form of a franchise). Id. at 777. Thus, the taxpayer's purpose in making the expenditures was to maintain its sales and profits by recapturing those customers who had moved to the suburbs. Id. at 780. See generally Note, supra note 49, at 320-21.

58. 475 F.2d at 786-87. The court viewed the Lincoln Savings holding as applying only to the creation or enhancement of a capital asset. Because the expenditures at issue did not create or enhance "an item of ownership of a permanent or fixed nature which [was] convertible into cash," the taxpayer was allowed to currently deduct the pay-
ordinary and necessary business expenses within the meaning of section 162.\textsuperscript{59} The court reached its decision after analyzing the distinction between intangible contributions to tangible assets and intangible contributions to intangible assets.\textsuperscript{60} The court reasoned:

[A]n intangible contribution to tangible assets, such as a company’s engineer’s supervision of the construction of a particular section of a new factory building, makes his salary, or a proportionate part of it, a capital expenditure connected with the building of the factory. If, however, the sales manager of an ongoing concern has contributed 25\% of his time to devising a new or different method of attracting customers and selling candy, i.e. an intangible asset to his company, the deductibility or non-deductibility of that 25\% of his salary turns upon the question of whether or not the new method is a capital asset and therefore non-deductible. It is a capital asset 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[,] . . . so that [it is] no longer regarded as an expense but as a distinct and recognized property interest.\textsuperscript{61}

The \textit{Briarcliff} decision thus added an additional criterion to the

\textit{ments. Id.} at 786. This narrow interpretation of \textit{Lincoln Savings} resulted from the court’s reluctance to apply I.R.C. § 263 and the “separate and distinct asset” test to the enhancement of an intangible asset (increased distribution and sales). \textit{Id.} at 781, 783-85. \textit{See also infra} notes 60-62 and accompanying text.

59. 475 F.2d at 787. The court believed that the facts of this case brought it “squarely within the long recognized principle that expenditures for the protection of an existing investment or the continuation of an existing business or the preservation of existing income from loss or diminution, are ordinary and necessary within the meaning of § 162 and not capital in nature.” \textit{Id.} (citations omitted). Because the expenditures were ordinary recruiting costs of enlisting sales agents for a long-established concern and seeking sales agents for its usual and customary product, they were currently deductible. \textit{Id.}

60. \textit{Id.} at 784. According to the court, this distinction is important because an intangible contribution to a tangible asset would almost always produce a capital expenditure, though an intangible contribution to an intangible asset might not. \textit{See Note, supra} note 9, at 1137; \textit{cf.} \textit{Central Tex. Sav. & Loan Ass’n v. United States}, 731 F.2d 1181, 1185 (5th Cir. 1984) (“Even an intangible property right, such as the right to do business, may be a capital item.”); \textit{Seligman v. Commissioner}, 84 T.C. 191, 202 (1985) (holding that expenditures that created a separate and distinct intangible asset—the legally enforceable right to receive certain administrative services in the future—had to be capitalized).

61. 475 F.2d at 784-85 (emphasis in original and added). The court concluded that the agreements between Briarcliff and the suburban storeowners provided no property interest to the candy company. Therefore, no separate and distinct asset was created or enhanced.
Lincoln Savings standard: whether the asset that is created or enhanced has an "ascertainable and measurable value."\textsuperscript{62}

In \textit{NCNB Corp. v. United States},\textsuperscript{63} the Fourth Circuit applied the "separate and distinct asset" test to expenditures incurred by the North Carolina National Bank (NCNB) in connection with its establishment of a state-wide network of branch banks.\textsuperscript{64} The expenditures in question included the costs of "metro studies,"\textsuperscript{65} "feasibility studies,"\textsuperscript{66} and applications to the Comptroller of the Currency.\textsuperscript{67} After concluding that the costs NCNB incurred in exploring branch expansion were analogous to the costs in 

\textit{Briarcliff} of developing a franchise network,\textsuperscript{68} the court held that NCNB's expenditures did not create or enhance a "separate and distinct additional asset."\textsuperscript{69} In \textit{Central Texas Savings 

\textit{Id.} Following the court's reasoning, a tangible expenditure that created or enhanced a separate and distinct intangible asset with an unascertainable value would have to be currently deducted even if it provided a future benefit to the taxpayer. One commentator observed:

This definition [of a capital asset] seems inadequate as a means of resolving any but the clearest cases. Many expenditures clearly capital—the cost of a non-transferable license, or stock in a closely-held corporation, for example—produce benefits no more susceptible to precise valuation than benefits that are not assets. Measurability of the benefits of an expenditure in terms of time may be relevant in capitalization cases, but there is no reason why measurability in terms of dollar value should determine whether a cost must be capitalized.

Gunn, supra note 49, at 498 (footnotes omitted).

\textit{Id.} at 286. \textit{See generally Note, The Deductibility of Bank Branching Expenditures: Central Texas Savings 


\& LEE L. REV. 839 (1983)}.

\textit{Id.} at 289. The court reasoned that because NCNB's expenditures were made in order to develop and operate a state-wide network of branch banking facilities—a business strategy that was necessary to maintain its competitive position in the industry—they would be deductible under I.R.C. § 162 as "expenditures for the protection of an existing investment, the continuation of an existing business, or the preservation of existing income from loss or diminution." \textit{Id.} (citing Briarcliff Candy Corp. v. Commissioner, 475 F.2d at 787); see supra note 59.

\textit{Id.} at 290. The court stated: "The branch has no existence separate and apart from the parent bank; as a branch bank, it is not readily salable and has no market value other than the real estate which it occupies and the tangible equipment therein." \textit{Id.}
Savings & Loan Association v. United States, a Fifth Circuit case with essentially the same facts as NCNB, the court reached the opposite conclusion. The court declared that "[t]he character of the item acquired determines the tax treatment of the expenditures made to acquire it." Because the savings and loan association enjoyed a property interest in its branch offices—an interest that was easily valued at the time each branch was permitted to begin operations—the court found the offices to be separate and distinct assets within the Lincoln Savings definition. As such, the expenditures incurred in investigating and in starting up new branch offices had to be capitalized. Although it is difficult to reconcile the decisions in Central Texas and NCNB given the considerable similarity in their fact patterns, the Fifth Circuit's greater reliance on the future benefit aspect of the expenditures, and its view that the deduction of the investigatory and start-up expenses was an inaccurate reflection of the taxpayer's income, provide some explanation for the discrepancy.

The "separate and distinct asset" test set forth by the Supreme Court in Lincoln Savings continues to be the predominant standard applied by courts in distinguishing capital expenditures from ordinary business expenses. Legal com-

70. 731 F.2d 1181 (5th Cir. 1984).
71. The taxpayer made several expenditures in investigating and in starting up new branch banks, including professional fees for economic research and analysis to determine the potential market at each location, and attorneys' fees and permit fees incident to licensing the new locations. Id. at 1182.
72. Id. at 1184.
73. Id. at 1185. Central Texas's property interest included the separate right, acquired by permit, to do business in a new territory, the right to receive new accounts for new customers in a new market, and the right to challenge the entry of competitors into the local market. Id.
74. Id. The court stated: "The taxpayer obtained a separate and identifiable business right that was exercised in a separate office by a separate staff in an exclusive territory." Id.
75. Id. For a criticism of the Central Texas decision, see Note, Bank Branching Expenditures, supra note 64, at 155-61.
76. 731 F.2d at 1183, 1185.
77. Id.; see infra notes 118-28 and accompanying text; see also Note, Bank Branching Expenditures, supra note 64, at 158-59.
78. For a more detailed explanation of the divergence in results of NCNB and Central Texas, see Note, Bank Branching Expenditures, supra note 64, at 147-50, 155-61. Three significant factors included: (1) disparate views concerning the proper test for determining what is an "ordinary business expense"; (2) different interpretations concerning the relationship of Code § 195 (relating to the capitalization of start-up expenditures) and § 162; and (3) the Fifth Circuit's emphasis on the separate, tangible characteristics of a bank branch. Id. at 148, 150, 159.
79. See, e.g., Honodel v. Commissioner, 722 F.2d 1462 (9th Cir. 1984) (holding that flat investment fees paid by the taxpayer to an investment advisory service in connection
mentators, however, have leveled sharp criticism against the Lincoln Savings standard.\(^{80}\) One commentator suggests that limiting capitalization to costs that create or enhance a “separate and distinct additional asset” might not satisfactorily explain the kind of distinctions that seem desirable in cases such as Briarcliff.\(^{81}\) In the case of contract rights, for example, “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.”\(^{82}\) Because the Lincoln Savings standard is not deemed to be determinative of all capitalization issues, it is best to view the “separate and distinct asset” test as a condition sufficient for capitalization rather than as a universal test.\(^{83}\) Consequently, courts have applied additional line-drawing criteria in the classification of expenditures.\(^{84}\)

D. The New Business/Old Business Test

The new business/old business test maintains that a taxpayer “has not ‘engaged in carrying on any trade or business’ within the intendment of [Code] section 162(a) until such time as the business has begun to function as a going concern and perform[s] those activities for which it was organized.”\(^{85}\) Consequently, expenditures to start a new business require capitalization, while expenditures restricted to the enterprise’s old business, even though to be conducted in a new manner, should

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with particular real estate purchases were expenditures that served to create or enhance a separate and distinct asset); Seligman v. Commissioner, 84 T.C. 191 (1985) (holding that monthly payments for administrative services in connection with the leasing of computer equipment were capital expenditures because the payments created a separate and distinct asset—the legal right to receive future services).

The future benefit test is also applied as a necessary condition to capitalization under the Lincoln Savings standard. See supra note 54.

80. See Gunn, supra note 49, at 496-98; Note, supra note 8, at 547; Note, supra note 49, at 333-35.

81. Gunn, supra note 49, at 496.

82. Id.

83. Note, supra note 49, at 334-35 (“Interpretation of Lincoln as a universal capitalization test, requiring the presence of a separate and distinct asset, contravenes the goal of our tax system to reflect income clearly.”). See also Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 225 (1985).

84. See infra notes 85-128 and accompanying text.

85. Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir.), vacated on other grounds, 382 U.S. 68 (per curiam), original holding on this issue reaff’d, 354 F.2d 410 (4th Cir. 1965), overruled on other grounds, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982). See generally Note, supra note 9, at 1132-35.
be expensed. The standard was first applied in *Richmond Television Corp. v. United States*. The taxpayer, incorporated in 1952 to operate a television station, incurred staff training expenses prior to receiving its Federal Communications Commission (FCC) license. The court held the expenditures to be nondeductible “pre-operating expenses” because Richmond Television did not begin “carrying on any trade or business” until receipt of its FCC license in 1956.

In *Briarcliff Candy Corp. v. Commissioner*, the Second Circuit held that expenditures incurred in establishing a new method for conducting an ongoing business were deductible under section 162. The Tenth Circuit applied this rationale in *Colorado Springs National Bank v. United States* to conclude that start-up expenditures incurred incident to a bank’s new credit card system were currently deductible business expenses. The court stated:

> The credit card system enables a bank to carry on an old business in a new way. A new method is distinguishable from a new business. . . . [Because] [t]he challenged exp-

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86. NCNB Corp. v. United States, 651 F.2d 942, 956 (4th Cir. 1981), rev’d en banc, 684 F.2d 285 (4th Cir. 1982); see also I.R.C. § 195 (requiring the capitalization of start-up expenditures).

87. 345 F.2d 901 (4th Cir.), vacated on other grounds, 382 U.S. 68 (per curiam), original holding on this issue reaff’d, 354 F.2d 410 (4th Cir. 1965), overruled on other grounds, NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982).

88. 345 F.2d at 903-04.

89. *Id.* at 907. The court did not rule on whether the training expenses could be amortized as capital expenditures. *Id.* at 908-09.

90. 475 F.2d 775 (2d Cir. 1973).

91. *Id.* at 782. The court stated:

> Every new idea and every change of method in making sales, even in promoting special sales or developing new sales territory, do not require that the expenses connected with the operation be non-deductible under § 162. . . . In fact, expenditures by an already established and going concern in developing a new sales territory are deductible under § 162.

92. . . . [T]he changes which [the taxpayer] made in its own internal organization to spread its sales into a new territory were not comparable to the acquisition of a new additional branch or division to make and sell a new and different product [which would require capitalization].

93. *Id.* at 1190-91; see also First Sec. Bank of Idaho v. Commissioner, 592 F.2d 1050 (9th Cir. 1979); Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979); First Nat'l Bank of S.C. v. United States, 558 F.2d 721 (4th Cir. 1977); Note, *supra* note 9, at 1134-35. See generally Comment, Colorado Springs National Bank v. United States—Deductibility of Start-Up Expenses for a Credit Card Program, 1975 *Utah L. Rev.* 279.
penditures were for the continuation of an existing business and for the preservation and improvement of existing income, . . . they were ordinary expenses. 94

In *NCNB Corp. v. United States*, 95 the Fourth Circuit applied the new business/old business standard in the context of bank branching expenditures. Although the taxpayer had arguably created a separate and distinct asset (the bank branch itself), 96 the court concluded that the expenditures were currently deductible because they were incurred for the “continuation of an existing business.” 97

The new business/old business test is not the predominant standard used by the courts to distinguish capital expenditures from ordinary and necessary business expenses. 98 The test is useful in those situations where a taxpayer incurs expenditures unrelated to its normal business objectives. It must be recognized, however, that an expenditure’s relation to a new business of the taxpayer is a *sufficient* but not *necessary* condition for requiring capitalization; 99 the new business/old business test merely represents one of several standards that courts may choose to apply.

94. 505 F.2d at 1190, 1193.
95. 684 F.2d 285 (4th Cir. 1982) (en banc).
96. *See* Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984) (holding that a bank branch was a separate and distinct asset).
97. 684 F.2d at 290; *see also supra* notes 64-69 and accompanying text.
98. *See supra* note 79 and accompanying text.
99. *NCNB Corp. v. United States*, 651 F.2d 942, 957 (4th Cir. 1981), *rev'd en banc*, 684 F.2d 285 (4th Cir. 1982). The panel decision of *NCNB* discussed at length the implications of the new business/old business standard:

When the costs at issue relate to a new business, income will almost certainly be *unclearly* reflected if those costs are set off against revenues flowing from the enterprise’s old business.

Where the expenditure relates to the enterprise’s old business, it may or may not be appropriate to consider the expenditure as part of the cost of producing current revenues. In some situations there may be a clear cause-and-effect relation between the expenditure on the old business and a future revenue stream which has not yet begun to flow. If so, carrying forward and capitalizing the costs is appropriate. In other situations, “no useful purpose” would be served by allocating the costs to a subsequent period, or the costs “cannot, as a practical matter, be associated with any other [than the current] period.” If so, they should be charged to current expense. . . .

. . . It is the current or future nature of the matching income, not the newness or non-newness of the business which controls. The test is simply not one of whether the business is an old or a new enterprise. Relation to a new business of the enterprise in question is thus a *sufficient* but it is not a *necessary* condition for carrying a cost forward to subsequent accounting periods.

*Id.* at 956-57 (emphasis in original) (citations omitted).
E. The Origin-of-the-Claim Doctrine

Under the origin-of-the-claim doctrine, the basis for requiring capitalization is the integral relationship between the expenditure and a capital asset.\textsuperscript{100} Although the doctrine is theoretically applicable to a variety of corporate expenditures,\textsuperscript{101} courts have primarily used the origin-of-the-claim test to determine whether litigation expenses should be capitalized or currently deducted.\textsuperscript{102} Briefly stated, the test declares that legal expenses must be capitalized if "the origin of the claim litigated is in the process of acquisition [or disposition of a capital asset]."\textsuperscript{103} The rationale for this standard "rests on the belief that all expenses which stem from a capital transaction should . . . be 'matched' or equated with all gains from the same capital transaction and the expenses should receive identical tax treatment as the gains."\textsuperscript{104}

\begin{itemize}
  \item \textsuperscript{100} Lee & Murphy, supra note 49, at 484.
  \item \textsuperscript{101} See, e.g., Honodel v. Commissioner, 722 F.2d 1462, 1467 (9th Cir. 1984) ("[T]he deductibility of any expense [investment fees in this case] related to tax advice or assistance must still turn on whether the origin of the tax-related expense was ordinary and necessary, or was a capital acquisition or disposition."); Great Lakes Pipe Line Co. v. United States, 352 F. Supp. 1159, 1172 (W.D. Mo. 1972) (applying the origin-of-the-claim test to payments by a corporate taxpayer to secure release from employment contracts), aff'd in unpub. opinion, 505 F.2d 735 (8th Cir. 1974).
  \item \textsuperscript{103} Woodward v. Commissioner, 397 U.S. 572, 577 (1970). In turn, legal expenses would be currently deductible if incurred (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax. I.R.C. § 212. See also Treas. Reg. § 1.212-1 (1957).
  \item The application of the origin-of-the-claim test is still developing. In the context of litigation, the Tax Court has held:

  Quite plainly, the "origin-of-the-claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires the examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. . . . Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.

  \item \textsuperscript{104} Sharples v. United States, 533 F.2d 550, 555 (Ct. Cl. 1976). According to Lee and Murphy:

  To allow a current deduction for such an expenditure while taxing related gain from the capital asset as capital gain, unreduced for the expenditure, would distort the taxpayer's income through a double deduction, or at least a deduction and a half (an ordinary deduction for the expenditure and a capital gain deduc-
In *Woodward v. Commissioner*, the Supreme Court analyzed the tax treatment of expenses incurred in certain appraisal litigation. The taxpayers, majority stockholders of an Iowa corporation, voted for perpetual extension of the corporate charter, and under Iowa law became obligated to purchase at its "real value" the stock of a minority shareholder who had voted against the extension. Because the parties could not reach agreement on the value of those shares, the taxpayers brought an action in state court to appraise the minority interest. The issue addressed by the Supreme Court was whether the litigation expenses incurred by the taxpayers were deductible under Code section 212 as "ordinary and necessary expenses paid . . . for the management, conservation, or maintenance of property held for the production of income," or were nondeductible capital expenditures incurred in connection with the acquisition of capital stock. After stating that "costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures," the Court applied the origin-of-the-claim test to conclude that the litigation expenses were not deductible.

Closely linked to the origin-of-the-claim doctrine is the tax benefit rule of *Arrowsmith v. Commissioner*. As one pair of

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Lee & Murphy, supra note 49, at 484.
106. Id. at 573. United States v. Hilton Hotels Corp., 397 U.S. 580 (1970), the companion case to *Woodward*, also involved the tax treatment of legal expenses incurred during stockholder appraisal litigation.
107. 397 U.S. at 572.
108. Id. at 573.
109. The taxpayers paid attorneys', accountants', and appraisers' fees of over $25,000 for services rendered in connection with the appraisal litigation. Id. at 573-74.
110. I.R.C. § 212. Whereas I.R.C. § 162 applies to business expenses incurred by corporations, "§ 212 applies only to individuals, trusts, and estates, and is primarily concerned with expenses attributable to marketable securities and other passive investments, such as the cost of investment advice and custodial services." 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 20.1.1, at 20-5 (1981).
111. 397 U.S. at 574.
112. Id. at 575.
113. Id. at 577-79. The Court declared: "Where property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price. . . . [T]he expenses incurred in [the appraisal] litigation were properly treated as part of the cost of the stock that the taxpayers acquired." Id. at 579. Thus, the Court held that the "origin of the claim litigated [was] in the process of acquisition itself." Id. at 577.
114. 344 U.S. 6 (1952). The "classic" tax benefit rule deals with the recovery of previ-
commentators observe, *Arrowsmith* "applies the origin-of-the-claim doctrine in all cases where the payment is made in a year subsequent to the original transaction." Accordingly, where an integral relationship exists between the two transactions, the character of the transaction in the earlier year will color the character of the transaction in the subsequent year. "The important connection among the origin of the claim doctrine, the *Arrowsmith* tax benefit rule, and the classic tax benefit doctrine is that two transactions are linked in order to prevent a distortion of taxpayer's income."

**F. The Clear Reflection of Income Test**

The "clear reflection of income" standard derives from Code section 446. The standard generally provides that where a taxpayer's method of accounting clearly reflects income, it is presumptively controlling of federal income tax treatment. The

ously deducted items. I.R.C. § 111.

In *Arrowsmith*, two shareholder-taxpayers reported the liquidating distributions of a corporation as *capital gains*. In 1944, four years after the final distribution of assets, a judgment was rendered against the corporation and against one of the taxpayers individually. Each of the two taxpayers paid half of this judgment and deducted 100% of the amount so paid as an *ordinary business loss* in his 1944 income tax return. The Supreme Court held that the losses should be treated as *capital losses* because the taxpayers' "liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings." 344 U.S. at 8. Thus, the tax benefit initially received by the taxpayers—a capital gains deduction—dictated the character of the subsequent deduction (which was related to the original transaction). *See generally* Lee & Murphy, *supra* note 49, at 499-509.

116. *Id.* at 503. Lee and Murphy also maintain that *Arrowsmith* is applicable "where the expense does not create or enhance a capital asset, but is integrally related to a capital transaction and flavored by it because failure to equate the tax character of the two transactions would result in a distortion of income." *Id.* at 504. *See also* Sharples v. United States, 533 F.2d 550, 554 (Ct. Cl. 1976).

118. I.R.C. § 446 provides in part:

(a) **GENERAL RULE.**—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) **EXCEPTIONS.**—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.


Although the accounting profession and concerned regulatory agencies may support a particular accounting method that is believed to reflect income accurately, the courts
Supreme Court has recently endorsed a standard that is based on "clear reflection of income" principles. In Commissioner v. Idaho Power Co., the Court declared that "where a taxpayer's generally accepted method of accounting is made compulsory by [a] regulatory agency and that method clearly reflects income; it is almost presumptively controlling of federal income tax consequences." Without relying on the "separate and distinct asset" test of Lincoln Savings, the Court concluded that the depreciation expense on equipment used in the construction of capital assets was a cost that must be capitalized; only through capitalization would income be "clearly reflected."

Because a major objective of the Internal Revenue Code is to match expenses against income produced, the "clear reflection of income" standard would appear to be the most satisfactory have discretion to accept or reject such a belief. See, e.g., American Auto. Ass'n v. United States, 367 U.S. 687, 693 (1961) (holding that generally accepted accounting practices are not binding on the Treasury); Old Colony R.R. v. Commissioner, 284 U.S. 552, 562 (1932) (holding that agency-imposed accounting rules are not binding upon the Commissioner); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814, 817 (4th Cir.) (according some significance to a company's accounting method), cert. denied, 302 U.S. 722 (1937).

120. 418 U.S. 1 (1974).


122. The Court cited Lincoln Savings only for the proposition that agency-imposed compulsory accounting practices are not irrelevant and may be afforded some significance. 418 U.S. at 15; see Note, supra note 8, at 547.

123. 418 U.S. at 13-14, 19.

124. Id. at 14 ("[T]his capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized."). In Cincinnati, N.O. & T. Pac. Ry. v. United States, 424 F.2d 563 (Ct. Cl. 1970), the court concluded that some costs that are capital in nature need not be capitalized if income will still be clearly reflected. Id. at 573; Note, supra note 8, at 545. The Supreme Court in Idaho Power seemingly rejected this contention when it stated: "The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income." 418 U.S. at 16; see also Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 215 (7th Cir. 1982) ("[E]xpenses, whatever their character, must be capitalized if they are incurred in creating a capital asset . . . ."). But as one commentator noted:

By applying "clear reflection of income" principles in Idaho Power, the Court apparently acknowledged the generalization that capital expenditures may not be immediately deducted, because in almost all cases income will be clearly reflected only by correlating the deduction with the future production of income. But the Court's reliance on income-reflecting principles itself implies that a cost ordinarily characterized as a capital expenditure might be treated as immediately deductible if, as in Cincinnati Railway, the circumstances of the industry and of the individual taxpayer ensure that income will still be clearly reflected.

Note, supra note 8, at 548 (emphasis in original).

125. See supra note 8; see also 1 B. Bittker, supra note 110, ¶ 20.4.1, at 20-64 to -66.
method for distinguishing capital expenditures from ordinary
business expenses. As one commentator argues, "[C]apitalization of an expenditure should be required only where capitalization is necessary to reflect income accurately." Nevertheless, the "clear reflection of income" standard does not provide an adequate means, in and of itself, to distinguish between capital and ordinary expenditures. A court remains faced with the problem of determining whether or not income is being accurately reflected by a taxpayer's accounting method. In order to make this determination, and to provide taxpayers with a set of concrete guidelines for classification, a more objective standard is necessary.

II. A Universal Standard for Distinguishing Between Capital and Ordinary Expenditures

For over fifty years, the feasibility of a universal standard for distinguishing nondeductible capital expenditures from currently deductible trade or business expenses has been an issue of controversy in both judicial opinion and legal discourse. Although the "separate and distinct asset" test of Lincoln Savings comes close to being a universal standard, courts have not applied it in such a manner. Furthermore, the test is not determinative of all capitalization issues. A universal standard that (1) can be applied to any expenditure; (2) promotes the objectives of the Tax Code by matching expenses against income; and (3) clarifies and simplifies the confused state of the law on the issue, appears below.

126. See Note, supra note 8, at 571.
127. Id. at 548.
128. Such guidelines are necessary to add predictability and uniformity to the tax treatment of expenditures. See infra notes 132-38 and accompanying text.
129. See, e.g., Welch v. Helvering, 290 U.S. 111, 115 (1933) ("One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."); NCNB Corp. v. United States, 684 F.2d 285, 287 (4th Cir. 1982) (en banc) ("[N]either courts nor the accounting profession have devised a universal, foolproof method of distinguishing current expenses from capital costs."); Gunn, supra note 49, at 497 ("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.'"); Note, Income Tax Accounting: Business Expense or Capital Outlay, 47 Harv. L. Rev. 669, 677 (1934) ("To deduce a uniform criterion of capital and expense consistent with both the cases and the accounting authorities seems impossible.").
130. See supra notes 12 & 83 and accompanying text.
131. See supra notes 83 & 116.
A. Justification for Reform

Uniformity of decision among the circuits is vitally important on issues concerning the administration and construction of the tax laws. Underlying this principle is the idea that inconsistent application of the law by the various circuits is harmful to the taxpayer. For example, in order to know whether a certain expenditure is currently deductible or must be capitalized, taxpayers need concrete, uniform standards to apply. As the Second Circuit declared in *Briarcliff Candy Corp. v. Commissioner*: "The taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are." In the absence of "clear criteria," predictability of tax treatment, an important consideration for business planning and strategy, is jeopardized.

A further complication that can arise from inconsistent application of the tax law is forum shopping. Taxpayers are assuredly motivated by different concerns in their desire to expense or capitalize an expenditure. For example, a corporation with a net operating loss for the tax year may desire to capitalize an expenditure rather than take a deduction that would not provide any current tax benefits. Alternatively, a corporation with unusually high net income for the tax year but with relatively few current deductions might desire to expense as much as possible. The existence of diverse or inconsistent line-drawing criteria for distinguishing capital expenditures from ordinary business expenses would lead taxpayers to forum shop on the basis of which circuit would provide the desired result. Given the variety of

133. 475 F.2d 775 (2d Cir. 1973).
134. Id. at 785.
135. See Lee & Murphy, *supra* note 49, at 546 ("Predictability in tax matters is important. Definite, set rules enhance predictability.").
136. Of course, the ability to carry forward or to carry back a net operating loss could change this motivation. See I.R.C. § 172.
137. The general harms of forum shopping include unequal protection of the law and a lack of uniformity in the administration of the law. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 75 (1937) (considering the problem of forum shopping between state and federal courts in diversity of citizenship actions). Forum shopping in the context of divergent capital/ordinary line-drawing standards prevents similarly situated taxpayers from receiving equal protection of the tax laws (uniform tax treatment).
line-drawing standards that courts apply in the area,\textsuperscript{138} and the importance of predictability and uniformity in tax administration, a universal standard for distinguishing capital from ordinary expenditures is clearly desirable.

\textbf{B. An Amendment to the Internal Revenue Code}

SECTION 263A.\textsuperscript{138} DISTINGUISHING CAPITAL EXPENDITURES FROM ORDINARY AND NECESSARY BUSINESS EXPENSES.

(a) \textbf{General Rule.}—An expenditure proximately related to the creation, improvement, acquisition, or disposition of any asset must be capitalized.

(b) \textbf{Definitions.}—For purposes of this section—

(1) \textbf{Proximately Related.}—The expression “proximately related” means intimately connected in circumstance.

(2) \textbf{Improvement.}—The term “improvement” refers to any enhancement or increase in value that provides a future benefit beyond the taxable year.

(3) \textbf{Asset.}—The term “asset” means any tangible or intangible property interest that:

(A) embodies a probable future economic benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows; and

(B) a particular taxpayer can obtain and control others’ access to the benefit.

(c) \textbf{Exceptions.}—The exceptions noted in sections 263(a)(1)(A)-(H) and sections 263(b)-(h) shall also apply for purposes of this section.\textsuperscript{140}

\textsuperscript{138} See supra notes 22-128 and accompanying text. Because the standards are not completely independent, the courts can also apply many combinations of line-drawing criteria. See, e.g., NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (en banc) (applying the “separate and distinct asset” test, the new business/old business test, and the “clear reflection of income” test, to conclude that bank branching expenditures were currently deductible).

\textsuperscript{139} Section 263B would be an appropriate section number if the proposed § 263A of the Tax Reform Act of 1985, supra note 16, is eventually enacted into law. See infra note 179.

\textsuperscript{140} Subsection (c) was included to assure that the exceptions to capitalization in
C. Explanation and Analysis of the Proposed Standard\textsuperscript{111}

A major objective of the proposed amendment is to match expenses against revenues so as to reflect income clearly and accurately.\textsuperscript{142} Basing the standard on a definition of “capital expenditure” rather than “ordinary business expense” most appropriately accomplishes this objective because “section 162 [ordinary] expenses can be defined only by referring to the definition of section 263 capital expenditures.”\textsuperscript{143} The specific language embodied in the proposed amendment, if applied consistently by the courts, should both prevent any distortion of income due to mismatching, and provide taxpayers with a predictable and uniform standard for the tax treatment of expenditures.

Subsection (a) of the amendment provides a general rule for the capitalization of expenditures. This rule employs language from several judicially adopted standards that purport to distinguish capital expenditures from ordinary business expenses.\textsuperscript{144} The heart of the proposed amendment, however, lies in the three terms defined in subsection (b).\textsuperscript{145}

1. “Proximately Related”— The principle that expenditures that are “proximately related” to a capital transaction should be capitalized derives from the origin-of-the-claim doctrine.\textsuperscript{146} Cases decided under this doctrine generally hold that litigation

\footnotesize{
\textsuperscript{111}I.R.C. § 263, many of which have significant public policy objectives, would not be superseded by the proposed amendment.

\textsuperscript{141} To promote consistent application of the proposed amendment among the circuits, this section should be utilized as a basis for any interpretive Treasury regulations.

\textsuperscript{142} See supra note 8.

\textsuperscript{143} Note, supra note 8, at 543 (“The provisions are, in effect, two sides of the same coin: definition of one implies definition of the other. The search for a useful standard must therefore turn to the meaning of the term ‘capital expenditure.’”).

\textsuperscript{144} See, e.g., Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (“creation” of a separate and distinct asset); Woodward v. Commissioner, 397 U.S. 572, 575 (1970) (“costs incurred in the acquisition or disposition of a capital asset”); Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926) (“[I]mprovements . . . are additions to capital investment which should not be applied against current earnings.”).

\textsuperscript{145} Note that “creation,” “acquisition,” and “disposition” are not defined. These terms should be taken in their usual and customary business sense.

\textsuperscript{146} See Lee & Murphy, supra note 49, at 494-96. The definition provided in subsection (b)(1), however, is not derived from an origin-of-the-claim case. See Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1230 (Cl. Cl. 1969) (“[E]xpenditures . . . intimately related to, and connected with, the acquisition of a capital asset are to be treated as part of the cost of or investment in the asset.”); Perlmutter v. Commissioner, 44 T.C. 382, 403 (1965) (expenses incurred “in connection with” the acquisition of a capital asset must be capitalized), aff’d, 373 F.2d 45 (10th Cir. 1967).
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expenditures incurred "as a direct result of" or "in connection with" a capital transaction must be capitalized. This analysis, however, can apply to any expenditure, not just litigation expenses. Thus, if an expenditure is "intimately connected in circumstance" to a capital transaction, it should be capitalized. An expenditure that is not deemed to be proximately related to a capital transaction should be currently deducted to avoid a distortion of income.

2. "Improvement"— The definition of "improvement" contained in the proposed amendment prevents the capitalization of repair expenses that do not provide a future benefit to the taxpayer. Only those expenditures that increase the economic value of an asset to the taxpayer for periods beyond the taxable year must be capitalized. Any expenditure that extends the life of an asset, replaces an existing asset, or adapts an asset to a new or different use should be deemed to increase the asset's economic value.

3. "Asset"— Underlying the entire framework for reform in the distinction between capital expenditures and ordinary business expenses is the definition of an "asset." The definition offered in subsection (b)(3) of the proposed amendment combines both judicial and accounting conceptions of an asset. In Briarcliff Candy Corp. v. Commissioner, the court recognized that a contribution to an intangible asset could qualify as a capital expenditure. The Briarcliff requirement that an intangible asset have an "ascertainable and measurable value" before capital-

147. Munn v. United States, 455 F.2d 1028, 1033 (Ct. Cl. 1972).
149. See supra notes 100-17 and accompanying text.
150. For purposes of clarification, this definition should be contrasted with the requirement that an expenditure be intimately connected in time and circumstance. If an expenditure is "proximately related" to a capital transaction, it should be capitalized, notwithstanding the fact that the original transaction occurred years ago. The character of the transaction, or circumstance, is the significant factor.
151. A "capital transaction" would be defined as "the creation, improvement, acquisition, or disposition" of an asset.
152. Courts are not unfamiliar with applying a "proximate relation" standard in the tax area. See Bingham's Trust v. Commissioner, 325 U.S. 365, 373-74 (1945); Treas. Reg. § 1.212-1(d) (1957); 1 B. Bittker, supra note 110, ¶ 20.5.2, at 20-102 to -106.
154. See Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926); Lee & Murphy, supra note 49, at 528.
155. 475 F.2d 775 (2d Cir. 1973).
156. Id. at 784-85. See supra notes 60-62 and accompanying text.
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ization will be permitted is not incorporated in the proposed amendment, however, because "there is no reason why measurability in terms of dollar value should determine whether a cost must be capitalized." Any expenditure proximately related to the creation, improvement, acquisition, or disposition of an intangible asset must be capitalized, assuming the conditions set forth in subsection (b)(3) are met. Of course, if the expenditure or the intangible asset has an indeterminable useful life, then no depreciation or amortization of the capitalized expense will be permitted. The idea that a taxpayer must have a "property interest" in an item for it to be classified as an asset derives from Commissioner v. Lincoln Savings & Loan Association, where the Supreme Court held that the presence of a property interest in an FSLIC Secondary Reserve provided significant evidence that a premium paid into the Reserve by the taxpayer should be capitalized.

The two conditions set forth in subsection (b)(3) are borrowed from Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises. The accounting profession's conception of an asset is most suitable for assuring a proper matching of expenses and revenues, i.e., a "clear reflection of income." Consequently, a "probable future economic benefit" is the key descriptive phrase of the definition. "Probable" is included in the definition to acknowledge that "business and economic activities occur in an environment characterized by uncertainty in which few outcomes are certain," not to describe a criterion for capitalization. "Future economic benefit" refers to the fact that "[a]n asset has the capacity to serve the enterprise by being exchanged for something else of

157. Gunn, supra note 49, at 498. See also supra note 62.
158. Treas. Reg. § 1.167(a)-3 (1956). See also Note, supra note 8, at 539 n.18. The proposed amendment must be read in conjunction with all Tax Code provisions and regulations.
159. 403 U.S. 345 (1971).
160. Id. at 355-56. General property law should be invoked to determine whether a "property interest" exists.
161. 1 FINANCIAL ACCOUNTING STANDARDS BOARD (FASB), ACCOUNTING STANDARDS—ORIGINAL PRONOUNCEMENTS AS OF JUNE 1, 1982, at 3080, 3089 (1980) [hereinafter cited as FASB].
162. An important principle of financial accounting is that expenses incurred in the generation of revenue should be matched with that revenue during the same fiscal period. See H. FINNEY & H. MILLER, PRINCIPLES OF ACCOUNTING—INTRODUCTORY 103-04 (G. Johnson & J. Gentry 8th ed. 1980).
163. FASB, supra note 161, at 3088 n.9. "Probable" refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. Id. (citing WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE 1132 (2d college ed. 1972)).
value to the enterprise, by being used to produce something of value to the enterprise, or by being used to settle its liabilities.'\textsuperscript{164} Thus, rights to receive services of other entities for specified or determinable future periods can be assets of particular business enterprises because future liabilities will be reduced; accordingly, future net cash inflows will be indirectly increased.\textsuperscript{165}

Subsection (b)(3)(B) indicates that "a business enterprise must control future economic benefit to the extent that it can benefit from the asset and can deny or regulate access to that benefit by others."\textsuperscript{166} For example, permitting access only at a price would qualify as control.\textsuperscript{167} "The enterprise having [control of] an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners."\textsuperscript{168}

III. APPLICATION OF THE PROPOSED INTERNAL REVENUE CODE AMENDMENT\textsuperscript{169}

Application of the proposed universal standard for distinguishing between capital expenditures and ordinary business expenses entails a four-step process. First, a court must determine whether the expenditure in question is proximately related to the creation of an asset.\textsuperscript{170} To make this determination, the court should apply subsection (b)(3) to ascertain whether an asset is involved. If the court concludes that an asset is being or has been created, it must then decide if the expenditure is proximately related to this creation. If it is, the expenditure should be capitalized in order to "clearly reflect income." The second, third, and fourth steps of the process involve substitution of the

\textsuperscript{164} FASB, supra note 161, at 3107-08. "The most obvious evidence of future economic benefit is a market price." Id.

\textsuperscript{165} Id. at 3089. Prepaid insurance or rent are examples of such assets. It should be noted that "legal enforceability of a right is not an indispensible prerequisite for an enterprise to have an asset if the enterprise otherwise will probably obtain the future economic benefit involved." Id. at 3110.

\textsuperscript{166} Id. at 3109.

\textsuperscript{167} Id. "[G]eneral access to things such as clean air or water resulting from environmental laws or requirements cannot qualify as assets of individual [taxpayers], even if the [taxpayer] incurred costs to help clean up the environment." Id. at 3110. On the other hand, clean air it provides in a laboratory or water it provides in a storage tank are future economic benefits that can be controlled by the taxpayer. Id.

\textsuperscript{168} Id. at 3109.

\textsuperscript{169} See supra note 141.

\textsuperscript{170} See supra note 145.
terms “improvement,” “acquisition,” and “disposition,” respectively, for “creation” in the above inquiries. The determination under any one of the four steps that an expenditure should be capitalized is dispositive of the issue; no further steps need be applied. This process may be illustrated by the following general examples:

Example (1). X Corporation entered an agreement to merge with Y Corporation and under state law became obligated to purchase at its “real value” the stock of those minority shareholders dissenting from the merger plan. Taxpayers A, B, and C, minority stockholders of X Corporation, dissented from the merger and incurred legal expenses in connection with litigation to appraise the value of their shares. Because the litigation expenses are proximately related to the disposition of an asset (the minority’s stock), capitalization is required.

Example (2). Taxpayer, a furniture moving and storage company, sustained a casualty loss during the taxable year when its warehouse was totally destroyed by a fire. To preserve goodwill among its customers, and to protect its business reputation, the taxpayer reimbursed its uninsured customers whose household goods were destroyed during the fire. Because the restitution payments are proximately related to the preservation of an asset (goodwill), rather than to the creation, improvement, acquisition...
tion, or disposition of an asset, capitalization is inappropriate. The payments should be currently deducted. 174

Example (3). Taxpayer, a meat-packing corporation, lined the walls and floor of its basement with concrete to protect it from the seepage of oil spilled on the ground by a neighboring refinery. The purpose of the expenditure for the concrete liner was to permit continued use of the basement for normal operations (storage and curing). Because the expenditure did not enhance or increase in value any asset of the taxpayer, but merely kept the meat-packing plant in ordinarily efficient operating condition, 175 capitalization is inappropriate.

Example (4). Assume the same facts as in example (3) except that the purpose of the concrete lining was to extend the useful capacity to earn profits in excess of the normal rate of return due to establishment of a favorable community reputation and consumer identification of the business name.

General Television, Inc. v. United States, 449 F. Supp. 609, 611 (D. Minn. 1978) ("[G]oodwill is seen as a self-regenerating asset whose economic value fluctuates but does not necessarily diminish."); aff'd, 598 F.2d 1148 (8th Cir. 1979); and (2) it is inherent in goodwill's characterization as a "property right" that a taxpayer can control others' access to the economic benefit.

See Rev. Rul. 76-203, 1976-1 C.B. 45 (holding that expenditures made to preserve goodwill are ordinary and necessary business expenses deductible under Code § 162(a)). See generally 1 B. Bittker, supra note 110, ¶ 20.4.7, at 20-86 to -87.

Under the proposed standard, an expenditure that is proximately related to the creation, improvement, acquisition, or disposition of goodwill would have to be capitalized. Of course, if the useful life of the expenditure—the length of time that a benefit will accrue—cannot be ascertained with reasonable accuracy, no depreciation allowance will be permitted. Treas. Reg. § 1.167(a)-3 (1956). Although the Treasury regulations specifically provide that "[n]o deduction for depreciation is allowable with respect to goodwill," id., a depreciation allowance should be permitted for an expenditure that results in the creation of goodwill for a limited and ascertainable length of time. Cf. Alabama Coca-Cola Bottling Co. v. Commissioner, 28 T.C.M. (CCH) 635, 655 (1969) (holding that advertising costs involving expenditures for physical assets with ascertainable useful lives had to be capitalized and depreciated over five years, despite the possible long-term impact on goodwill).

A strict application of the proposed universal standard to advertising expenses that result in the creation of goodwill requires the capitalization of such expenditures. The Internal Revenue Service, however, has long acquiesced in the deduction of advertising costs. See Treas. Reg. § 1.162-20(a)(2) (1965) ("Expenditures for institutional or 'good will' advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future."). Professor Bittker suggests that the Service's acquiescence in the deduction of advertising expenditures may have been implicitly ratified by congressional silence. 1 B. Bittker, supra note 110, ¶ 20.4.5, at 20-84. Because the proposed universal standard must be read in conjunction with all Code provisions and regulations, advertising expenditures to create goodwill should generally be treated as currently deductible.

174. See Rev. Rul. 76-203, 1976-1 C.B. 45 (holding that expenditures made to preserve goodwill are ordinary and necessary business expenses deductible under Code § 162(a)). See generally 1 B. Bittker, supra note 110, ¶ 20.4.7, at 20-86 to -87.


176. See Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950) (holding
lives of the basement floor and walls, which had been deteriorating over the past several months due to normal wear and tear. Because the expenditure increased the economic value of the taxpayer’s basement, an asset that contributes indirectly to net cash inflows, capitalization is required.\footnote{The issue of whether prepublication expenses should be capitalized or expensed could become moot if \S\ 905 of the Tax Reform Act of 1985, supra note 16, is enacted into law. Section 905 amends the Internal Revenue Code by inserting the following new section after \S\ 263:

\begin{quote}
\textbf{SEC. 263A. CAPITALIZATION OF CERTAIN EXPENSES WHERE TAXPAYER PRODUCES PROPERTY.}
\begin{enumerate}
\item[(a)] \textbf{GENERAL RULE.}—In the case of any taxpayer who produces real or tangible personal property, the following costs shall be capitalized:
\begin{enumerate}
\item the direct costs of such production, and
\item such production’s proper share of those indirect costs (including taxes) part or all of which are assignable to such production.
\end{enumerate}
\item[(f)] \textbf{PRODUCTION.}—For purposes of this section—
\begin{enumerate}
\item \textbf{IN GENERAL.}—The term “produce” includes construct, manufacture, develop, improve, raise, or grow.
\item \textbf{TREATMENT OF PROPERTY PRODUCED UNDER CONTRACT FOR THE TAXPAYER.}—The taxpayer shall be treated as producing any property produced for the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying subsection (a) to the taxpayer.
\end{enumerate}
\end{enumerate}
\end{quote}

The House Ways and Means Committee Report on the Tax Reform Act of 1985, H.R. Rep. No. 426, 99th Cong., 1st Sess. 625 (1985), declared in regard to \S\ 905: “[I]n order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of production costs for all tangible property, subject to appropriate exceptions where application of the rules might be unduly burdensome.” Although the Committee Report did not explicitly state that prepublication expenses of authors and publishers would be covered by \S\ 905, this can be inferred from the “reasons for change” given by the committee, id., and by the language
\footnote{See supra note 154 and accompanying text. See generally I B. Bittker, supra note 110, \S\ 20.4.8, at 20-88 to -93.}}

The remainder of this Note is devoted to an application of the proposed universal standard to two controversial expenditures: prepublication expenses of authors and publishers, and bank branching expenses.\footnote{See supra note 13.}

A. \textit{Prepublication Expenses of Authors and Publishers}\footnote{See generally supra note 110, 120.4.8, at 20-88 to -93.} 

Prepublication expenditures include research, travel, editorial, and office costs, in addition to the expenses associated with the
final manufacture of the product. These costs are all incurred in the production of a book, an income-producing asset with a useful life beyond the taxable year. In both *Faura v. Commissioner* and *Snyder v. United States*, prepublication expenditures of an author were held to be currently deductible ordinary business expenses. The decisions were based on an established line of precedent and on an analysis of section 2119 of the Tax Reform Act of 1976. However, in *Encyclopaedia Britannica, Inc. v. Commissioner*, the Seventh Circuit denied a current deduction for prepublication costs, relying instead on the “clear reflection of income” principles of *Idaho Power*. Because the taxpayer incurred prepublication expenses for the creation of a book “intended to yield . . . income over a period of years,” the court had “no doubt” that they were capital expenditures. An application of the proposed universal standard to the prepublication expenditures incurred in *Faura, Snyder, and Encyclopaedia Britannica*, also leads to the conclusion that capitalization is

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181. See Note, supra note 8, at 537.

182. 73 T.C. 849 (1980).

183. 674 F.2d 1359 (10th Cir. 1982).

184. See generally Note, supra note 8, at 555-56. Cf. Hadley v Commissioner, No. 18277-82 (T.C. Apr. 28, 1986) (holding that prepublication expenditures of an author are subject to the capitalization requirements of I.R.C. § 280); Garrison v. Commissioner, No. 23172-83, slip op. at 5 (T.C. Apr. 22, 1986) (“[Section 280] provides that, in the case of an individual, amounts attributable to the production of a book are required to be capitalized and deducted over the life of the income stream generated from the production activity.”).

185. See 73 T.C. at 852-57.

186. Section 2119 of the Tax Reform Act of 1976, supra note 180, addresses regulations relating to the tax treatment of certain prepublication expenses of publishers. The *Faura* court decided to extend the provision to the expenses incurred by authors. 73 T.C. at 859, 862. The *Snyder* court merely relied on the *Faura* decision, rather than analyzing the applicability of § 2119. 674 F.2d at 1365.

187. 685 F.2d 212 (7th Cir. 1982).

188. Id. at 214. See also Note, supra note 8, at 556-57. For a discussion of *Idaho Power*, see supra notes 121-24 and accompanying text.

189. 685 F.2d at 214. See generally Limberg & Lightner, *Despite Contrary Authority, Prepublication Costs May Still Be Treated Favorably*, 63 J. Tax’n 82 (1985). The expenditures at issue in *Encyclopaedia Britannica* were payments made, under contract, to another company to do all the necessary research work and to prepare and edit a natural science dictionary. Subsection (f)(2) of proposed § 263A of the Tax Reform Act of 1985, supra note 179, could possibly be applied to these expenditures to require capitalization.
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appropriate. First, under subsection (b)(3) of the standard, a book would be classified as an asset to an author or publisher because it embodies a "probable future economic benefit." Furthermore, it seems clear that the purpose of prepublication expenditures is the creation of a book. Because prepublication expenses are "intimately connected in circumstance" to the creation of a specific asset, they must be capitalized in order to reflect income clearly.

B. Bank Branching Expenditures

In NCNB Corp. v. United States, the Fourth Circuit allowed a bank to currently deduct the costs of starting up new branch offices. The court reasoned that the expenditures were incurred to expand an existing business rather than to acquire a "separate and distinct asset." Because the court believed that the expansion was necessary for NCNB to maintain its position in the banking industry, the expenditures were held deductible under Code section 162. In Central Texas Savings & Loan Association v. United States, a case with essentially the same facts as NCNB, the Fifth Circuit held that expenditures incurred in investigating and opening new bank branches had to be capitalized. The court concluded that the branches were "separate and distinct assets" within the meaning of Lincoln Savings, basing its conclusion on the existence of operating permits granted to Central Texas by the Savings and Loan Commissioner of Texas. Whether the bank branching expenditures considered in NCNB and Central Texas would be classified as

190. The other conditions set forth in subsection (b)(3) are met as well: (1) an author or publisher has a tangible property interest in a book; (2) the book's probable future economic benefit involves a capacity to contribute directly to future net cash inflows (through royalty payments to an author or book sales to a publisher); and (3) the taxpayer can control access to the benefit (through a copyright).
191. 684 F.2d 285 (4th Cir. 1982) (en banc).
192. For a discussion of NCNB, see supra notes 63-69 and accompanying text. See also Fischer, Circuit Courts Split on Deductibility of Bank Costs of Starting Up a New Branch, 15 TAX ADVISER 546 (1984).
193. 684 F.2d at 290.
194. Id.
195. 731 F.2d 1181 (5th Cir. 1984).
196. For a discussion of Central Texas, see supra notes 70-78 and accompanying text.
197. See supra notes 48-53 and accompanying text.
198. 731 F.2d at 1182, 1185. The court believed that the permits gave Central Texas an easily valued property interest in the branch offices. Id. at 1185.
capital expenditures under the proposed universal standard depends upon the classification of a bank branch under subsection (b)(3). A branch office would be deemed an asset under this subsection if it embodied a probable future economic benefit with a capacity to contribute to future net cash inflows. The NCNB court apparently believed that branch offices were needed to maintain the bank’s competitive position rather than increase its future net revenues. Ultimately, the question as to whether a bank branch is intended to increase future net cash inflows is one of fact. If the bank branch is deemed to be an “asset” within the meaning of subsection (b)(3), it seems clear that investigatory and pre-operating expenditures would be proximately related to the creation of a specific asset, thus requiring capitalization.

CONCLUSION

The multitude of line-drawing criteria developed by courts to distinguish between capital expenditures and ordinary business expenses has resulted in a great deal of confusion and inconsistency in tax treatment. To enhance predictability of treatment and uniformity of application among the circuits, a universal capitalization standard is necessary. As Justice Oliver Wendell Holmes once remarked, “[T]he tendency of the law must always be to narrow the field of uncertainty.” Only through a universal capitalization standard will the existing uncertainty in the tax treatment of expenditures be eliminated. The standard proposed by this Note reduces confusion and inconsistency by providing clear guidelines for both courts and taxpayers. More importantly, these guidelines will result in a “clear reflection of income” if properly applied to an expenditure.

—Steven J. Greene

199. 684 F.2d at 290.
200. It is a difficult task to identify whether the purpose of a particular business undertaking is to increase income, maintain the level of income, or maintain growth in income. If the purpose is to increase or maintain growth in income, the expenditures that are proximately related to the undertaking should be classified under the proposed standard as capital expenditures; the business undertaking would be considered as resulting in the creation of an asset within the meaning of subsection (b)(3) because future net cash inflows are desired.