Tax Treatment of Prepublication Expenses of Authors and Publishers

Michigan Law Review

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Entertainment, Arts, and Sports Law Commons, Legislation Commons, and the Taxation-Federal Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mlr/vol82/iss3/14
Tax Treatment of Prepublication Expenses of Authors and Publishers

Section 162 of the Internal Revenue Code$^1$ allows a deduction for a taxpayer's "ordinary and necessary" business expenses. Not all the costs incurred in the normal course of running a business are immediately deductible, however. Rather, section 263$^2$ of the Code denies a current deduction for those costs incurred in the creation or acquisition of "property having a useful life substantially beyond the taxable year."$^3$ Such costs must be capitalized rather than immediately deducted; they constitute the taxpayer's basis in the property and, if deductible at all, must be depreciated over the property's useful life.$^4$

Courts have reached different results when faced with the question of whether the prepublication expenses of authors and publishers must be capitalized pursuant to section 263, or whether such expenses are instead deductible under section 162.$^5$ The production of a book or manuscript entails numerous research, travel, office and editing costs, all of which appear to be ordinary and necessary to the writing and publishing business. These costs are incurred, however, in the production of a book, an income-producing asset with a useful life beyond the taxable year. Thus, the taxpayer is asked to identify properly deductible business expenses in an industry that produces only capital assets.$^6$ Denial of a present deduction could have a sig-

---

1. I.R.C. § 162(a) (1982) provides in part: "(a) In General.—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 . . . ."

2. I.R.C. § 263 (1982) provides in part: "(a) General Rule. — 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."


4. I.R.C. § 167(a) (1982) provides in part: "(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)— (1) of property used in the trade or business, or (2) of property held for the production of income."


Not all property is depreciable. See note 18 infra.

5. Compare Snyder v. United States, 674 F.2d 1359, 1365 (10th Cir. 1982) (author of book allowed to treat expenses as ordinary and necessary business expenses), and Faura v. Commissioner, 73 T.C. 849 (1980) (same), with Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982) (publisher's prepublication expenses must be capitalized).

6. Copyrights and manuscripts are not capital assets for purposes of the capital gains provisions while in the author's hands. I.R.C. § 1221(3)(A) (1982); see notes 153-60 infra and accompanying text. They are, however, potentially income-producing assets.

537
significant impact on small publishers and aspiring authors, yet allowing all such expenses to be deductible against current income would not comport with accepted principles of capital accounting and tax treatment. The courts have so far failed to provide a well-reasoned solution to this dilemma.

This Note analyzes the tax treatment of prepublication costs. Part I presents the analytic framework of the business expense/capital expenditure distinction and searches for practical, income-reflecting criteria that achieve theoretically correct results. Part II covers the historic treatment of prepublication expenditures, concluding that neither the courts nor the Internal Revenue Service (IRS) have been consistent in their approach and that both have largely ignored the income-reflecting goals outlined in Part I. Part III applies the income-reflecting approach in order to develop a principled method of examining the tax consequences of various prepublication expenses.

I. THEORETICAL GROUNDS FOR DISTINGUISHING CAPITAL EXPENDITURES FROM BUSINESS EXPENSES

Basic tax principles require the matching of costs with the income produced by those costs. This effort to reflect clearly the taxpayer's actual income in any given year underlies the distinction between capital expenditures and business expenses. Unfortunately, the practical criteria that the IRS and the courts have developed to clarify the business expense/capital expenditure distinction contain defects that render those criteria unworkable. In particular, judicial attempts to clarify the distinction by resorting to section 162's "ordi-
inary and necessary” requirements have proven unsuccessful. Moreover, the IRS’s “useful life beyond the taxable year” standard, although theoretically defensible, is beset by administrative problems. Ultimately, the courts’ analysis of “clear reflection of income” principles leads to the conclusion that only in this concept can legitimate judicial instruction be found.

A. The Conceptual Framework

The basic goal of the Internal Revenue Code’s provisions is to determine accurately the taxpayer’s actual income. Fundamental principles of timing in both accounting and taxation serve this goal by requiring that deductions be taken and income realized in the years to which they are properly attributable. The business expense/capital expenditure distinction follows logically from these timing principles: section 263 prevents the current deduction of costs properly attributable to later years.

Capital expenditures are not attributable to the current year because the taxpayer’s wealth has not yet been decreased. Sums paid out to create, purchase, or improve property do not represent true costs in that year because the taxpayer gains property the value of which is presumably at least equal to the sums expended. However, if the asset acquired is subject to exhaustion, use of the asset over a

---

10. See Part I-B infra.
11. See Part I-C infra.
14. See M. Chirelstein, supra note 12, ¶ 6.02, at 104.
15. Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974). The taxpayer in Idaho Power had taken depreciation deductions for certain equipment used in the construction of buildings for its own business. The Commissioner disallowed these deductions on the ground that depreciation of equipment is part of the cost of constructing a capital asset, and therefore must be capitalized. The Court upheld the Commissioner’s deficiency determination.
16. Despite the literal meaning of § 263’s language (quoted at note 2 supra), the provision is given a broad interpretation that encompasses the creation, purchase or improvement of any type of property. See M. Chirelstein, supra note 12, ¶ 6.02, at 104.
17. In effect, one asset has been converted into another. See Kahn, Accelerated Depreciation — Tax Expenditure or Proper Allowance for Measuring Net Income?, 78 Mich. L. Rev. 1, 13 (1979).
18. Some items, such as goodwill and unimproved land, are not subject to exhaustion, and therefore are not depreciable. See, e.g., Treas. Reg. § 1.167(a)-2 (1956) (no depreciation deduction allowed for unimproved land, which cannot be exhausted); Treas. Reg. § 1.167(a)-3 (1956) (intangible assets must have a “limited useful life” in order to be depreciable). Because the taxpayer incurs no cost in using property that cannot be exhausted, no deduction should be allowed either for purchase or for use. The cost of assets not subject to depreciation may be
period of time represents a genuine cost to the taxpayer. Depreciation is the accounting device that recognizes the "true cost" of use, thus spreading the real cost of using the asset over the periods in which the asset benefits the taxpayer.

The denial of an immediate deduction for capital expenditures is, therefore, a basic principle of income taxation, not simply a technical statutory requirement. Capital expenditures, rather than being expenses of the current year, represent an investment in property with a useful life of more than one year. The costs of this property will be allocable to future years during which the property produces income. In contrast, section 162 business expenses are costs properly allocable to the present year, because their benefit is almost immediately "used up." Thus, the theoretically sound approach to distinguishing business expenses from capital expenditures is to determine the characterization that matches costs with income produced and that therefore clearly reflects the taxpayer's actual income.

B. Distinctions Based on the Definition of "Business Expense"

In an effort to avoid the case-by-case determinations that the "clear reflection of income" standard would require, the courts and the IRS have repeatedly sought more practical, objective criteria. One such criterion has been the statutory requirement that expenses be both "ordinary" and "necessary" in order to qualify for deduction under section 162. The definition of "necessary" has presented lit-

---

19. 2 A.P.B. ACCOUNTING PRINCIPLES: ACCOUNTING TERMINOLOGY BULLETIN No. 1 — REVIEW AND RESUME ¶ 48, at 9512 (1973) (quoted in Commissioner v. Idaho Power Co., 418 U.S. 1, 10 n.7 (1974)).

20. Calculation of the "true cost" of use is by no means a settled subject among tax commentators. Section 167 provides several methods for calculating depreciation; in some situations § 168 requires that an "accelerated" method be employed. For the debate over the "proper" assessment of "true cost," compare M. CHIRELSTEIN, supra note 12, ¶¶ 6.07(d)-6.08, at 132-40 (arguing that "sinking fund" depreciation represents true economic cost), with Kahn, supra note 17, at 30-43 (arguing that accelerated depreciation measures cost at least as accurately as does any other method of depreciation).

21. See H. FINNEY & H. MILLER, supra note 13, at 287; Kahn, supra note 17, at 13-14.


24. See notes 17-21 supra and accompanying text.


26. See 1 B. BITTKER, supra note 23, ¶ 20.4.1, at 20-64 to -67; Gunn, supra note 22, at 452.

27. Expenses must satisfy each of these requirements; that is, the expenses must be both "necessary" and "ordinary." Commissioner v. Lincoln Sav. & Loan Assn., 403 U.S. 345, 353 (1971); Welch v. Helvering, 290 U.S. 111, 113 (1933).
tle interpretive difficulty. However, the concept of "ordinary" expenses has been less susceptible of easy definition. Justice Cardozo's now-classic formulation reveals the problematic nature of the term: "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." Subsequent interpretation refined Justice Cardozo's "riddle" to a "recurrent in the industry" test, under which an expense, though unique in the course of one taxpayer's lifetime, is currently deductible if at least a "normal" business response, given the taxpayer's circumstances and line of business. This approach, however, fails to provide guidance in specific situations, because it merely shifts the ambiguity from "ordinary" to "recurrent" or "normal." Furthermore, an expense can often be made to seem "recur-

28. In Welch v. Helvering, 290 U.S. 111 (1933), the Court concluded that a taxpayer attempting to establish the necessity of an expense need only show that the expense was "appropriate and helpful" to his business. 290 U.S. at 113. Although this standard is no more precise than "necessary" (though apparently broader), the courts have avoided the problem of making fine distinctions by accepting the taxpayer's business judgment of the necessity of the expenditure in question. 290 U.S. at 113 ("we should be slow to override [the businessman's] judgment"); see also Texas Instruments, Inc. v. United States, 551 F.2d 599, 605 (5th Cir. 1977) (expense is ordinary if "'a hard-headed businessman, under the circumstances, would have incurred the expense'") (quoting Tulia Feedlot, Inc. v. United States, 513 F.2d 800, 804 (5th Cir.), cert. denied, 423 U.S. 947 (1975)); Comment, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning With the Internal Revenue Code, 72 YALE L.J. 108, 113 n.20 (1962).

29. Welch, 290 U.S. at 115. Justice Cardozo's full statement, though often quoted see, e.g., Commissioner v. Lincoln Sav. & Loan Assn., 403 U.S. 345, 353 (1971); Faura v. Commissioner, 73 T.C. 849, 852 (1980); 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25.09, at 42-43 (J. Doheny ed., rev. 1979)), is hardly a model of clarity. Still, his observations help explain why the distinction between capital expenditures and business expenses can be so elusive:

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. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such purpose, whether the amount is large or small, are the common and accepted means of defense against attack. . . . 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.

Welch, 290 U.S. at 115-13.

30. See Deputy v. Du Pont, 308 U.S. 488, 495 (1940) ("Ordinary has the connotation of normal, usual or customary. To be sure, an expense may be ordinary though it happen [sic] 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.") (emphasis supplied).

31. More modern cases generally do not apply this "recurrent" test, opting instead to contrast "ordinary" with "capital." See notes 33-37 infra and accompanying text. One exception to this trend has been Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982), in which the court applied a "recurrent to the taxpayer" standard. See notes 125-27 infra and accompanying text.
rent" if it is examined in a broad enough context.\(^{32}\)

The most pervasive modern approach for distinguishing "ordinary" expenses contrasts ordinary business expenses with capital expenditures.\(^{33}\) In *Commissioner v. Tellier*,\(^{34}\) the Supreme Court

---

\(^{32}\) See 1 B. BITTKER, supra note 23, \$ 20.3.2, at 20-47:

The Hometown Bank of Sauk Center may be the first in its neck of the woods to distribute bubble gum to kiddies whose parents open new accounts, but it is probably not the first bank in America to do so; and if, mirabile dictu, no other American bank ever thought of the idea, the Sauk Center bank is assuredly not the first American business to peddle its wares in a lurid or undignified manner.


Courts have taken other approaches to the "ordinary" standard. Unfortunately, these approaches do little to enhance understanding of the "ordinary" standard and nothing to refine the business expense/capital expenditure distinction.

First, in a misguided attempt to disallow deductions for unusual expenditures, courts have contrasted "ordinary" expenses with those that are "extraordinary." See, e.g., Goede! v. Commissioner, 39 B.T.A. 1 (1939) (stock dealer denied deduction for premiums paid for insurance on life of the President, whose death he feared would disrupt the stock market); Treblecock v. Commissioner, 64 T.C. 852 (1975) (deduction for cost of minister's services in rendering business advice denied, where minister used prayer rather than business skill), affd. mem., 557 F.2d 1226 (6th Cir. 1977). The tax law, however, should not penalize a taxpayer for creativity. "There is no sound reason to deny a deduction merely because the taxpayer is unusually imaginative or innovative . . . ." 1 B. BITTKER, supra note 23, \$ 20.3.2, at 20-47. Section 162 itself sets up a number of filters through which an expense must pass to be deductible. The expense must be (1) "paid or incurred during the taxable year," (2) for "carrying on any trade or business," (3) an "expense," and (4) an "ordinary and necessary" expense. See Commissioner v. Lincoln Sav. & Loan Assn., 403 U.S. at 352. Legislation, rather than a judicial doctrine of "extraordinariness," should be required to disallow expenses that successfully pass through these filters.

Second, courts have used the "ordinary" standard to deny deductions for personal expenses on the ground that they are not the "normal" response of businessmen. See Brown v. Commissioner, 446 F.2d 926 (8th Cir. 1971) (president of coffee company denied deduction for cost of safari to coffee-growing countries where trip not necessary to his continued employment, even though trip contributed to his reputation as a coffee expert); Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956) (corporation's "promotional" expenses in creating "horticultural show place" at home of president and majority shareholder were not ordinary where primary benefit appeared to be enhancing value of president's home); Henry v. Commissioner, 36 T.C. 879 (1961) (tax lawyer's expenses in maintaining yacht on which he flew pennant emblazoned with "1040" were not deductible where promotional purpose was subsidiary to personal purpose). Although the results in these cases may be correct, they could just as easily have been achieved by relying on I.R.C. \$ 262 (1982), which denies a deduction for personal expenditures.

Third, courts have used the "ordinary and necessary" standard to deny deductions whose allowance "would frustrate sharply defined national or state policies proscribing particular types of conduct . . . ." Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33 (1958). Legislation has largely supplanted this doctrine by disqualifying specified expenditures. See I.R.C. \$ 162(c), (f), (g) (1982).

Finally, a "reasonable in amount" qualification has been imputed to the "ordinary" standard. See Commissioner v. Lincoln Elec. Co., 176 F.2d 815, 817 (6th Cir.), cert. denied, 338 U.S. 949 (1949). This qualification, however, adds little to the "ordinary" standard, since often the best evidence of reasonableness is that the amount was actually paid in an arm's length transaction. Cf. M. CHIRELSTEIN, supra note 12, \$ 6.04, at 117 (question of "reasonableness" arises only in situation where parties to transaction are related in some way).

The erroneous manner in which courts have applied the term "ordinary" suggests that, by itself, "ordinary" does not provide an adequate means of distinguishing capital expenditures from business expenses.

\(^{34}\) 383 U.S. 687 (1966).
stated:
The principal function of the term "ordinary" in section 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.35

Although ordinary business expenses are certainly deductible immediately, and capital expenditures just as certainly are not, the term "ordinary" hardly clarifies this distinction. Since section 263 already prohibits immediate deduction of capital expenditures,36 reading "ordinary" to have the same effect amounts to saying that "business expenses are those costs which are not capital expenditures" — a true enough statement, but not one that illuminates the difference between the two concepts.37

If "ordinary" expense functions only as a contrast to "capital expenditure," then section 162 expenses can be defined only by referring to the definition of section 263 capital expenditures. 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."

C. Distinctions Based on the Definition of "Capital Expenditure"

Neither the Code nor the Regulations define the term "capital expenditure."38 However, one criterion, adopted in the Regulations39 and applied by many courts,40 requires that the costs of ac-

35. 383 U.S. at 689-90 (citation omitted).

36. By its terms, § 263 prohibits "any" deduction for capital expenditures (see note 2 supra), apparently including future deductions for depreciation. Such a reading, however, would clearly conflict with the theory of capitalization, which denies a deduction in the present year because the costs represented are attributable to, and should be deducted in, future years. See notes 14-21 supra and accompanying text.

37. Bittker observes that "[v]iewed as a prohibition against deductions for capital expenditures, however, the phrase 'ordinary and necessary' is a handkerchief thrown over something that is already covered by a blanket." 1 B. BITTKER, supra note 23, ¶ 20.3.2, at 20-43 (footnote omitted).

38. See I.R.C. § 263 (1982) and Regulations promulgated thereunder; cf. Gunn, supra note 22, at 448 ("The only apparent function of section 263 in the statutory scheme is to provide a heading under which the tax services can list the capital expenditure cases.") (commenting on the lack of definition within § 263).

39. Treas. Reg. § 1.263(a)-1(b) (1958) provides in part that capital expenditures:

   include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures . . . .

   Treas. Reg. § 1.263(a)-2 (1958) provides in part:

   The following paragraphs [of this section] include examples of capital expenditures:

   (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.
quiring or constructing “property having a useful life substantially beyond the taxable year” be treated as capital expenditures. 41 This “useful life” 42 test is theoretically defensible as a generalization, for it guarantees capitalization of all expenditures that will produce benefits in future taxable years. 43 The “useful life” test is no more than a generalization, however, because some payments that it characterizes as “capital” can be deducted immediately without distorting income. 44

Although strict application of the “useful life” standard will usually reflect taxpayers’ actual income, this achievement must be weighed against the massive administrative problems that this approach poses. 45 The courts and the IRS have responded to these problems in varying ways. The IRS has issued regulations designed to ease the accounting burden by allowing immediate deduction of various minor purchases. 46 The courts have reacted either by looking at the “clear reflection of income” principles that underlie the “useful life” test 47 or by rejecting the “useful life” test in favor of a “separate and distinct asset” formulation. 48

Several courts that have looked behind the “useful life” test base their capitalization decisions on “clear reflection of income” principles. 49 These cases hold that capitalization is simply a method of

42. Note that “useful life,” both in the context of capitalization and of depreciation, means the period during which the asset may reasonably be expected to be useful to the taxpayer in his business or in the production of income. Treas. Reg. § 1.167(a)-1(b) (1956). In other words, the asset’s useful years are those in which it produces a benefit. This period may be considerably shorter than the physical life of the asset. See Kahn, supra note 17, at 15.
43. Indeed, this criterion is little more than a tautology; to say that the useful life of the property extends beyond the present year is to say that the property produces benefits in future years. See note 42 supra.
44. See notes 56-59 infra and accompanying text.
45. For example, virtually every salary and advertising expense would have to be divided between its immediate impact on the customer and its long-term contribution to the company’s goodwill. See 1 B. BITTKE, supra note 23, § 20.4.1, at 20-67. Further, many relatively minor purchases would have to be capitalized, creating an accounting burden for the taxpayer not justified by the relatively small increase in accuracy in the determination of income. See Cincinnati, N.O. & T. Pac. Ry. v. United States, 424 F.2d 563, 572 (Cl. Ct. 1970); Gunn, supra note 22, at 457.
46. See Treas. Reg. § 1.162-3 (1958) (manufacturer allowed to deduct cost of incidental materials and supplies if inventories and records of consumption are not kept); Treas. Reg. § 1.162-6 (1958) (professionals allowed to deduct cost of “books, furniture, and professional instruments and equipment, the useful life of which is short”); Treas. Reg. § 1.162-12(a), T.D. 7198, 1972-2 C.B. 166, 167 (farmers allowed to deduct the cost of “ordinary tools of short life or small cost”).
47. See notes 49-59 infra and accompanying text.
48. See notes 60-64 infra and accompanying text.
accounting for assets. Under this approach, section 263 must be read together with the accounting provisions of section 446. Thus, in *Cincinnati, New Orleans & Texas Pacific Railway v. United States*, the Court of Claims clearly rejected a strict reading of section 263 in favor of the income-reflecting principles of section 446:

> [T]he conclusiveness of the one year rule, simply does not square with basic philosophy concerning asset accounting as reflected in the regulations and in [section 446] . . . . The determinative question, therefore, is not what is the useful life of the asset in question, although that inquiry is relevant, but does the method of accounting employed clearly reflect income.

In effect, the Court of Claims concluded that capitalization of all capital expenditures, which section 263 seems to require, is inconsistent with the income-reflecting goal that section 263 is designed to serve. Thus, the court concluded that some costs that are capital in nature need not be capitalized, so long as income will still be clearly reflected.

A finding that a particular taxpayer's method of accounting does clearly reflect income may be based on either theoretical or practical
grounds. For theoretical reasons, accountants and concerned regulatory agencies may have agreed that the chosen method generally produces no distortion of income, a conclusion that the courts may or may not accept. As a practical matter, the accounting method may produce no significant distortion either because the taxpayer is in a steady state or because the distortion is small in relation to the taxpayer’s total income. When confronted with either practical or theoretical considerations, courts relying on the “clear reflection of income” goal must examine costs on a case-by-case basis in order to determine whether capitalization is required.

The problems posed by the “useful life” test and the exceptions created to deal with those problems have led other courts to find that an extended useful life is not decisive. In Commissioner v. Lincoln Savings & Loan Assn., the Supreme Court found that “the presence
of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year. Rather than rely on the "useful life" criterion, the Court enunciated an alternative test: "What is important and controlling, we feel, is that the payment serves to create or enhance 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."

This "separate and distinct asset" standard is seriously flawed, however, because it bears little or no relation to the ideal of reflecting income. Nothing in the Lincoln Savings formulation requires that the asset be income-producing beyond the taxable year; in fact, many separate and distinct assets will be consumed within a single year.

The Supreme Court has more recently moved to a position that is apparently based on "clear reflection of income" principles. In Commissioner v. Idaho Power Co., the Court failed to cite the "separate and distinct asset" test handed down only two years earlier. Rather, the Court relied on clear reflection of income principles in finding that depreciation on construction equipment was a cost that

---

62. 403 U.S. at 354 (1971). Lincoln was a member of the FSLIC and as such required to pay insurance premiums into so-called Primary and Secondary Reserves. Insured institutions have no property interest in the Primary Reserve. They do, however, retain an interest in the Secondary Reserve; the "additional premium" paid into the Secondary Reserve is suspended when the aggregate of the two Reserves exceeds a certain level. Lincoln deducted both premiums as ordinary business expenses. The Commissioner allowed deduction of the Primary premium, but disallowed the Secondary premium. The Tax Court held that the Secondary Reserve premium was a capital expenditure, deductible only when funds from the Secondary Reserve were used to pay Primary Reserve premiums or to meet actual losses of the FSLIC. 51 T.C. 82 (1968), revd., 422 F.2d 90 (9th Cir. 1970).

63. 403 U.S. at 354.

64. For example, the costs of office supplies and of material properly included in inventory would have to be capitalized under this criterion. The test is too narrow, as well as too broad, because it fails to account for at least one type of commonly recognized capital expenditure: the cost of a professional education. The IRS and commentators agree that at least part of the cost of obtaining a professional education is business-related and hence represents a capital expenditure. See Treas. Reg. § 1.162-5(b)(1), T.D. 6918, 1967-1 C.B. 36, 37 (such expenditures "constitute an inseparable aggregate of personal and capital expenditures"); M. CHIRELSTEIN, supra note 12, ¶ 6.02, at 112; Shaw, Education as an Ordinary and Necessary Expense in Carrying on a Trade or Business, 19 TAX L. REV. 1 (1963); Wolfman, The Cost of Education and the Federal Income Tax, 42 F.R.D. 535 (1966). However, the education that results from this expenditure is not an "asset" in any usual sense of that term. Most definitions of "asset" refer to "property"; most definitions of "property" require at least that the item be transferable and that the "owner" have some degree of legal protection against interference by third parties. See BLACK'S LAW DICTIONARY 108, 1095 (5th ed. 1979); I B. BITTKER, supra note 23, ¶ 20.4.1, at 20-67; Gunn, supra note 22, at 473; Reich, The New Property, 73 YALE L.J. 733, 771 (1964). An education does not meet either of these requirements — by its very nature it can be neither transferred nor protected against interference. Thus, the capital expenditure for professional education does not create a separate and distinct asset.

65. 418 U.S. 1 (1974); see note 15 supra.

66. Lincoln Savings is cited only for the proposition that agency-imposed accounting practices may be accorded some significance. 418 U.S. at 15.
must be capitalized.67 Unlike the Court of Claims in Cincinnati Railway, however, the Supreme Court did not expressly conclude that expenses that are capital in nature need not be capitalized if the taxpayer's income will still be clearly reflected.68 In fact, the language used by the Court69 suggests that it views section 263 as mandating capitalization of all capital expenditures — i.e., costs related to the production of income in future years. Nevertheless, the Court in Idaho Power was not faced with a situation like the one in Cincinnati Railway, where the immediate deduction of a capital expenditure clearly reflected the taxpayer's income. 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.

The definition of “capital expenditure,” then, is just as problematic as that of “business expense.” Many courts have determined that the IRS's “useful life” standard is not controlling.70 In its place, they have relied on the “clear reflection of income” principles underlying that standard.71 This judicial reliance has important implications. A given cost may be defined as a capital expenditure in that it goes to the creation or acquisition of property that will produce benefits in future years. Yet capitalization of that expenditure should be required only where capitalization is necessary to reflect income accurately. By and large, the rule that capital expenditures may not be currently deducted will comport with the principles underlying it. However, the rule should be discarded where “clear reflection of income” principles do not require its application, and where adminis-

67. Idaho Power, 418 U.S. at 13-14 (“The significant fact is that the exhaustion of construction equipment does not represent the final disposition of the taxpayer's investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. . . . [T]his capitalization prevents the distortion of income that would otherwise occur . . . .”). In discussing the weight to be given agency-mandated practices, the Court concluded that a compulsory practice that clearly reflects income is “almost presumptively controlling” of tax consequences, quoting § 446 for support. 418 U.S. at 15 & n.10.

68. See notes 52-55 supra and accompanying text.

69. 418 U.S. at 16 (“The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income.”) (emphasis added); see also Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982) (interpreting Idaho Power to require the capitalization of all capital expenditures).

70. See note 60 supra and accompanying text.

71. See notes 50-60 & 67-70 supra and accompanying text.
trative or other considerations militate against it. In such situations, the capital expenditure should be immediately deducted.

II. HISTORIC TREATMENT OF PREPUBLICATION EXPENSES

This part traces the historic treatment of prepublication expenditures. Section A deals with the period before Revenue Ruling 73-395.72 Treatment during this time was confusing, to say the least. Although the IRS's Revenue Rulings required capitalization, it later acknowledged an exception for the research expenses of professors. Furthermore, the IRS apparently accepted a line of court cases allowing authors an immediate deduction for their expenses. However, neither the Revenue Rulings nor the cases really addressed the problem of distinguishing capital expenditures from business expenses.

In 1973, the IRS issued Revenue Ruling 73-395, which clearly requires capitalization of prepublication expenditures. Section B discusses that ruling, as well as the congressional and judicial response it produced, concluding that current treatment of the prepublication expenses dilemma remains inadequate.

A. Prepublication Expenses Before Revenue Ruling 73-395

The IRS has long maintained that prepublication expenses are capital expenditures that may be recovered only through depreciation of the asset acquired.73 A 1922 ruling divides “expenses of publishing copyrighted books”74 into two categories: those that are essentially prepublication expenses75 and those arising from the ac-

73. I.T. 1287, I-1 C.B. 28 (1922). Commentators have suggested that this ruling was only intended to cover the relatively insignificant costs of copyrighting a manuscript, and that in any case, the Commissioner later allowed authors to deduct legitimate expenses. Shine, Some Tax Problems of Authors and Artists, 13 TAX L. REV. 439, 446 (1958); Note, A Comparison of the Tax Treatment of Authors and Inventors, 70 HARV. L. REV. 1419, 1422 n.26 (1957). These commentators all apparently rely on the line of cases discussed in notes 89-97 infra and accompanying text. The language of I.T. 1286 suggests, however, that more than copyrighting costs were included. See note 75 infra. For evidence that the IRS requires capitalization of prepublication expenses, see note 79 infra and accompanying text.
74. I.T. 1287, I-1 C.B. 28 (1922). This phrase appears to encompass only publishers, since it refers only to expenses of publishing. However, the IRS apparently understood “publishing” to include the work of both publishers and authors. The first category of expenses, for example, includes those for “producing and copyrighting” the manuscript, as opposed to those for publishing alone. See notes 75 & 76 infra and accompanying text. Expenses for producing the text must surely encompass the author’s prepublication expenditures as well as the publisher’s development costs.
75. What this Note refers to as “prepublication expenses” were referred to by the IRS as expenses “for producing and copyrighting the text...” I.T. 1287, I-1 C.B. at 28 (emphasis added). This language casts further doubt on the contention of some commentators that the ruling applied only to copyrighting costs. See note 73 supra. For an argument that production and copyrighting costs should be treated separately, see Part III-A infra.
tual printing of the manuscript. The latter costs are to be included in inventory and allocated among the books on hand on an aliquot basis. Expenditures "for producing and copyrighting the text" — prepublication expenses — "represent the cost of a capital asset, which . . . may be returned to its owner through annual depreciation allowances . . . ."78 The IRS has continued to take this position in its rulings and private letters,79 but until recently had failed to challenge a line of cases allowing authors an immediate deduction.80

The Commissioner did, however, argue that the research expenses of professors are capital expenditures and hence not immediately deductible.81 In Brooks v. Commissioner,82 the IRS argued that where a scholar did not expect to realize present profit from the publication of research, the expenses represented an investment in future earning capacity and thus were capital expenditures.83 The Ninth Circuit rejected this argument on the ground that the research was undertaken to maintain the scholar's position in the field, in the good faith belief that eventually the research would yield a profitable stipend from a foundation.84 The IRS later accepted this position, at least to the extent that the expenses represent an investment in the researcher's reputation and cannot "be considered to have been incurred for the purpose of producing a specific income-producing asset."85

This professorial exception cannot be justified on purely theoretical grounds. An investment in reputation is generally regarded as capital in nature, since good reputation produces future income.86

76. I.T. 1287, I-1 C.B. 28 (1922).
77. Id. at 28. Books are inventory items for publishers. The costs of printing are production costs that must be allocated to goods produced during the year. See Treas. Reg. § 1.471-11(a), T.D. 7285, 1973-2 C.B. 163; note 108 infra. This position has been consistently followed. See Rev. Rul. 68-194, 1968-1 C.B. 87; Rev. Rul. 73-395, 1973-2 C.B. 87.
78. I.T. 1287, I-1 C.B. 28 (1922).
80. See text at notes 89-97 infra. These cases dealt only with the questions of whether the taxpayer was in a trade or business at all and, if so, how much of his expense was business related and how much personal. The issue of distinguishing §§ 162 and 263 was never addressed.
81. See Brooks v. Commissioner, 274 F.2d 96 (9th Cir. 1959); G.C.M. 11654, XII-1 C.B. 250 (1933); Wolfman, Professors and the "Ordinary and Necessary" Business Expense, 112 U. Pa. L. Rev. 1089 (1964).
82. 274 F.2d 96 (9th Cir. 1959).
83. 274 F.2d at 98.
84. 274 F.2d at 97-98.
85. Rev. Rul. 63-275, 1963-2 C.B. 85; see Faura v. Commissioner, 73 T.C. 849, 854 (1980) (Revenue Ruling 63-275 "approved deductibility of research expenses incurred by college and university professors in their capacity as educators"). Note that the IRS seems to be using something akin to the "separate and distinct additional asset" test discussed at notes 61-64 supra and accompanying text.
86. See, e.g., Welch v. Helvering, 290 U.S. 111 (1933) (expenses to establish good business
The IRS was no doubt struggling with the problem that the business of professors includes the production of income-producing assets—a problem confronting authors and publishers in general. Despite the limited exception for professors, however, the IRS has continued to hold that ordinary authors and publishers are subject to the capitalization requirement.

The Tax Court and Courts of Appeals, on the other hand, have consistently allowed the immediate deduction of prepublication expenses of authors. In *Doggett v. Burnett*, the only case to deal with a publisher, the taxpayer was allowed an immediate deduction for the expenses of printing, advertising, and selling the works of a British religious teacher. Since the taxpayer expected in good faith to receive a present profit from the sale of the books, the court concluded that the enterprise was a business and that the taxpayer's expenses were deductible under section 214(a)(1) of the Revenue Act of 1926, the predecessor of section 162. *Doggett* was followed by a number of Tax Court cases in which authors had claimed business expense deductions for travel, research and office costs associated with their business of writing. The only question debated in these cases was whether the expenses were deductible as business expenses or as personal expenses, under section 162. Expenses incurred to preserve an existing business reputation may be deductible under § 162, but must be carefully distinguished from expenses related to personal reputation.

---


88. See note 79 supra.

89. See, e.g., Brooks v. Commissioner, 274 F.2d 96 (9th Cir. 1959); Doggett v. Burnett, 65 F.2d 191 (D.C. Cir. 1933); Faura v. Commissioner, 73 T.C. 849, 852-55 (1980) (summarizing prior cases). The only exception to this rule has been Encyclopaedia Britannica Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982). This exception, however, was after Rev. Rul. 73-395 had been issued. See notes 121-24 infra and accompanying text.

90. 65 F.2d 191 (D.C. Cir. 1933).

91. 65 F.2d at 193-94. The court did not mention whether the taxpayer incurred expense for acquisition of the works.

92. 65 F.2d at 194.

93. Ch. 27, 44 Stat. 9, 26 (1926).

94. 65 F.2d at 194. The Commissioner apparently did not argue that any of the taxpayer's expenses should be treated as capital expenditures. Since apparently none of the expenses dealt with were for acquisition or editing, they were presumably either inventoriable production costs or the daily expenses of running the business.

95. Leona Anderson, 21 T.C.M. (P-H) ¶ 52,107 (1952) (taxpayer in business of radio broadcasting entitled to deduction for cost of purchasing script); Kluckhohn v. Commissioner, 18 T.C. 892 (1952) (newspaper correspondent allowed to deduct that portion of cost of wife's trip to Australia which was properly allocable to research for books and articles written by
cases was the extent to which the expenses deducted were truly business, as opposed to personal, expenses. Both the Tax Court and the Commissioner apparently assumed that the portion of the expenses related to business would be immediately deductible, and thus did not attempt to distinguish business expenses from capital expenditures.

B. Revenue Ruling 73-395 and the Response of Congress and the Courts

The IRS eventually realized that it was undermining the capitalization requirement by challenging authors' expense deductions solely on the ground that the expenses were really personal. The line of cases allowing immediate deduction culminated in 1971 with *Stern v. United States*, which allowed a writer to deduct expenses incurred while researching, writing and arranging material for a portion of a forthcoming book that was first published as a magazine article. The IRS responded to *Stern* by issuing Revenue Ruling...
73-395, in which it stated that the IRS did not consider Stern controlling and that the court's holding would not be followed as precedent. The IRS reaffirmed its position on prepublication expenses, saying:

Expenditures that are directly attributable to producing and copyrighting a manuscript of a literary composition by a taxpayer result in the creation of an asset having a useful life that extends substantially beyond the close of the taxable year and are thus capital in nature and not deductible for Federal income tax purposes.

On its face, this ruling applies to all writing, editing, illustrating and publishing costs short of the actual printing and binding of the book.

Revenue Ruling 73-395 produced objections from the publishing industry. These objections were heard in Congress, which enacted section 2119 of the Tax Reform Act of 1976. Section 2119 relieves publishers from the effect of Revenue Ruling 73-395 and allows

103. 1973-2 C.B. at 87. Although the language of this passage is somewhat unclear, the text of the Ruling indicates that the IRS intended that it would apply to both publishers and authors.
104. The costs of printing and binding are to be inventoried and apportioned on an aliquot basis to the books on hand at the end of the taxable year. Treas. Reg. § 1.471-1 (1956); Rev. Rul. 73-395, 1973-2 C.B. 87.
105. See H.R. REP. No. 658, 94th Cong., 1st Sess. 337 (1975), reprinted in 1976-3 C.B. (Vol. 2) 695, 1029 (“Your committee has been made aware of the concerns of the publishing industry as to whether Rev. Rul. 73-395 . . . correctly interprets present law . . .”).
107. By its terms, § 2119 applies only to expenses incurred by taxpayers in the “trade or business of publishing.” § 2119(c). However, in Faura v. Commissioner, 73 T.C. 849 (1980), the Tax Court concluded that § 2119 applied to authors as well as publishers. The court noted the use of the pronoun “his” in the phrase “his trade or business of publishing,” assuming that “its” would have been more appropriate had § 2119 been addressed only to “corporate members of the publishing industry.” 73 T.C. at 859. Additionally, the Tax Court found the definition of “business of publishing” broad enough to include “being the author of a published work.” 73 T.C. at 859. This definition is so broad, however, as to eliminate the distinction between publishers and authors entirely — obscuring a line clearly drawn by the Senate in its deliberations.

A more careful analysis of the legislative history makes it apparent that Congress intended § 2119 in its final form to apply only to publishers. As originally passed by the House, § 2119 covered only “publishers.” H.R. 10612, 94th Cong., 1st Sess. § 1306, 121 CONG. REC. 38,396, 38,637 (1975) (§ 1306 of the Bill as passed by the House was renumbered § 2119 in the final version). That the Senate Committee did not consider the phrase “trade or business of publishing” to include authors is evident from its amendment of the section to read “trade or business of writing or publishing.” H.R. 10612, 94th Cong., 1st Sess. § 1305, 122 CONG. REC. 24,015 (1976). In the Senate Report of the bill, the Finance Committee noted:

The committee believes that it would be discriminatory to allow publishers to deduct expenses which authors must capitalize. Therefore, the committee believes it appropriate to provide relief from Revenue Ruling 73-395 to authors, as well as to publishers.

The Committee amendment is substantially the same as the provision in the House bill except that it extends its application to authors.

S. REP. No. 938, 94th Cong., 2d Sess. 404-05 (1976), reprinted in 1976-3 C.B. (Vol. 3) 49, 442-43 (emphasis added). When the bill went to the Conference Committee, the Senate adopted the
them to continue treating prepublication expenses as they had in the past, at least until the IRS issues specific regulations. 108 Congress required only that the IRS deal with prepublication expenses through regulations rather than revenue rulings; Congress did not express a preference for either capitalization or immediate deductibility. 109

House version "with necessary technical changes." S. Rep. No. 1236, 94th Cong., 2d Sess. 502 (1976), reprinted in 1976-3 C.B. (Vol. 3) 806, 906. Although the Finance Committee version was never passed by the Senate (see note 109 infra) and thus was not before the Conference Committee, the Faura dissent points out that "the 'necessary technical changes' included every change proposed by the Senate Finance Committee, except the change that would have added the words "writing or."" 73 T.C. at 865 (Chabot, J., dissenting) (quoting S. Rep. No. 938, at 404-05) (emphasis in original). Thus, the conferees undoubtedly knew of the divergent language; their choice of the House language points to their intent not to include authors within the purview of § 2119.

108. Section 2119 provides:

(a) General Rule.—With respect to taxable years beginning on or before the date on which regulations dealing with prepublication expenditures are issued after the date of the enactment of this Act, the application of sections 61 (as it relates to cost of goods sold), 162, 174, 263, and 471 of the Internal Revenue Code of 1954 to any prepublication expenditures shall be administered—

(1) without regard to Revenue Ruling 73-395, and

(2) in the manner in which such sections were applied consistently by the taxpayer to such expenditures before the date of the issuance of such revenue ruling.

(b) Regulations To Be Prospective Only.—Any regulations issued after the date of the enactment of this Act which deal with the application of sections 61 (as it relates to cost of goods sold), 162, 174, 263, and 471 of the Internal Revenue Code of 1954 to prepublication expenditures shall apply only with respect to taxable years beginning after the date on which such regulations are issued.

(c) Prepublication Expenditures Defined.—For purposes of this section, the term "prepublication expenditures" means expenditures paid or incurred by the taxpayer (in connection with his trade or business of publishing) for the writing, editing, compiling, illustrating, designing, or other development or improvement of a book, teaching aid, or similar product.


109. The Tax Court concluded in Faura v. Commissioner, 73 T.C. 849 (1980), that § 2119 expressed congressional disapproval of the position taken in Rev. Rul. 73-395 (i.e., that prepublication expenditures must be capitalized). 73 T.C. at 859-60. This conclusion is not supported by the legislative history. The Senate Committee did not approve of requiring authors to capitalize their expenses while publishers were allowed to deduct them. S. Rep. No. 938, 94th Cong., 2d Sess. 404 (1976), reprinted in 1976-3 C.B. (Vol. 3) 49, 442 ("The Committee believes that the IRS's position to disallow any deductions for authors' prepublication expenses . . . results in inequitable treatment for taxpayers who are professional authors engaged in the business of writing. The Committee believes authors should be allowed to deduct as business expenses the essential, reasonable costs of earning income from their writing."). However, the Committee found that Senate support for any attack on Rev. Rul. 73-395 was so slim that it withdrew the entire provision from Senate consideration. 122 Cong. Rec. 24,019 (1976).

The House Report and the Report of the Joint Committee on Taxation indicate only a concern that retroactive application of a capitalization requirement to publishers who had consistently been deducting their expenses immediately would be unfair. See H.R. Rep. No. 658, 94th Cong., 1st Sess. 337-38 (1975), reprinted in 1976-3 C.B. (Vol. 2) 695, 1029-30 ("Your committee understands that historically tax accounting practices in the publishing industry have varied greatly and no standard procedures have been developed . . . . [Y]our committee is concerned about the retroactive application of Rev. Rul. 73-395 which would affect practices consistently followed by many taxpayers for years . . . ."); Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 624-35 (1976). Since the language of the House bill was followed, and the Joint Committee
Since the passage of section 2119, the IRS has continued to require capitalization of prepublication expenditures,\textsuperscript{110} despite suspension of Revenue Ruling 73-395.\textsuperscript{111} Only publishers falling within the limited scope of section 2119 are exempt from this treatment. In private letters, the IRS has urged that publishers must show that they had established a consistent practice of expense deduction before the effective date of the statute.\textsuperscript{112} Thus, new publishers and those publishers without a prior consistent practice\textsuperscript{113} are still subject to the IRS's interpretation of sections 162 and 263.

In recent cases, the courts have split on the proper treatment of prepublication expenditures. In \textit{Faura v. Commissioner},\textsuperscript{114} the Tax Court found that all prepublication expenditures of an author were ordinary business expenses, relying on an established line of precedent\textsuperscript{115} and an independent analysis of section 2119.\textsuperscript{116} As the dissent in \textit{Faura} pointed out, the legislative history of section 2119 does not support the majority's broad interpretation, which held that section 2119 applies to authors as well as publishers.\textsuperscript{117} However, both the dissenting and concurring judges felt that the precedent cited by the majority was sufficient to support the holding.\textsuperscript{118} The Tenth Circuit also adhered to this line of precedent in \textit{Snyder v. United States}.\textsuperscript{119} Neither of these cases, however, analyzes the purposes underlying sections 162 and 263, nor do they justify their holdings in

\textsuperscript{110} See, e.g., Letter Ruling 8201015 (Sept. 21, 1981). I.R.C. § 6110(i)(3) (1976) provides that these letters may not be cited as precedent.

\textsuperscript{111} News Release IR-1575 (Mar. 17, 1976).

\textsuperscript{112} Letter Ruling 8201015, supra note 110. The IRS's position in this matter seems reasonable. Section 2119 by its terms protects only those with consistent practices, and the burden is always on the taxpayer to show entitlement to a deduction. See, e.g., \textit{Walker v. Commissioner}, 362 F.2d 140 (7th Cir. 1966) (deficiency assessment entitled to presumption of correctness; burden on taxpayer to show greater deduction permissible). See generally 1 B. BITTKER, supra note 23, at 20.1.9, at 20-23 to -26.

\textsuperscript{113} The IRS seems to be uncertain about what “consistency” requires. In Letter Ruling 8201015, supra note 110, the agent contended that \textit{all} prepublication expenditures had to be treated identically for consistency to be achieved. The writer of the letter concluded that “[s]uch internal consistency with respect to all other expenses is not necessary, however; the taxpayer need only treat each particular type of expense in a consistent manner.”

\textsuperscript{114} 73 T.C. 849 (1980).

\textsuperscript{115} See \textit{73 T.C.} at 852-57; notes 89-97 supra and accompanying text.

\textsuperscript{116} See \textit{73 T.C.} at 859; notes 107 & 109 supra.

\textsuperscript{117} \textit{73 T.C.} at 864-67 (Chabot, J., dissenting); note 107 supra.

\textsuperscript{118} \textit{73 T.C.} at 862-63 (Tannenwald, Nims, JJ., concurring); \textit{73 T.C.} at 863 (Chabot, J., dissenting). Although Judge Chabot concluded that precedent supported the majority's holding, he thought that the court should have overruled such precedent. \textit{73 T.C.} at 863.

\textsuperscript{119} 674 F.2d 1359 (10th Cir. 1982). The taxpayer had expenses for photographic equipment and for trips to talk with publishers about a planned book of photographs. In dicta, the court suggested that the taxpayer's expenses in creating the book would be deductible, citing \textit{Faura}. 674 F.2d at 1365. The court did not discuss § 2119.
terms of “clear reflection of income” principles.  

In Encyclopaedia Britannica, Inc. v. Commissioner, the Seventh Circuit denied a business expense deduction for prepublication costs, pointing out that none of the cases cited as precedent offered a rationale for immediate deduction. Instead, the court relied on the “clear reflection of income” principles discussed in Idaho Power. Since the payments were for the creation of a book intended to yield Britannica income over a period of years, the court had “no doubt” that the payments ought to be capitalized.

The court was, however, disturbed by the Faura and Snyder holdings. Rather than reject them outright, Judge Posner distinguished these cases on two grounds. First, he found that the specific expenses in question were not ordinary expenses because not recurrent to Britannica and thus could not be immediately deductible even if other prepublication expenses were. Second, Judge Posner attempted to limit Faura to a situation where the production of a series of assets would render allocation of expenses among them so technically complex as to be virtually impossible. In other words, the Britannica court read Faura as a concession to administrative

120. See notes 12-26 supra and accompanying text.
121. 685 F.2d 212 (7th Cir. 1982).
122. 685 F.2d at 215. Among the cases cited as precedent were Faura, Snyder, and the line of cases on which they relied. See notes 89-97 supra and accompanying text.
123. 685 F.2d at 214 (“The object of sections 162 and 263 of the Code, read together, is to match up expenditures with the income they generate.”). For a discussion of Idaho Power, see notes 65-69 supra and accompanying text.
124. 685 F.2d at 214.
125. 685 F.2d at 216-17. Britannica had made payments to another corporation for preparation of a manuscript to be published by Britannica, and had then deducted these payments as ordinary business expenses. 685 F.2d at 214. Normally, Britannica produced all its manuscripts in-house. Relying on a constricted version of the old “recurrent costs” standard, the court found that the payments were not “ordinary.” The court’s approach was “constricted” because the court looked only to the taxpayer’s own practices, rather than to the industry as a whole. Cf. notes 30-32 supra and accompanying text (“recurrent in the industry” test looks to the “normal” business response). The court’s version of the “recurrent” test implies that any publisher who is consistent will have only ordinary business expenses, whether he purchases all his manuscripts, or creates them all in-house. Judge Posner apparently recognized that his use of the “recurrent” standard raised this problem, and emphasized that the consistency question was not before the court. 685 F.2d at 217 (“[W]e need not consider whether a conventional publisher should be permitted to deduct royalty advances made to its authors as current operating expenses, merely because those advances are for it recurring business expenses because its business is producing capital assets.”).

The “recurrent” standard is no longer in general use. See notes 30-32 supra and accompanying text. However, assuming that the court correctly applied the “recurrent” standard, Britannica’s payments still seem “ordinary” by many standards. Justice Cardozo pointed out that an expense might be ordinary though encountered by a taxpayer only once during his lifetime. See note 29 supra. Britannica had contracted out for the manuscript because it was short-staffed; even if the range of experience is limited to publishers who create manuscripts in-house, Britannica’s action must surely be the ordinary response in a short-staffing situation.
126. 685 F.2d at 216. Judge Posner noted that such allocation problems are more likely to arise with publishers than with authors. 685 F.2d at 215.
difficulties.\textsuperscript{127} The court then pointed out that the payments by Britannica were "unambiguously identified" with a specific asset, and concluded that the administrative considerations of \textit{Faura} were not relevant in the case at bar.\textsuperscript{128} However, no language in \textit{Faura} purports to limit its holding to technically complex situations. Indeed, the author had produced only two manuscripts from the expenses deducted;\textsuperscript{129} the expenses could have been easily allocated between the two. The Seventh Circuit's narrow reading of \textit{Faura}, then, seems unjustified.

Ultimately, judicial and administrative treatment of prepublication expenditures continues to be inadequate. Although \textit{Encyclopaedia Britannica} began in the right place, by considering \textit{Idaho Power}'s "clear reflection of income" principles, the court went off course in its attempts to distinguish \textit{Faura}. Regardless of whether \textit{Encyclopaedia Britannica}'s expenses should have been capitalized,\textsuperscript{130} the "recurrent cost" test enunciated by the Seventh Circuit and the court's reliance on an administrative burden rationale are misleading and poorly related to the court's basic "clear reflection of income" premise. Moreover, the IRS has not taken any action to solve the dilemma. Despite the IRS's apparent intention to require most authors and publishers to capitalize their expenses, it has given no indication that regulations are forthcoming.\textsuperscript{131}

III. \textsc{Applied Analysis of Prepublication Costs}

This part examines prepublication costs in light of the concepts developed in Part I, suggesting an analysis of the problem more prin-

\textsuperscript{127} At least \textit{some} publishers must be able to allocate their costs among manuscripts, since the legislative history of \textsection{} 2119 indicates that the publishing industry has followed varied practices with respect to capitalization of costs. \textit{See} note \textsuperscript{109} supra.

\textsuperscript{128} 685 F.2d at 216.

\textsuperscript{129} 73 T.C. at 849-50.

\textsuperscript{130} \textit{Cf.} Part III-C \textit{infra} (discussing proper treatment of publisher's expenses).

\textsuperscript{131} The problem of prepublication expenditures has been the subject of a special IRS study since the suspension of Revenue Ruling 73-395. \textit{See} News Release IR-1575 (Mar. 17, 1976). Although \textsection{} 2119 only requires regulations as to publishers, the Office of the Chief Counsel has advised against issuing any new revenue ruling applicable to authors until the study is complete. G.C.M. 37,557 (May 31, 1978). The IRS also has under study the possible applicability of I.R.C. \textsection{} 280 (1982), which requires that, in the case of an \textit{individual} taxpayer, production costs for films, books, records and similar property be deducted over the years in which the property is income-producing. Consideration of the anti-tax-shelter nature of this provision suggests that it properly applies only to \textit{purchasers} of manuscripts and that the production costs referred to are those of a publisher, not an author. \textit{See} Gilleran, \textit{Amortization Shelters in Books, Records, Artwork, and Similar Property — Mirage or Oasis in the Tax Shelter Desert?}, 56 Taxes 695, 697 (1978). This position is supported by the relevant legislative history. S. Rep. No. 938, 94th Cong., 2d Sess. 77 (1976), \textit{reprinted in} 1976-3 C.B. (Vol. 3) 49, 115, states that \textsection{} 280's requirements apply to production costs and that "in the case of a book, principle production begins with the preparation of the material for publication." \textit{See generally} Letter Ruling 7921008 (Jan. 29, 1979) (discussing the relationship between \textsection{} 280 of the Code and \textsection{} 2119 of the Tax Reform Act).
cipated than any that has been developed by the courts or the IRS. Section A contends that not all prepublication expenditures are encompassed by the IRS's regulatory requirement that the taxpayer capitalize costs incurred in securing a copyright. Rather, this Regulation properly covers only the direct costs of registration. As a result, the inquiry turns to the proper treatment of expenses other than registration costs. Section B examines the prepublication expenditures of authors and concludes that authors receive income from the sale of services rather than the sale of an asset. This position is supported by the denial of capital gains treatment for the author's sale of his manuscript. Thus, an author should be allowed to deduct expenses incurred in generating his or her fee. Finally, section C examines the prepublication expenditures of publishers, discussing the nature of the industry and its typical accounting practices, and concludes that fixed costs and royalties must be capitalized and deducted over a book's useful life. Running costs, however, are properly included in inventory.

A. Manuscripts and Copyrights

The regulations promulgated under section 263 require the capitalization of "[a]mounts expended for securing a copyright and plates, which remain the property of the person making the payments."\(^\text{132}\) Since a copyright is a long-lived asset\(^\text{133}\) which at least theoretically benefits the holder in future years,\(^\text{134}\) capitalization of this cost is necessary to achieve clear reflection of income.\(^\text{135}\) The question remains, however, to what extent "amounts expended for securing a copyright" includes amounts expended to create a copyrightable manuscript.\(^\text{136}\)

The IRS has historically equated the production of a manuscript with the securing of a copyright, forcing capitalization of all the costs

\(^{132}\) Treas. Reg. § 1.263(a)-2(b) (1958); see note 39 supra.


\(^{134}\) In the absence of other evidence, a copyright may be depreciated over its legal life. Treas. Reg. § 1.167(a)-6(a) (1956). The IRS allows publishers to depreciate over a shorter period if they can demonstrate the shorter useful life. Rev. Rul. 73-395, 1973-2 C.B. 87. The value, and hence the benefit, of a copyright is tied to the income-producing potential of the work which it protects, although many works have value (to their publishers) independent of the existence of copyright. For example, Charles Dickens' *A Tale of Two Cities*, long out of copyright, is valuable enough to be presently available in 16 editions. See 1 BOOKS IN PRINT, 1982-83 — AUTHORS 1179 (1982).

\(^{135}\) See notes 23-26 supra and accompanying text.

\(^{136}\) An argument can be made that where the IRS has meant to include creation costs in its pronouncement, it has used the phrase "producing and copyrighting." See, e.g., Rev. Rul. 73-395, 1973-2 C.B. at 87; I.T. 1287, 1-1 C.B. at 28. Since no mention of production is made in the regulations, the IRS must not have meant to include it.
of producing a book. Presumably the IRS reasoned that because a manuscript is necessary to obtain a copyright, costs incurred in producing the manuscript are necessary to securing the copyright.

The IRS's position, however, is not unobjectionable. The language of the regulation itself supports an argument against treating the costs of creation as part of the costs of securing a copyright. Significantly, the regulation speaks of costs for "securing" a copyright. Since a copyright endures from the moment the manuscript is created, treatment of creation as a component of "securing" may seem like a logical step. However, the mere existence of a copyright does not secure it. To secure the copyright, and thus to obtain its benefit, the copyright must be registered. Thus, the costs of "securing" a copyright are really the costs of registration.

This result comports with the author's purpose in incurring various expenses, since only registration expenses are paid with the copyright in mind; creation expenses have as their end only the manuscript, which incidentally gives rise to a copyright.

The manuscript and the copyright are, furthermore, distinct assets with potentially different tax consequences. With respect to capitalization, the important comparison is the span over which the

137. See, e.g., Rev. Rul. 73-395, 1973-2 C.B. 87 (permitting depreciation of cost of manuscript over life of copyright); O.D. 966, 5 C.B. 155, 156 (1921) (cost of producing book is part of securing copyright).


139. Neither registration nor deposit of copies with the Library of Congress is a condition of copyright protection. 17 U.S.C. §§ 407(a), 408(a) (Supp. IV 1980). Despite these express statements, registration is, in effect, a condition of copyright protection. Section 411 of the Copyright Act makes registration a prerequisite to any infringement action. 17 U.S.C. § 411 (Supp. IV 1980). The existence of federal statutory copyright, whether secured or not, completely preempts any common law copyright. Thus, from the moment of fixation, the copyright holder's only remedies are statutory. See Gorman, An Overview of the Copyright Act of 1976, 126 U. PA. L. REV. 856, 865 (1978); Note, Copyright and Privacy Protection of Unpublished Works—The Author's Dilemma, 13 COLUM. J.L. & SOC. PROBS. 351, 361-64 (1977). Further, § 412 requires that registration take place before the infringement, if the copyright holder is to obtain the statutory damages or attorney's fees otherwise available to successful plaintiffs in copyright actions. Thus, effective protection of the copyright is dependent on registration. See Washingtonian Publishing Co. v. Pearson, 306 U.S. 30, 40 (1939) ("Without right of vindication a copyright is valueless"); Levine & Squires, Notice, Deposit and Registration: The Importance of Being Formal, 24 UCLA L. REV. 1232, 1261-63 (1977).

The same conclusion follows under the operation of the 1909 Copyright Act. Although statutory copyright did not exist until publication of the work with proper copyright notice, common law copyright, which existed from creation of the work, was unimpaired as to unpublished works by the 1909 Copyright Act. 17 U.S.C. §§ 2, 10 (1976); see R. WINCOR & I. MANDELL, COPYRIGHT, PATENTS & TRADEMARKS: THE PROTECTION OF INTELLECTUAL & INDUSTRIAL PROPERTY 8-9 (1980). Statutory protection, then, existed only if the copyright was "secured" by registration. Thus, only the costs of registration were costs to secure copyright.

140. The requirements for registration are set forth in §§ 408 and 409 of the 1976 Copyright Act. 17 U.S.C. §§ 408-409 (Supp. IV 1980). They prescribe deposit of a specified number of copies of the work, along with presentation of of the application for registration and the filing fee. Currently, the fee is ten dollars. 37 C.F.R. § 202.3(c)(2) (1983). Thus, the costs of registration should be minimal.
asset produces income. A copyright is a bundle of legal rights, conferred as much for the public’s benefit as for the author’s. A copyright has a legally determinable life. Whatever its actual useful life, which may be much shorter, a copyright’s income potential is always bounded by its legal lifespan. A manuscript, however, knows no such legal bounds — its income-producing life is potentially infinite. Although such long-lived manuscripts are rare, their existence demonstrates that the benefits produced by a manuscript are not necessarily exhausted within the period of the copyright’s existence. This difference in potential useful life should imply a different tax treatment of expenses incurred in creating those lives (or, at least, a separate treatment). Thus, although the IRS may be justified in requiring capitalization of the costs of registering — and thus securing — a copyright, this requirement implies nothing about the proper tax treatment of other prepublication expenses.

B. Prepublication Expenses of Authors

The prepublication expenditures of authors fall into two groups: the costs of creation and the costs of obtaining publication. This division is natural because the costs of creation go toward completing the work that is the product of the author’s literary efforts. At the end of this creation phase, the author’s efforts will have produced a potentially valuable manuscript. The costs of this phase may include research, office supplies, depreciation on equipment, and stenographic assistance, among other things. The costs of obtaining publication generally add little to the potential value of the manuscript, since they involve only minor revision. In a sense, however, the costs of obtaining publication are the costs of realizing the potential value.
of the manuscript, since, without publication, the manuscript will never produce any income. The costs of obtaining publication include, among other things, money paid for copying, postage, travel to meet with publishers, and agent's fees.\textsuperscript{145}

1. \textit{Creation Costs}

Under the principles developed in Part I of this Note, the author's creation costs seem to be clear instances of capital expenditure — that is, they create property having a useful life substantially beyond the taxable year.\textsuperscript{146} However, one can argue that that the author is \textit{not} receiving income from the asset he produces, but rather from a sale of his services. If the author is indeed selling services, then his costs ought to be expensed — that is, deducted in the year they are incurred — despite the fact that he receives his compensation in the future.\textsuperscript{147}

In creating a manuscript, an author may have many actual expenditures — for example, travel, research\textsuperscript{148} and office expenses, the cost of supplies, depreciation on equipment,\textsuperscript{149} and stenographic help.\textsuperscript{150} Yet the author's major investments in the manuscript are his time and labor.\textsuperscript{151} In essence, the author's creativity and labor have produced the book; all other costs, substantial though they may be,  

\footnotesize{145. The vast majority of books accepted by trade publishers are placed through literary agents. J. DESSAUER, \textit{BOOK PUBLISHING: WHAT It Is, WHAT It DOES} 31 (1974). In other branches of the industry, most books received are either unsolicited, or were specifically contracted for by the publisher. \textit{See} note 168 \textit{infra}.}

\footnotesize{146. \textit{See} Part I-A \textit{supra}. Of course, not all, or even most, books are resounding successes. On average, only 30\% of new titles are profitable, with another 30\% breaking even and the remaining 40\% showing a loss. B. COMPAIGNE, \textit{THE BOOK INDUSTRY IN TRANSITION} 20 (1978). In general, scholarly works and textbooks will have longer useful lives than trade books. \textit{See} note 87 \textit{infra}.}

\footnotesize{147. Certainly this is true of authors who report their income on the cash basis, a method of accounting that actually contemplates mismatching of expense and income. One widely accepted definition of “income,” is that known as the Haig-Simons definition: “income equals personal consumption plus accumulation of wealth over a stated period of time.” Kahn, \textit{supra} note 17, at 3; \textit{see} H. SIMONS, \textit{PERSONAL INCOME TAXATION} 50 (1938). The cash method of accounting is expressly recognized as an exception to this definition, since it allows taxpayers in effect to defer recognition of income. \textit{See} Kahn, \textit{supra} note 17, at 9-10. That the cash method permits authors to defer recognition of income should not be taken to prohibit them from deducting their expenses in what would otherwise be the proper year.}

\footnotesize{148. I.R.C. § 174(a)(1) (1982) permits an election to treat research and experimental expenditures in connection with the taxpayer's trade or business as current expenses rather than as capital expenditures. However, Treas. Reg. § 1.174-2(a)(1) (1957) provides that “research in connection with literary, historical, or similar projects” is not included in the election.}

\footnotesize{149. If authors are required to capitalize the costs of producing their manuscripts, the \textit{Idaho Power} doctrine would mandate that depreciation on equipment such as typewriters be included in that cost. \textit{See} notes 65-69 \textit{infra} and accompanying text. In addition to the expense of typewriters, many authors now use word processors. \textit{See} McDowell, \textit{Publishing: From Word Processor to a Book}, N.Y. Times, Feb. 25, 1983, at 21, col. 1.}

\footnotesize{150. The Regulations specifically allow the deduction of similar expenses by professionals. \textit{See} Treas. Reg. § 1.162-6 (1958).}

\footnotesize{151. \textit{See} Shine, \textit{supra} note 73, at 446.}
are subordinate to the actual labor of writing. This suggests that payments received by the author from publishers are more in the nature of compensation than of gain from the sale of an asset. Clearly, the author's income derives from his input of labor, rather than from the value of the materials.\(^{152}\)

The characterization of royalties as compensation rather than as gain from the sale of an asset comports with the non-capital gains treatment of the sale. Under section 1221(3)\(^{153}\) of the Internal Revenue Code, manuscripts are not capital assets while in the hands of the author, and thus are not eligible for capital gains treatment.\(^{154}\) This result follows from the purposes of the capital gains provisions and the congressional determination that the "personal efforts" involved in producing a literary work do not fall within the scope of those purposes. Although the propriety of the capital gains provisions is hotly debated,\(^{155}\) there is some agreement that their basic aim, though blurred by amendments, is directed toward investment.\(^{156}\) Thus, profits attributable to personal effort are properly de-

---

152. Any value the manuscript has beyond the value of its materials must be due to the addition of labor. The value of the author's labor is dependent on the income the manuscript can be expected to produce. This is particularly clear in the case of authors whose compensation is directly tied to the income they produce through the device of royalties.

153. I.R.C. § 1221 (1982) provides in part:
For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

. . . .

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,
(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).

154. See I.R.C. § 1222 (1982). All capital gains and losses are defined in terms of capital assets.


156. United States v. Midland-Ross Corp., 381 U.S. 54, 56-57 (1965); Commissioner v. Gillette Motor Transp., 364 U.S. 130, 134 (1960); Holt v. Commissioner, 303 F.2d 687, 690-91 (9th Cir. 1962); Bellamy v. Commissioner, 43 T.C. 487, 497-98 (1965); 3B J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 22.11 at 85 (J. Doheny ed., rev. vol. 1980) ("Presumably what remains, after such noncapital assets have been carved out, is investment property."); cf. Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955) ("The preferential treatment provided by [the capital gains provisions] applies to transactions in property which are not the normal source of business income."); Miller, Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code, 64 Yale L.J. 1, 1 (1954) (discussing the "paradox that the capital gains tax often applies to gains not from an investment of capital but from personal effort"). The arguments typically advanced in favor of the capital gains provisions reflect this emphasis on investment. See, e.g., Blum, supra note 155, at 266 ("Full taxation of gains would tend to retard investment by enterprises, discourage risk-taking, and interfere with the mobility of capital.").
nied capital gains treatment. In specifically excepting literary compositions from the definition of capital assets, Congress has determined that the author’s conversion of his services into a product is insufficient to regard profits from the sale of that product as profit due to investment. Rather, the author’s profit is attributable to personal effort and thus should be taxed at ordinary income rates.

If the author’s profit on the sale of his manuscript is taxed as ordinary income because his profit is essentially the product of personal effort, then the sale of the manuscript must be characterized as a sale of services, rather than as a sale of property, at least for capital gains purposes. Although section 1221 is a characterization provision, whereas sections 162 and 263 are timing provisions, it seems reasonable to conclude that the characterization of the transaction as a sale of services should carry over to the timing provisions as well. If the author’s activity is characterized as the performance of services, then his expenses must be the expenses of performing services, rather than the costs of constructing an asset. Since section 162 permits an immediate deduction of the expenses of performing services,

---

157. The many provisions of the Code which allow capital gains treatment of profit from personal effort, e.g., I.R.C. § 1235 (1982) (sale of patents), are not to the contrary. These provisions are not based on theoretical grounds but on policy. See Miller, supra note 156, at 82 (“No intention has been expressed by Congress or the courts to extend the capital gains tax to personal service income as such. Congress has merely approved some instances of this extension as ‘incentives’ and relief from ‘unduly harsh’ taxation.”) (footnotes omitted). The favorable treatment of patents as compared to that of copyrights is a topic beyond the scope of this Note. For a discussion of the discrimination in the Code between patents and copyrights, see Pilpel, Developments in Tax Law Affecting Copyrights in 1954, 33 TAXES 271 (1955); Note, supra note 73.

158. Prior to the addition of § 1221(3) in 1950, Pub. L. No. 814 § 210, 53 Stat. 50 (1950), professional authors were denied capital gains treatment on the ground that manuscripts were “primarily for sale to customers” in the ordinary course of business. See Fields v. Commissioner, 14 T.C. 1202, 1214-16 (1950), aff’d, 189 F.2d 950 (2d Cir. 1951). Amateurs, however, received capital gains treatment. See, e.g., Herwig v. United States, 105 F. Supp. 384, 390-92 (Ct. Cl. 1952). Section 1221(3) was prompted by the capital gains treatment received by then-General Eisenhower on the sale of his memoirs of WWII. Although § 1221(3) was added to remove the loophole for amateur authors, there can be little doubt that the exclusion of professional authors from capital gains treatment was actually based on a “personal efforts” ground rather than on the “primarily for sale to customers” exclusion. Both the House and Senate Reports on the addition of § 1221(3) indicate a concern that capital gains treatment should not be given to profit from “personal effort.” See H.R. REP. No. 2319, 81st Cong., 2d Sess. 54 (1950), reprinted in 1950-2 C.B. 380, 421; S. REP. No. 2375, 81st Cong., 2d Sess. 43 (1950), reprinted in 1950-2 C.B. 483, 515.

159. See Surrey, Definitional Problems in Capital Gains Taxation, 69 HARV. L. REV. 985, 1001-02 (1956) (“[P]rofits attributable to creative ‘personal efforts’ are not regarded as entitled to capital gain treatment. This is, presumably, a result of the realization that salaries, wages, commissions, and professional fees are on the ordinary income side . . . and the feeling that profits coming from other personal efforts belong with these classes of income.”) (footnote omitted).

160. In his section on personal services income, Marvin Chirelstein states that “the income received by an inventor or an artist from the transfer of a patent or copyright fairly plainly belongs to the class of ordinary receipts. The principal element of value in either case derives from personal effort . . . .” M. CHIRELSTEIN, supra note 12, ¶ 19.01, at 320; see also Pilpel, Tax Law Affecting Copyrights: 1954-56, 35 TAXES 76 (1957).
regardless of the time of compensation, the author's creation costs should be allowed as an ordinary and necessary business expense.\textsuperscript{161}

2. Costs of Obtaining Publication

Once the author has created his manuscript, he must publish or arrange for the sale of his product to obtain any income. He may incur costs for photocopying, mailing, travel to visit publishers, and agent's fees.\textsuperscript{162} If the author is, in effect, attempting to sell his services,\textsuperscript{163} then the costs of obtaining publication are analogous to the costs of job-seeking. Assuming that one is established in the trade or business of writing, these costs may be expensed whether or not the search for employment is successful.\textsuperscript{164}

\begin{table}
\begin{tabular}{|c|c|}
\hline
\textbf{161.} & The ordinary income characterization of authors' profits apparently motivated Senator Ribicoff's attempt to place authors under the protection of § 2119 of the Tax Reform Act of 1976: \\
\textbf{What makes Revenue Ruling 73-395 all the more unfair is the fact that while it requires expenditures to be depreciated, section 1221(3) of the Code prohibits authors from treating their output as "capital assets."} \\
\textbf{In other words, without the amendment that I am proposing, authors will be taxed at the higher "ordinary income" rates while they will only be able to depreciate expenses. This is patently unfair.} \\
\textbf{122 CONG. REC. I 1,296 (1976) (statement of Sen. Ribicoff).} \\
\textbf{Section 162 provides a deduction only for those carrying on a trade or business. Authors not engaged in a trade or business would have to show that they intended to produce income if they wish to qualify for a deduction under § 212. On the difficulties of establishing oneself as in the trade or business of being an artist, see T. Crawford, The Writer's Legal Guide 185-94 (1977); R. Duffy, Art Law 224-30 (1977); A Tax Guide for Artists and Arts Organizations 45-56 (H. Lidstone ed. 1979).} \\
\textbf{162. Should he be unsuccessful in obtaining publication, the author may either abandon the manuscript, or seek publication through a vanity press or printer. See T. Crawford, supra note 161, at 139-40 (discussing publication methods other than via a commercial publisher). Abandonment will pose a problem of proof if capitalization is required, particularly since interest may be shown in the early manuscript if later manuscripts prove more successful.} \\
\textbf{Publication by a vanity press involves the author's assumption of the costs of publication through an initial payment, usually determined on a per page basis. Although vanity press contracts typically provide high royalties, this practice is deceptive, since low sales mean that authors virtually never recover their initial investment. T. Crawford, supra note 161, at 141-45 (only 10% of investments are covered by sales).} \\
\textbf{163. See notes 146-61 supra and accompanying text.} \\
\textbf{164. Rev. Rul. 78-93, 1978-1 C.B. 38. The expenses of one already established in a business in seeking new employment are deductible on the theory that an employee is engaged in offering services to many employers, not simply his current one. Rev. Rul. 75-120, 1975-1 C.B. 55. One seeking employment for the first time, however, is apparently not considered to be "carrying on" a business, as required by § 162(a), so no deduction is allowed.} \\
\textbf{Alternatively, the costs of obtaining publication may be analogized to normal business operating expenses, since the business of writing necessarily involves such attempts. If the writer's business can be said to have begun with the writing of his work, rather than its publication, then the operating expense analogy will also solve the problem of first-time authors. See Richmond Television Corp. v. United States, 345 F.2d 901, 905 n.4, 906-07 (4th Cir.), vacated and remanded on other grounds, 382 U.S. 68 (1965) (pre-operating expenses of TV station are not deductible; operations begin when "the business has begun to function as a going concern and performed those activities for which it was organized"); Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 TAX L. REV. 347, 454-61 (1974) discussing pre-operating/operating distinction).} \\
\hline
\end{tabular}
\end{table}
C. Prepublication Expenditures of Publishers

The modern book publisher functions differently from virtually every other manufacturer. Although he ultimately produces goods for sale, the publisher's main concern is the creation and development of new products.165 Few publishers care to print the same books year after year.166 And, while most manufacturers have some interest in the improvement of old products and the development of new, none are as dependent on the constant introduction of new products as publishers are.

The prepublication work of publishers is divided into two phases.167 First, the publishers develop new products. This task involves the selection of manuscripts submitted for publication, the development of ideas for creation of in-house projects,168 the editing of

---

165. In 1979, 36,112 new titles were published, along with 9,070 new editions of previously published works. BUREAU OF THE CENSUS, U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1980, at 595 [hereinafter cited as STATISTICS]. In 1977, 1745 book publishers issued 42,780 new books and editions. Id. at 590, 595. Of 106,000 employees in book printing and publishing, only 51,000 were production workers — i.e., involved in the book manufacturing process — a low percentage compared with other manufacturing industries. See STATISTICS, supra, at 816-17.

166. Most publishers maintain a “backlist” of titles previously published that continue to sell year after year. See J. DESSAUER, supra note 145 at 30. Once a manuscript has reached the stage where plates have been created, the cost to the publisher of a new printing is relatively low. See H. BOHNE & H. VAN IERSSEL, PUBLISHING: THE CREATIVE BUSINESS 9 (1973) [hereinafter cited as H. BOHNE]. The culture of publishing is such, however, that most publishers want to bring new titles before the public. There are two major reasons for this phenomenon, which ultimately leads to the publication of twice as many titles as can be successfully marketed. See J. DESSAUER, supra note 145, at 36. First, the uncertainty of the market leads many publishers to publish as many titles as possible, in the hope that one or more will be that season’s “blockbuster.” See id. at 36-38. Second, many publishers feel constrained (or even desire) to publish so-called “conscience books” — books certain not to recover their costs, but which are of particular cultural merit. See L. COSER, C. KADUSHIN & W. POWELL, BOOKS: THE CULTURE AND COMMERCE OF PUBLISHING 15-16 (1982) [hereinafter cited as L. COSER]. See generally A. BLOND, THE PUBLISHING GAME (1971). Of course, for every conscience book published, a publisher must produce one or more profitable books in order to cover his loss.

167. These two phases cover only the prepublication operations of a publisher. The typical publishing operation is actually divided into five areas: editorial, production, marketing, fulfillment, and administration. The editorial area encompasses both the selection task (reading of submitted manuscripts and creation of projects) and the preparation task (traditional editing, proofreading, etc.). Production includes the planning and design of the physical book, choice of materials and supervision of the printing process. Marketing covers advertising, promotion and general publicity. Fulfillment involves the processing of orders, credit control, and maintenance of sales and inventory records. Administration is a general category covering fiscal and personnel management, corporate planning and policy, and accounting. See J. DESSAUER, supra note 145, at 26-27. Generally accepted accounting principles would allow the immediate deduction of marketing and fulfillment costs, because they are operating expenses rather than manufacturing costs. See H. FINNEY & H. MILLER, supra note 13, at 497. The regulations specifically recognize that advertising and other selling costs qualify as business expenses. Treas. Reg. § 1.162-4(a), T.D. 7345, 1975-1 C.B. 51, 52. Administrative costs are generally overhead that cannot be assigned to any specific function. This general overhead may be deducted immediately, as it relates to a specific time period, rather than to a specific product. See note 183 infra. For the treatment of editorial overhead, see notes 180-83 infra and accompanying text.

168. True in-house projects are proposed, written and edited by employees of the pub-
manuscripts accepted for publication, and the planning and design of the physical book. In other words, the publisher must obtain, either through in-house creation or through purchase and in-house development, the finished work that will then be reproduced for sale. 169 The second task is the actual manufacturing of the books themselves. The costs of these two prepublication functions — creation and manufacture — must be accounted for differently; the first function is the process of acquiring an asset with a useful life beyond the taxable year, whereas the second is the process of producing goods for sale. 170

Four types of cost are associated with the publisher’s creative function: acquisition costs, editorial selection costs, editorial preparation costs and plant costs. 171 Since these costs go to the acquisition and development 172 of assets having a useful life beyond the taxable year, they must be capitalized unless the publisher can demonstrate

---

169. In accounting terms, the completed manuscript is a non-current asset — that is, one whose value extends over a fairly lengthy period of time. Depreciable assets are specifically excluded from current assets. Accounting Research Bulletin No. 43, ch. 3, § A, ¶ 6, reprinted in Financial Accounting Standards: Original Pronouncements as of June 1, 1981, at 13 [hereinafter cited as ARB No. 43]. The books produced for sale are current assets, because publishers expect to realize their value in cash within a relatively short period of time. See S. Novak, Accounting Desk Book 58-60 (5th ed. 1977). Although publishers acquire manuscripts and copyrights, they are not barred by § 1221(3) from treating those properties as capital assets. Publishers who buy the rights to original manuscripts and those who contract out for books are obviously not within the “personal efforts” language of § 1221(3)(A), nor is their basis in the property determined by reference to the author’s. See P. Gitlin & W. Woodward, Tax Aspects of Patents, Copyrights and Trademarks 31 (1960); J. Merten, The Law of Federal Income Taxation § 1221:5 (J. Doheny ed. 1983). Even works produced in-house are not excluded from capital gains treatment by § 1221(3), at least where the copyright is held by a corporation. Rev. Rul. 55-706, 1955-2 C.B. 300, superseded on other grounds, Rev. Rul. 62-141, 1962-2 C.B. 182.

170. Failure to make the suggested distinction would lead to treatment of all costs directly traceable to production of the manuscript and book as manufacturing cost, which would be considered cost of inventory. This result would be incorrect for books which went into more than one printing, since the costs of developing the asset would be spread only over the life of the first printing, rather than over the life of the asset.

171. These are the costs of the editorial department and part of the costs of the production department. See note 167 supra. Plant costs include nonrecurring production costs — such as typesetting, design costs, and plates — and artwork supplied by the publisher. See H. Bohne, supra note 166, at 6-7; J. Dessauer, supra note 145, at 170. For the proper treatment of plant costs, see notes 191-94 infra and accompanying text.

172. Both tax practice and accepted accounting principles require that development costs be considered part of the cost of a non-current asset. See Mt. Morris Drive-In Theatre Co. v. Commissioner, 25 T.C. 272 (1955), aff’d, 238 F.2d 85 (6th Cir. 1956) (holding that where the need for a drainage system was obvious at the time original construction of a drive-in theater began, the cost of the drainage system was part of the cost of the theater and had to be capitalized); M. Chirelstein, supra note 12, ¶ 6.02, at 107-08; cf. Accounting Principles Board Opinion No. 17 — Acquisition of Intangible Assets ¶ 24, reprinted in Financial Accounting Standards: Original Pronouncements as of June 1, 1981, at 270 (costs of developing intangible assets which are not easily identifiable [such as goodwill] should be de-
that some other method of accounting will clearly reflect income.\textsuperscript{173}

Acquisition costs include advances, royalties, and flat fees paid to authors not on the publisher's payroll.\textsuperscript{174} They represent the purchase price paid by the publisher to obtain publication rights to

ducted when incurred). \textit{See generally} S. Novak, \textit{supra} note 169, at 70-72 (requiring capitalization of alterations needed to make building available for purpose for which acquired).

\textsuperscript{173} \textit{See} notes 49-59 \textit{supra} and accompanying text. For purposes of valuing a self-constructed asset, accountants generally divide costs into three types: direct materials cost, direct labor cost, and factory overhead. The sum of the direct costs is the prime cost; addition of indirect overhead costs yields the full or absorption cost. \textit{See} H. Finney & H. Miller, \textit{supra} note 13, at 497.

The three basic methods of valuing self-constructed assets take these costs into account differently. \textit{See} 43 U. CIN. L. REV. 948, 953 n.38 (1974). The prime cost method requires capitalization only of direct costs. This method has been specifically rejected for inventory valuation by both the Tax Court and the accounting profession because of its failure to clearly reflect income. \textit{See} Coors v. Commissioner, 60 T.C. 368, 394 (1973), \textit{affd. sub nom.} Adolph Coors Co. v. Commissioner, 519 F.2d 1280 (10th Cir. 1975), \textit{cert. denied}, 423 U.S. 1087 (1976); Photo-Sonics v. Commissioner, 42 T.C. 926 (1964), \textit{affd.}, 357 F.2d 656 (9th Cir. 1966); ARB No. 43, ch. 4, \textsection 5, \textit{supra} note 169, at 17-18; 1 L. Seidler & D. Carmichael, \textit{Accountants' Handbook} 18-9 (6th ed. 1981). For the same reason, it should be unacceptable for asset-valuing purposes.

The full absorption costing method requires capitalization of all direct and overhead costs attributable to acquisition of a non-current asset. This method is accepted for both accounting and tax purposes. \textit{See} Coors, 60 T.C. at 394; Oberman Mfg. v. Commissioner, 47 T.C. 471 (1967); ARB No. 43, ch. 4, \textsection 5, \textit{supra} note 169, at 16.

The direct costing method provides a middle ground between prime and full absorption costing by dividing indirect overhead costs into fixed and variable components. Fixed costs are those which do not vary with the production run; variable costs are those which can be expected to increase as volume of production increases. \textit{See} H. Finney & H. Miller, \textit{supra} note 13, at 505-07. Under a direct costing system, direct costs and variable indirect overhead costs are capitalized, or charged to the product. Fixed indirect overhead costs are charged as period costs and immediately deducted. \textit{See} 1 L. Seidler & D. Carmichael, \textit{supra}, at 18-37; \textit{2d id.}, at 33-54 to -58. The acceptability of direct costing is debatable. Although many accountants favor direct costing, the American Institute of Certified Public Accountants seems to disapprove of the method. \textit{See} 2 id. at 33-58 to -59. In Fort Howard Paper Co., 49 T.C. 275 (1967), the Tax Court approved the taxpayer's direct costing system, but apparently only because of the unique facts of the case — no fixed overhead costs were incurred, so the direct costs method produced the same results as the full absorption method. \textit{See} Coors, 60 T.C. at 396-97 (holding \textit{Fort Howard} to its facts). Seidler and Carmichael conclude that direct costing is generally unacceptable to both the AICPA and the IRS. 2 L. Seidler & D. Carmichael, \textit{supra}, at 33-58.

\textsuperscript{174} Standard author's royalties for fiction have been estimated at 10% on the first 5000 copies, 12.5% on the next 2500 copies, 15% on all copies over 7500. The rate is generally computed on the basis of the catalogue retail price, rather than the publisher's selling price, which is often much lower. \textit{See} 1 A. Lindey, \textit{Entertainment, Publishing and the Arts} 177 (2nd ed. 1983).

When a publisher creates a manuscript entirely in-house, there are no acquisition costs as such, since no outsider is involved in the creative process. Instead, the publisher pays his own employees to research and write the text. This situation seems to be directly covered by \textit{Idaho Power}. \textit{See} 418 U.S. 1, 13 (1974) ("Construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset."); \textit{cf.} Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 214 (7th Cir. 1982). Since in-house preparation is most frequently employed for reference works, the completion of which may require years, capitalization of all these costs may impose a severe hardship on such publishers. \textit{See} L. Cosier, \textit{supra} note 166, at 33-34 (statement of Charles Scribner, Jr., describing 10- and 15-year projects undertaken by his publishing house). Such hardship, however, can only be alleviated by Congress, should it choose on policy grounds to create an exception to the general capitalization principles.
the manuscript, and as such must be capitalized.175 So long as advances are not deducted until earned,176 deduction of royalties in the year earned represents a perfect matching of cost with income produced, since the percentage of total cost deducted in any one year is exactly proportional to the income produced in that year.177 When a flat fee is paid,178 the cost would have to be amortized over the book's useful life, rather than deducted in the year of payment.

The editorial selection process involves the development of ideas, solicitation of books, and the reading of unsolicited manuscripts.179 The costs of this process are seemingly inallocable, since much of the editor's time will be devoted to projects that are ultimately rejected.180 Thus, these costs are generally charged to editorial overhead,181 which is treated by most publishers as a business expense and immediately deducted.182 Since a portion of this overhead is undoubtedly related to the development of the manuscripts that are published, proper treatment may come down to the feasibility of allocating a portion of the editorial overhead to the books actually chosen for publication.183

---

175. See generally S. Novak, supra note 169, at 70-72 (requiring capitalization of acquisition costs of non-current assets).

176. Advances generally take the form of guarantees — that is, the publisher cannot recover any portion not covered by royalties. See J. Dessauer, supra note 145, at 33. Most publishers maintain a reserve to cover unearned advances, deducting additions to this reserve as though they were earned royalties. See id. at 172, 177. If no such reserve were maintained, and royalties were deducted only when earned, a loss deduction would have to be taken when the publisher determined that additional sales were no longer likely.

177. A simple example will illustrate. Assume 5000 copies of a certain book are printed, with average income to the publisher of $10 per copy, a catalogue price of $20 and author's royalties of 10%. If 500 copies are sold in Year 1, 2000 in Year 2, 1000 in Year 3, and 750 in Year 4, the relationship between royalties and income would look like this:

<table>
<thead>
<tr>
<th>Year</th>
<th>Copies</th>
<th>Publisher's income</th>
<th>% Total income</th>
<th>Author's royalties</th>
<th>% of royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yr. 1</td>
<td>500</td>
<td>$ 5,000</td>
<td>11.8%</td>
<td>$1,000</td>
<td>11.8%</td>
</tr>
<tr>
<td>Yr. 2</td>
<td>2000</td>
<td>$20,000</td>
<td>47.0%</td>
<td>$4,000</td>
<td>47.0%</td>
</tr>
<tr>
<td>Yr. 3</td>
<td>1000</td>
<td>$10,000</td>
<td>23.5%</td>
<td>$2,000</td>
<td>23.5%</td>
</tr>
<tr>
<td>Yr. 4</td>
<td>750</td>
<td>$ 7,500</td>
<td>17.6%</td>
<td>$1,500</td>
<td>17.6%</td>
</tr>
<tr>
<td>Total</td>
<td>4250</td>
<td>$42,500</td>
<td></td>
<td>$8,500</td>
<td></td>
</tr>
</tbody>
</table>

Of course, this example ignores fluctuations in the publisher's selling price and does not provide for an accelerating royalty rate. Note, however, that this method of deduction functions properly without any need to estimate useful life.

178. See, e.g., Encyclopaedia Britannica, 685 F.2d at 214. Flat fees are generally paid only for reference works, textbooks and mass-market paperbacks on timely subjects. The useful lives of the two former types are generally long and calculable with some degree of accuracy. The useful life of a topical mass-market paperback will generally be so short that in most cases, all expenditures will be deductible in the year incurred.

179. See note 167 supra.

180. See H. Bohne, supra note 166, at 8.

181. See id. at 8.

182. J. Dessauer, supra note 166, at 145, 171-73.

183. The cases and the commentators generally recognize that overhead expense traceable to construction activity must be capitalized as a cost of the asset constructed. See Acer Realty
Editorial preparation costs are those associated with the process of bringing the text into final form. These activities include traditional editing, conferences with authors, and proofreading. The cost of editorial preparation is treated differently by different publishers. The Association of American Publishers recommends that preparation costs be treated as business expenses. However, since preparation costs are more easily identified with particular books than are selection costs, some publishers treat them as a cost of inventory, while others amortize them over the useful life of a series of books. Allocation of these costs to specific books, or at least to a line of books, does not seem too onerous a task.

---

184. See note 167 supra.

185. J. DESSAUER, supra note 145, at 172-73.

186. See J. DESSAUER, supra note 145, at 172-73 (discussing AAP guidelines).

187. J. DESSAUER, supra note 145, at 171. Those publishers who inventory editorial preparation costs are, in essence, ignoring the creation-manufacture distinction. See note 170 supra and accompanying text.

188. As the IRS has pointed out, "although each editor works on many manuscripts, he can work on only one manuscript at a time." Letter Ruling 760211060A (Feb. 11, 1976). Since some publishers manage to allocate editorial expenses (see text at note 187 supra) and at least one commentator recommends allocation as a method of budget control, the burden cannot be too unbearable. See H. BOHNE, supra note 166, at 8.
a problem, capitalization is required, since these are expenses to improve and put into service an asset having a useful life beyond the taxable year.189

So-called "plant costs" include nonrecurring production costs — such as typesetting, design costs and plates190 — and artwork supplied by the publisher.191 These costs are the final expenses of getting the manuscript ready for printing. Some trade publishers write off plant costs at the time of publication, as part of the costs of sales, on the ground that the short useful life of trade books means that any attempt to stretch out deduction of plant costs would simply result in larger deductions in later months when inventories were written down.192 Other trade publishers and most elementary and high school textbook publishers,193 however, amortize their plant costs.194 Since plant costs are easily identified to individual books, allocation presents no problem.195 Thus, plant costs must also be capitalized, as costs of putting an asset into production, unless the publisher can demonstrate that the asset has a useful life of less than one year.

Finally, the publisher's running costs are the costs associated with the manufacturing function — the costs of paper, printing and binding.196 These costs are typically inventoried and deducted as a cost of sale.197 The inventorying of running costs achieves clear reflection of income by deducting only the running cost of books actu-
ally sold, rather than the entire investment in inventory. This practice has been approved by the IRS.

CONCLUSION

The only satisfactory method of distinguishing business expenses and capital expenditures is based on the "clear reflection of income" principles that justify the distinction in the first place. In dealing with the prepublication expenses of publishers and authors, however, neither the courts nor the IRS has made adequate use of these principles. Proper analysis of an author's prepublication expenses reveals that the author is receiving income from the sale of services rather than from the production of an asset, and thus should be allowed to deduct his expenses immediately. Those prepublication expenses of the publisher that are associated with the creative function, however, must be capitalized unless the publisher can demonstrate either that his books have a short useful life or that some other accounting practice clearly reflects income. Although this analysis requires a separate determination of proper accounting methods for each publisher, it is the only theoretically defensible solution in an industry marked by the diversity of its members.

198. Inventory not sold immediately becomes part of the publisher's backlist and is eventually remaindered or pulped. Until recently, publishers typically wrote down excess inventory, carrying the books at reduced prices for tax purposes. The Supreme Court disapproved of this practice in the tool industry in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), a decision that the IRS specifically applied to publishers. See, e.g., Rev. Rul. 80-60, 1980-1 C.B. 97; Rev. Proc. 80-5, 1980-1 C.B. 284. These rulings have forced some publishers to reduce their backlists, putting many books out of print. See L. Coser, supra note 166, at 370-71; cf. Brown & Roberts, Who's Burning the Books: The Thor Power Ruling Under Attack, 118 TAX NOTES 859, 862 (1980) (suggesting that post-Thor procedures might make the publishing industry more efficient). Although a number of bills designed to mitigate the impact of Thor Power were introduced in the Senate, none was ever reported out of committee. See Procedural Difficulties Encountered by Smaller Business in Dealing with the IRS: Hearings on S. 2805 Before the Subcomm. on Taxation, Financing, and Investment of the Senate Comm. on Small Business, 96th Cong., 2d Sess. (1980) (bill to delay Rev. Rul. 80-60, 1980-1 C.B. 97); Miscellaneous Tax Bills IX: Hearings on S. 1276 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance, 97th Cong., 1st Sess. 21 (1981) (bill to permit small businesses to write down a percentage of excess inventory). When publishers decide to eliminate inventory, the books are either remaindered or pulped. Hardcover books which fail to sell are generally remaindered and sold at a fraction of their original price. See A. Blond, supra note 166, at 71-72; J. Dessauer, supra note 145, at 146. Although exact figures on remainders are uncertain, between 35% and 55% of the books ordered by bookstore chains are eventually returned to publishers. L. Coser, supra note 166, at 7. Approximately 50% of all mass-market paperbacks are returned to manufacturers and destroyed. Id. at 7; see A. Blond, supra note 166, at 72.