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RECENT DEVELOPMENTS

Federal Income Taxation—DEDUCTIBILITY OF START-UP EXPENDITURES UNDER SECTION 162—THE “CLEAR-REFLECTION-OF-INCOME” TEST

Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir. 1974), AND *First Security Bank of Idaho v. Commissioner*, 63 T.C. 644, CCH 1975 TAX CT. REP. DEC. NO. 33,081 (1975).

Section 162(a) of the Internal Revenue Code [“Code”]¹ allows a deduction for an (1) ordinary and (2) necessary (3) expense (4) incurred in the taxable year (5) in carrying on a trade or business.² Voluminous litigation under this provision has raised many important questions,³ the most difficult being the distinction between a deductible business expense and a capital expenditure for which no current deduction is allowed.⁴ Previous judicial opinions examining this important issue consist of “little more than a description of the expenditure . . . and a conclusion that it is, or is not, capital,”⁵ and have left the law in “a state of hopeless confusion.”⁶ The cause of such superficial treatment is the use of analytic tools that are not

¹ INT. REV. CODE OF 1954 [hereinafter cited as IRC].

² *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 352 (1971).

³ See generally J. CHOMMIE, FEDERAL INCOME TAXATION §§ 44-55 (2d ed. 1973) [hereinafter cited as CHOMMIE].

⁴ IRC § 263. That section provides that no deduction shall be allowed for amounts “paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”

IRC §§ 162, 263 are not totally inclusive. *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 358 (1971); *Iowa Southern Utilities Co. v. Commissioner*, 333 F.2d 382, 385 (8th Cir.), cert. denied, 379 U.S. 946 (1964). Analytically, an item may be characterized as a capital expenditure without any reference to § 263. See, e.g., *George L. Schultz*, 50 T.C. 688, 698 (1968), *aff'd per curiam*, 420 F.2d 490 (3d Cir. 1970) (costs not described in § 263 may still be subject to capitalization on the ground that they were preoperating or acquisition costs). See also CHOMMIE § 50, at 104. One commentator finds that § 263 is redundant in light of § 162 and that its only apparent function “in the statutory scheme is to provide a heading under which the tax services can list the capital expenditure cases.” *Gunn, The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C. IND. & COM. L. REV. 443, 448 (1974).

⁵ *Gunn*, *supra* note 4.

The Board of Tax Appeals early observed that in capital expenditure cases “no court has ever yet attempted to make a definition that can apply to any case except the one under review.” *American Seating Co.*, 4 B.T.A. 649, 658 (1926), *acquiesced in part*, VII-I CUM. BULL. 2 (1928).

⁶ *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973) (referring to intangible assets).

consistent with the ultimate purpose of the Code—the determination and taxation of net income.⁷

Two recent decisions, *Colorado Springs National Bank v. United States*,⁸ and *First Security Bank of Idaho v. Commissioner*,⁹ illustrate the quandary in which the law now finds itself. The taxpayer banks in both instances contended that certain expenses incurred in starting a credit card operation were deductible as business expenses pursuant to section 162(a). The government argued that a credit card operation was a new line of business for the banks. Preoperating costs of setting up the credit card system were not incurred in “carrying on a trade or business,” and, therefore, did not qualify as section 162 deductions. It also contended that since the outlays would enhance future years’ income, they were consequently not ordinary but rather capital expenditures.

Both courts hesitated to embrace the government’s traditionally phrased and narrowly focused arguments which ignored the purpose of the capital-noncapital classification—the accurate reflection of the taxpayer’s net income in a given year. While holding the disputed expenditures to be deductible, neither court suggested a satisfactory alternative analysis. One possible approach would be to rely on generally accepted accounting principles to determine whether the allowance or exclusion of a specific expense would better reflect the taxpayer’s net income in a given year.¹⁰

⁷ Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed As a Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1146-47 (1943). “The fundamental fact is that Congress has given every indication that what it intends to tax is net income; and a construction which leads in substance to a tax on gross income is just as inconsistent with the statute as one which allows a taxpayer to receive income free from tax.” *Id. Accord*, REPORT OF THE PRESIDENT’S TASK FORCE ON BUSINESS TAXATION 60 (1970).

⁸ 505 F.2d 1185 (10th Cir. 1974).

⁹ 63 T.C. 644, CCH 1975 TAX CT. REP. Dec. No. 33,081 (1975).

¹⁰ This more flexible rule is by no means a novel suggestion. It has been alluded to by court (Cincinnati, N.O. & T.P. Ry. v. United States, 424 F.2d 563 (Ct. Cl. 1970)), commentator (Gunn, *supra* note 4, at 452; Nolan, *The Merit in Conformity of Tax to Financial Accounting*, 50 TAXES 761 (1972)), and the President’s Task Force on Business Taxation:

The objective of generally accepted accounting principles and tax accrual concepts is basically the same—the determination of the net income of the business on an annual basis. Both business taxpayers and government auditors are generally familiar with accounting principles, and compliance would be facilitated by conforming the determination of taxable income more closely with such principles. Business taxpayers would have greater confidence in the fairness and integrity of the tax if such differences were minimized.

REPORT OF THE PRESIDENT’S TASK FORCE ON BUSINESS TAXATION 60 (1970).

The Treasury has also recognized the need for greater conformity and has made some effort to amend the Regulations to that end. For example, in 1971 the Regulations were amended to permit accrual basis taxpayers to treat advance payments received on the sale of goods as income at the time such amounts are treated as earned for financial accounting

I

CONVENTIONAL SECTION 162 DOCTRINE

Under section 162(a), a taxpayer engaged in carrying on a trade or business may deduct all ordinary and necessary expenses paid or incurred in a given taxable year.¹¹ In determining whether "start-up" (preoperating) costs are deductible business expenses or non-deductible capital expenditures, two of the five criteria¹² embodied in section 162(a) are particularly important. The first is that the expense be "ordinary";¹³ the second, the requirement that the expense be incurred while "carrying on a trade or business."¹⁴ The distinction is of great importance to the taxpayer; if an item is found to be a capital asset rather than a currently deductible expense, its cost may, at best, be recovered only through amortization over the life of the asset.¹⁵ Moreover, if the taxpayer cannot demonstrate that the capital asset has a determinable useful life, the taxpayer is unable to amortize its costs at all,¹⁶ and the only tax benefit gained results from an increased cost basis¹⁷ in the asset.¹⁸

purposes. Treas. Reg. § 1.451-5 (1971). In fact, the language of § 446(a) of the Code, which requires that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," suggests this very approach. Section 446(b) permits the taxpayer's income to be recomputed when it is found that the taxpayer's method "does not clearly reflect income." The broad perspective suggested by § 446 would be a welcome addition to the typically narrow tests created by the courts in § 162 litigation. Section 446(a)-(b) is set out in note 105 *infra*.

¹¹ Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 352 (1971). See notes 2-3 *supra*.

¹² See text accompanying note 2 *supra*. In Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1191 (10th Cir. 1974), the government also made the argument that certain expenses were not "necessary." However, in light of the broad interpretation the Supreme Court has given "necessary" (Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (all expenses that are "appropriate and helpful" to the taxpayer's business qualify as necessary)), it is unlikely that a start-up expense would be found nondeductible on that basis.

¹³ See notes 19-30 and accompanying text *infra*.

¹⁴ See notes 31-42 and accompanying text *infra*.

¹⁵ IRC §§ 167, 611-13A. The taxpayer will eventually, of course, be able to recover his entire expenditure, less a salvage value, if any, through depreciation or depletion allowances. Nevertheless, basic time value of money principles make it advantageous to the taxpayer to be able to deduct the total expense in the current year, thereby reducing his current tax bill and increasing his current after-tax income.

¹⁶ Treas. Reg. § 1.167(a)-3 (1960) permits depreciation of intangible assets only when the taxpayer is able to estimate the useful life of the asset with "reasonable accuracy." See note 79 *infra*.

¹⁷ The tax benefit may be realized in two ways. If the asset is sold, the increased basis when subtracted from the sales price (amount realized) yields a smaller capital gain. IRC §§ 1001-02, 1011-12, 1016. A tax benefit may also accrue under the loss provisions of the Code. *Id.* § 165.

¹⁸ If the asset is inseparable from the business, as is goodwill, then no tax benefit can be

A. *Capital or Ordinary*

To categorize an expense as "ordinary" for the purposes of section 162(a), generally, it must be shown that the expense was incurred and associated with the production of income in a given taxable year.¹⁹ An expense that, for example, benefits income in two years must be apportioned between them. Part is deductible in the first tax year; the remainder, the deferred expense, is treated as an asset on the balance sheet in the first year and is deducted in the second.²⁰

The traditional approach to the question of whether an item is capital or ordinary has been to focus on discrete aspects of the transaction. The test most often employed has been whether the expenditure would create some "ensuing benefit" in subsequent years.²¹ Simply stated, an expenditure should be capitalized

realized until all or part of the business is sold or merged. Treas. Reg. § 1.167(a)-3 (1966). See Rev. Rul. 70-45, 1970-1 CUM. BULL. 17. This rule ignores one of the most basic principles of modern financial accounting—the assumption of continuity. Thus, many legitimate expenditures, which sound accounting practice dictates should be deducted from gross income, are disallowed as deductions by the Code. See notes 88-91 and accompanying text *infra*.

¹⁹ Treas. Reg. § 1.461-1(a)(1) (1960) (cash basis taxpayers) (1957); *id.* § 1.461-1(a)(2) (accrual basis taxpayers). A possible exception to this general rule is found where expenditures made to maintain or manage a building devoted to rental purposes are currently deductible despite the fact that the property generates no current revenue. *Id.* § 1.212-1(b) (1960). The regulations explain this apparent conflict by focusing on a broad definition of income in § 212 rather than by creating an exception to the annual accounting principle. *Id.*

²⁰ This method of deferring expenses mirrors the basic principle of accrual accounting requiring that costs be matched with the revenues they produce in a given accounting period. Hence, contrary to the lay notion that an asset is a form of property rather than an expense, as a matter of accounting theory, an asset is nothing more than a capitalized cost. DeCapriles, *Modern Financial Accounting*, 37 N.Y.U.L. REV. 1001, 1020-21 (1962). For example, an automobile with a useful life of five years which costs \$5,000 will be treated on the income statement as an expense of \$1,000 per year for the next five years. Until expensed, the balance of the purchase price will appear on the asset side of the balance sheet. This account does not represent the physical property but rather identifies a cost already incurred that is associated with the production of revenue in future accounting periods.

²¹ The most important criterion under this formulation is whether the current outlay contributes to the production of income in future periods. Expenditures for plant and equipment, as well as intangible assets, have traditionally been categorized as capital and therefore nondeductible on this basis. *Houston Natural Gas Corp. v. Commissioner*, 90 F.2d 814 (4th Cir.), *cert. denied*, 302 U.S. 722 (1937) (solicitation costs and the costs of hook-ups to gas mains held nondeductible capital expenditures because the establishment of goodwill and the elimination of competition represented something of permanent value). Other factors are, however, considered by the courts: (1) Are the expenses recurring? See, e.g., *Cincinnati, N.O. & T.P. Ry. v. United States*, 424 F.2d 563 (Ct. Cl. 1970). But see *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965) (deduction of one-time construction costs of substitute facilities for landowner to replace those demolished by expanding open-pit mine). (2) Is there a general plan of reconditioning? See Bayles & Rich, *Repair or Capital Expense: The Tenth Circuit's General Plan of Betterment Rule*, 1974 UTAH L. REV. 272. For a general discussion of the relative impact of these various factors, see Shugerman, *Basic Criteria for Distinguishing*

if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year.²²

Dissatisfaction with this criterion among the lower courts²³ led the Supreme Court to suggest a new formulation in *Commissioner v. Lincoln Savings & Loan Association*.²⁴ In that case, the taxpayer savings and loan association was required to pay a yearly assessment, in addition to regular insurance premiums, to the federal agency that insured the accounts of its depositors. It sought to deduct this assessment as an ordinary business expense under section 162. In finding such payments to be nondeductible, the Court posited a new test:

What is important and controlling . . . is that the . . . payment serves to *create or enhance* for Lincoln what is essentially a *separate and distinct additional asset* and that, as an inevitable consequence, the payment is capital in nature²⁵

The Second Circuit interpreted *Lincoln Savings* to be a "radical shift in emphasis"²⁶ and proceeded to use the "separate-asset" test as an inflexible criterion for capital-noncapital categorizations. There was nothing in *Lincoln Savings*, however, that would indicate that the Court intended to do more than describe existing law.²⁷ Since 1960, the regulations have provided that outlays which "result in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year" are capital in nature.²⁸ Moreover, the converse of that rule—that expenditures that do not result in the creation of an asset are currently deductible even

Revenue Charges From Capital Expenditures in Income Tax Computations, 49 MICH. L. REV. 213 (1950). See also 1 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT & ESTATE TAXATION §§ 3.02, .08, .10 (1973).

²² *Hotel Kingkade v. Commissioner*, 180 F.2d 310, 312 (10th Cir. 1950).

²³ In attempting to limit the impact and application of the "ensuing-benefit" doctrine, the Tenth Circuit has stated that the traditional rule was intended to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year. *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968).

²⁴ 403 U.S. 345 (1971).

²⁵ *Id.* at 354 (emphasis added). The payments by Lincoln Savings were made to the Federal Savings and Loan Insurance Corp. The Court was careful to point out that Lincoln had acquired a distinct property interest as a result of those payments. That interest was in many respects analogous to a prepaid insurance account, which must be capitalized as a deferred expense even by taxpayers who do not use accrual accounting. *Commissioner v. Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1942).

²⁶ *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782 (2d Cir. 1973).

²⁷ *Gunn*, *supra* note 4, at 444.

²⁸ See note 19 *supra*.

though there is some ensuing benefit—had been judicially expressed prior to *Lincoln Savings*.²⁹ It thus was not the novelty of the rule but rather the eagerness of the Second Circuit to adopt a simplistic test for distinguishing capital and ordinary expenditures that led it to treat *Lincoln Savings* as some great revelation.

The real issue posed by *Lincoln Savings* and its progeny is not whether the “ensuing-benefit” test or the “separate-asset” test is proper; the crucial question is whether any single litmus paper standard satisfactorily can embody all the factors that should be considered in drawing the distinction between ordinary deductible expenses and capital outlays. Justice Cardozo long ago answered the question in the negative:

One struggles in vain for any verbal formula that will supply a ready touchstone. . . . Life in all its fullness must supply the answer to the riddle.³⁰

His comment, however, indicates only the breadth of the search. It leaves the articulation of a practical analytical tool to distinguish capital expenditures from deductible business expenses for future decision. Until some court takes the initiative in defining this new standard, the tax planner is left to wonder whether a particular outlay will be considered capital in nature by a court applying any one of the traditional tests.

B. *Operating versus Preoperating*

Section 162 also requires that an expense be incurred while “carrying on [a] trade or business” before a deduction will be allowed. The purpose of this requirement would appear to be to distinguish personal from business expenditures.³¹ Further, the distinction between capital expenditures and deductible expenses is drawn by the word “ordinary” in the statute.³² Nonetheless, courts have relied upon this language to develop a rule providing that expenditures made to start a business or to enable an established business to expand into a new field, must be capitalized.³³ Thus,

²⁹ David J. Primuth, 54 T.C. 374, 381-82 (1970) (concurring opinion, Tannenwald, J.) (concept of capitalization of expenditures limited to “cases of acquisition of tangible assets, or intangible assets, such as a license or goodwill or a going business, or preparation for engaging in a new field of endeavor”).

³⁰ *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

³¹ Strictly speaking, this criterion is unnecessary in light of IRC § 262 which denies deductions for personal expenses.

³² *Welch v. Helvering*, 290 U.S. 111, 114-16 (1933).

³³ This rule has been sharply criticized on the ground that mere corporate existence is the equivalent of doing business. See Erbacher, *Start-Up Costs: Are They Deductible by a Corpora-*

a distinction is made between operating and preoperating expenses—the former are deductible under section 162; the latter are deemed capital in nature.³⁴ The justification for the rule, predicated on the net-income premise of the Code,³⁵ and the annual nature of the tax assessment,³⁶ is that expenditures made to secure a stream of future income cannot be charged to current taxable income.³⁷ Although this rationale is correct, the same result is reached under the “ordinary” or the “incurred-in-the-taxable-year” requirements of section 162.

The leading cases interpreting the “carrying-on-business” rule involve corporations created to operate radio and television stations.³⁸ These decisions have held that a corporation is not carrying on a trade or business for the purposes of section 162 until its station is licensed and broadcasting.³⁹ The rationale of these cases presumably is that prelicense expenditures would produce income over a period of years at least equal to the term of the license and to allow a current deduction would distort taxpayers’ net income.⁴⁰ To the

tion for Federal Income Tax Purposes?, 48 TAXES 488 (1970). See also CHOMMIE § 50, at 111 (collecting cases on preinvestment expenditures).

³⁴ It is at once evident that this distinction is just another variation of the “ensuing-benefit” test, the presumption being that if an expenditure is preoperating it must have an ensuing benefit.

³⁵ Griswold, *supra* note 7, at 1146-47.

³⁶ IRC § 441 requires that a taxpayer compute his taxable income on an annual basis, which in most instances is the annual period used in keeping his books. See generally CHOMMIE § 80.

³⁷ See, e.g., *Weinstein v. United States*, 420 F.2d 700, 701 (Ct. Cl. 1970).

³⁸ *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated on other grounds*, 382 U.S. 68 (1965); *KWTX Broadcasting Co.*, 31 T.C. 952, *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959); *Radio Station WBIR, Inc.*, 31 T.C. 803 (1959); *Petersburg Television Corp.*, 20 CCH TAX CT. MEM. 271 (1961).

³⁹ In the leading case, *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated on other grounds*, 382 U.S. 68 (1965), the taxpayer deducted expenses incurred in training personnel for the operation of a television station before obtaining a license and commencing to broadcast. The Fourth Circuit disallowed the deduction because the expenses were incurred between the time of the decision to establish a business and actual commencement of broadcasting operations. The court held that

even though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he still has not “engaged in carrying on any trade or business” within the intentment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized.

Id. at 907. This test of commencement of the ultimate activity for which the enterprise was organized has been criticized by commentators as unrealistic. See *Erbacher*, *supra* note 33, at 498-500; Lee, *Preoperating Expenses and Section 174: Will Snow Fall?*, 27 TAX LAWYER 381, 394-96 (1974); *Deputy v. du Pont*, 308 U.S. 498, 499 (1940) (“‘carrying on any trade or business’ . . . involves holding one’s self out to others as engaged in the selling of goods or services”).

⁴⁰ Because of the difficulty in proving that an intangible asset is created by preoperating

extent that the "carrying-on-a-trade-or-business" criterion of these cases clearly reflected this principle, the proper result was reached.⁴¹ There remains the danger, however, that a court will focus on the label "carrying on business," as courts have done in resolving the ordinary-capital issue, without examining the underlying principles.⁴²

II

IN PURSUIT OF A NEW STANDARD

*Colorado Springs National Bank v. United States*⁴³ and *First Security Bank of Idaho v. Commissioner*⁴⁴ illustrate many of the dangers of applying the traditional tests discussed above. Although the decisions neither renounce these tests nor formulate new ones, they

expenditures and that such asset has a determinable useful life, there is the danger that no deduction would ever be allowed. Congress, recognizing this possible inequity, enacted IRC § 248 as partial relief. It permits a corporation to treat its organizational expenditures as deferred expenses that may be amortized over a period of five years. Previously, those expenses could only be deducted over the life of the corporation; because most corporate charters do not provide for a definite end to corporate existence, no "useful life" of the expenditures was ascertainable and no deduction was allowed.

The relief afforded by § 248, although salutary, is only partial, because it applies only to newly formed corporations and only to a limited range of incorporation expenses. See Treas. Reg. § 1.248-1(b) (1956). If a corporation plans to expand its business to a new field, it must form a subsidiary to take advantage of this section. A more satisfactory solution would be to extend the principle embodied in § 248 to business entities at all stages of existence by allowing start-up costs to be treated as deferred expenses that might be amortized over a five-year period.

Perhaps the most instructive aspect of § 248 is that Congress has, at least in this limited area, recognized that it is unreasonable to require the taxpayer to demonstrate that a deferred expense has an ascertainable useful life before any deduction is allowed. As a matter of administrative efficiency and accounting reality, it would be preferable to allow an inaccurate estimate, or provide one by statute, than to presume that the useful life is infinite. The tax section of the American Bar Association has recently proposed that such a rule be added to the Code. 29 TAX LAWYER 407 (1976). See note 88 *infra*.

⁴¹ A major difficulty is that many of these expenses cannot be deducted because they represent assets whose useful life cannot be accurately estimated. See notes 15-18 and accompanying text *supra*.

⁴² For example, suppose in opening the radio station, the corporate taxpayer hires someone to replace screens with storm windows. Because the station is not yet operating, the costs of having this work done are preoperating and, therefore, capital in nature. The expenditure, however, is a recurring one; twice each year, the taxpayer will have to hire someone to interchange the storm windows and the screens. The initial work done provides the taxpayer a benefit *only* in the year the cost was incurred. The presumption that requires its capitalization does not clearly reflect income.

⁴³ 505 F.2d 1185 (10th Cir. 1974). See generally Comment, *Colorado Springs National Bank v. United States—Deductibility of Start-Up Expenses for a Credit Card Program*, 1975 UTAH L. REV. 279.

⁴⁴ 63 T.C. 644, CCH 1975 TAX CT. REP. Dec. No. 33,081 (1975).

reflect an increased willingness to examine tax events as part of the entire economic life of the taxpayer and to reach decisions in accordance with a characterization that more accurately reflects net income.

The controversy in *Colorado Springs National Bank* arose when the taxpayer bank joined the Mountain States Bankcard Association, thereby enabling it to participate in the Master Charge credit card system. In addition to paying a \$10,000 one-time membership fee, the bank incurred other costs including computer time, advertising, solicitation, and employee training expenses.⁴⁵ The bank attempted to deduct these outlays as ordinary and necessary business expenses under section 162. The Commissioner, however, disagreed, and disallowed the attempted deductions on two grounds. First, they were incurred to enable the bank to enter a new line of business rather than to carry on a trade or business as required by section 162. Second, since the expenditures created an asset that would benefit the bank's credit card operation in ensuing years, they were not ordinary within the meaning of that section.

The district court found that, since the \$10,000 membership fee represented the right of the bank to handle Master Charge accounts, it enhanced the bank's value as a going concern by creating an intangible asset which was not currently deductible.⁴⁶ However, despite the court's finding that the credit card field represented a new line of business,⁴⁷ it concluded that the rest of the start-up costs were deductible because of their recurrent nature.⁴⁸

⁴⁵ There were six different types of costs incurred: (1) costs incurred in key punching and entering customer account data into the MSBA computer system; (2) computer assessment and service fees required by the MSBA for opening new accounts for bank customers; (3) advertising and promotional costs necessary to familiarize customers with the Master Charge Program; (4) charges for the services of credit investigating agencies; (5) travel, education, and entertainment expenses of employees attending MSBA training and indoctrination meetings; (6) wages for temporary clerical help. 505 F.2d at 1187.

⁴⁶ 73-2 U.S. Tax Cas. ¶ 9795, at 82, 579 (D. Colo. 1973) (oral opinion). The bank did not appeal this holding.

In *First Security Bank of Idaho v. Commissioner*, 63 T.C. 644, CCH 1975 TAX CT. REP. Dec. No. 33,081 (1975), the taxpayer bank found itself in a situation nearly identical to that of the Colorado Springs National Bank. However, by allocating a \$10,000 one-time fee to "support and instructional services alone," rather than describing it as a license or membership fee, the Idaho bank was allowed to deduct all fees and expenditures involved with the start of its BankAmericard operation. *Id.* at 651, CCH 1975 TAX CT. REP. at 2347.

⁴⁷ I find and I hold that this particular field, that is the credit card field, is a new type of business that this bank had not engaged in prior to its being licensed by Master Charge card association. It is not just an extension of the lending field, but it is a new concept that was developed and is being used.

Colorado Springs Nat'l Bank v. United States, 73-2 U.S. Tax Cas. ¶ 9795, at 82,579 (D. Colo. 1973).

⁴⁸ The largest single expense had been incurred in obtaining the credit bureau reports.

The Tenth Circuit stated that it was not bound by the lower court's conclusion that "the credit card field . . . is a new type of business that this bank had not engaged in prior to its being licensed."⁴⁹ It justified this position by explaining that the absence of any credibility issues placed the reviewing court in "as good position as was the trial court to draw those [ultimate] conclusions"⁵⁰ from the disputed facts. The court's motivation for rejecting the district court finding was undoubtedly the desire to permit the taxpayer to deduct its expenses without directly challenging the well-entrenched rule prohibiting the deduction of preoperating costs.⁵¹

The government framed its arguments in traditional terms. It contended that the credit card operation represented an endeavor apart from previous bank business; therefore, the traditional rule—that expenses made in preparation for a new business are not deductible—controlled.⁵² This argument was supported by cases that denied deductions to going concerns for expenses incurred in entering a new field,⁵³ opening a new branch,⁵⁴ or conducting a survey of business possibilities.⁵⁵

The Tenth Circuit, rejecting this line of reasoning, held that the bank had not engaged in a new line of business, but had merely employed a new method to conduct its old business. The bank had for years made consumer and commercial loans. The court found

The lower court thought that it was unusual for the government to contend that these expenditures should be capitalized since the reports were a normal incident to the granting of credit. The bank had in fact obtained such reports whenever loans were made in the past. This caveat is in direct contravention to the court's holding that the credit card field was a new field of business. *See* note 47 *supra*. Because the appellate court made independent findings of fact, this apparent inconsistency was rendered moot.

The contradiction, however, can be explained in terms of traditional tax theory. The membership fee was paid prior to the commencement of a new line of business; as a broadcasting station begins operations when it begins broadcasting, the bank began its new venture only after paying the fee. *See* text accompanying notes 31-42 *supra*. The subsequent start-up costs, therefore, were incurred while the bank was carrying on its new business. Although such an interpretation does not comport with Treas. Reg. § 1.248-1(a) (1956), which attempts to distinguish between "being in existence" and "beginning business," it is consistent with at least one theory of accounting and is the approach advocated by some commentators. *See* Erbacher, *supra* note 33, at 493. *See also* Gunn, *supra* note 4.

⁴⁹ 73-2 U.S. Tax Cas. at 82,579.

⁵⁰ 505 F.2d at 1189.

⁵¹ *See* text accompanying notes 31-42 *supra*.

⁵² The government's objective in pursuing this "preoperating"-expense theory was to fit the case within the rule of *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated on other grounds*, 382 U.S. 68 (1965). *See* note 39 *supra*.

⁵³ This concept is best illustrated in the broadcasting license context. *See* cases cited in note 38 *supra*.

⁵⁴ *Mid-State Products Co.*, 21 T.C. 696 (1954).

⁵⁵ *Davee v. United States*, 444 F.2d 557 (Ct. Cl. 1971).

that the bank's consumer loan function could now be performed by the "handy, plastic card."⁵⁶ Furthermore, the credit card system provided a simplified method for making commercial loans to merchants. Instead of advancing credit to the merchant on accounts receivable, the bank could discount payment from the credit card transaction immediately and receive the discount instead of collecting interest on a loan. Thus, by focusing on the purpose of the bank's activities rather than the means of implementing them,⁵⁷ the court was able to sidestep the government's doctrinal arguments against deductibility. Nevertheless, by preserving the distinction between "new methods" and "new business,"⁵⁸ the court obscured the factors that most likely motivated its decision.

The government additionally urged the court to find that the expenditures created a "separate and distinct" asset⁵⁹ which would have "ensuing benefit"⁶⁰ and should therefore be classified as "capital" rather than "ordinary."⁶¹ The court rejected this contention by distinguishing those decisions that applied the "ensuing-benefit" and "separate-and-distinct-asset" tests on the ground that those cases involved the creation of some property interest. The finding that the Master Charge expenditures created no such right⁶² evi-

⁵⁶ 505 F.2d at 1190.

⁵⁷ The credit card system performs the same [loan] function more easily. . . . The only change is in the method. . . .

The credit card system enables a bank to carry on an old business in a new way. A new method is distinguishable from a new business.

Id.

⁵⁸ This uneasy distinction between "new method" and "new business" falls squarely in line with the Second Circuit's decision in *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973). In that case, the taxpayer, manufacturer of Lofts Candy, set up a franchise division to supplement the sagging retail sales of its own stores. The goal was to establish agency and franchise outlets at a series of local drug stores. The court found that Lofts had previously been in both the wholesale and retail business and that the franchise operation was nothing more than a new method to develop new sales territory by an already ongoing concern. It stated:

Every new idea and every change of method in making sales, even in promoting special sales or developing new sales territory, do not require that the expenses connected with the operation be non-deductible under § 162.

Id. at 782. Thus characterized as an ongoing concern, Lofts was not entering a new business; the expenses therefore could not be validly categorized as preoperating and were properly viewed as incurred while "carrying on a trade or business."

⁵⁹ See text accompanying notes 23-30 *supra*.

⁶⁰ See text accompanying notes 21-22 *supra*.

⁶¹ The government also made a third argument that the expenses were not "necessary." The court, citing *Welch v. Helvering*, 290 U.S. 111, 113 (1933), summarily rejected this contention by finding all the start-up costs in issue to be "appropriate and helpful." 505 F.2d at 1191.

⁶² "The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable." 505 F.2d at 1192. The test proposed seemed to be

denced the court's sympathy for the taxpayer but ignored the characterization of many varieties of intangibles, including those not salable, as distinct items of property for other tax purposes.⁶³

First Security Bank presented a nearly identical problem to the Tax Court.⁶⁴ Although the court held that *Colorado Springs National Bank* controlled,⁶⁵ it found, contrary to that case, that no portion of the fees charged to the taxpayer for participation in the BankAmericard system constituted a license fee.⁶⁶ This particular finding was supported by the taxpayer's allocation of the entire fee to various services provided by the licensor in conjunction with the granting of the license⁶⁷ and no part of it to the right to participate and use the licensor's trademark.⁶⁸

whether the expense was ordinary in light of the "kind of transaction out of which the obligation arose and its normalcy in the particular business." *Id.* at 1193, quoting *Deputy v. du Pont*, 308 U.S. 488, 496 (1940). The additional guide this standard contributes is not evident from the decision.

⁶³ One court, for example, found that sums paid by a local bottler to its franchisor to secure the elimination of an unprofitable middleman contract were capital in nature. *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 393 F.2d 494 (4th Cir.), cert. denied, 393 U.S. 962 (1968) (following *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), vacated on other grounds, 382 U.S. 68 (1965)). But see *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805, 807 (6th Cir. 1948) (cost of release from burdensome lease deductible in year incurred).

⁶⁴ The two petitioning banks in this case were owned by the same bank holding company. They could consequently join the association as a single unit. Each bank therefore paid its pro rata share of the costs incurred. 63 T.C. at 646 n.7, CCH 1975 TAX CT. REP. at 2344 n.7. For the purposes of this Note they may be regarded as a single entity.

⁶⁵ The Tax Court did not even pause to reconsider the validity of the government's arguments. After noting that the contentions of both parties were essentially identical to those made in *Colorado Springs Nat'l Bank*, the court simply stated that "[u]nder the precise facts presented here we follow [the *Colorado Springs Nat'l Bank*] holding with regard to both [banks]." *Id.* at 650, CCH 1975 TAX. CT. REP. at 2346.

The court also cited *Jack E. Golsen*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971), in support of its decision. That case held that the Tax Court will follow the decisions of the Court of Appeals for the same circuit in which the case arises. *Id.* at 756-57. The implication is, of course, that the Tax Court in *First Security Bank*, deciding a controversy arising in the Tenth Circuit, had no alternative but to follow the result of the Tenth Circuit in *Colorado Springs Nat'l Bank*. The court in *First Security Bank* did indicate, however, that apart from the mandate of the *Golsen* decision, it was in agreement with the holding of *Colorado Springs Nat'l Bank*. 63 T.C. at 650 n.19, CCH 1975 TAX. CT. REP. at 2346 n.19.

⁶⁶ See note 46 and accompanying text *supra*.

⁶⁷ *Id.*

⁶⁸ 63 T.C. at 651, CCH 1975 TAX. CT. REP. at 2347. The contract with BankAmericard provided and the court found that the \$10,000 part of the fee for support and services that the government contended was equivalent to a license fee would not have been required had the bank already possessed "the operational know-how of a nationwide consumer credit card system as well as computer programming adequate to maintain said system." *Id.* at 651, CCH 1975 TAX CT. REP. at 2347. Despite this rationale, it is difficult to accept the conclusion that no

The approach taken by the parties and the courts in *First Security Bank* and *Colorado Springs National Bank* indicates the traditional tendency to rely on labels to solve what are largely accounting problems. The government, emphasizing that the credit card operation was a new business⁶⁹ and that future benefits would flow from the bank's start-up costs,⁷⁰ concluded that they were expenditures that should be capitalized. The taxpayers, relying on *Lincoln Savings*, maintained that the future-benefit test was not controlling and that because the expenditures in question did not create a separate and distinct asset, they were deductible.⁷¹ Framing the issue in this manner obscures the real question. A more illuminating approach is to apply accounting concepts and attack the clear-reflection-of-income question directly.

license fee was embodied anywhere in the \$25,000 charge. See text accompanying notes 86-87 *infra*.

A typical contract right similar in substance to credit card association membership fees is the franchise. The Internal Revenue Service has ruled that where the franchise agreement provides for an undefined succession of automatic renewals, it has an indefinite useful life, and consequently, may not be amortized. Rev. Rul. 66-140, 1966-1 CUM. BULL. 45. Unless a franchise contract by its terms specifically limits the duration of the right, the taxpayer will be unable to meet the burden of demonstrating a definite and ascertainable useful life. See, e.g., *Toledo TV Cable Co.*, 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973). But see *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969) (summary judgment for government reversed where taxpayer offered statistical proof of average useful life of franchise).

A recent Tax Court decision, *Rodeway Inns of America v. Commissioner*, 63 T.C. 414, CCH 1974 TAX CT. REP. Dec. No. 32,994 (1974), *acquiesced in*, 1975-19 INT. REV. BULLETIN 6, reflects an increased judicial willingness to examine all economic factors that determine the useful life of a franchise right. In that case, the court first found that the payments made by a franchisor to cancel a franchise agreement were capital in nature when the franchisee surrendered its exclusive right to the franchise for the 26 years remaining in the agreement. The court then rejected the government's rigid doctrinal argument that the useful life of the capital asset thus required was 26 years, and independently determined a useful life of five years. But see *Eagle Pass & Piedras Negras Bridge Co.*, 23 B.T.A. 1338 (1931), where, on analogous facts, the court willingly followed the government's reasoning without regard to an independent assessment of the actual useful life of the repurchased franchise.

⁶⁹ [T]he crucial question with regard to the deductibility of these start-up expenses is whether taxpayer's Master Charge program was a new business, separate and apart from its existing lending or credit operations or whether it was merely an extension of that established business.

Brief for Appellant at 13, *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974).

⁷⁰ The start-up costs were characterized as "basically one-time costs that were instrumental in creating an asset—the Master Charge System as a going concern—that had a useful life and substantial potential economic benefit for many years to come." *Id.* at 19.

⁷¹ The taxpayer argued that *Lincoln Savings* had "completely abrogated the previously existing general rule" that looked to the "ensuing benefit" to determine whether an expenditure was deductible. Brief for Appellee at 19, *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974).

III

THE "CLEAR-REFLECTION-OF-INCOME" TEST

The goal of financial accounting is to match current expenses with current income and thus determine current net income.⁷² To the accountant there is no real distinction between a deferred expense and an asset.⁷³ Each represents a current expenditure, all or part of which will have an income-producing (or cost-reducing) impact in a future accounting period.⁷⁴ Depreciation and depletion⁷⁵ of tangible assets, amortization of intangible assets, and capitalization of prepaid expenses all serve the expenditure-revenue matching function. To the extent that these generally accepted accounting conventions accurately portray net income,⁷⁶ financial accounting principles should supply the criteria for tax deductibility.⁷⁷

The Code requires an initial determination of whether an expenditure is currently deductible or a capital asset.⁷⁸ The taxpayer may be entitled to amortize the asset if able to prove a definite and determinable useful life.⁷⁹ If he cannot do so, however, the regula-

⁷² Accounting, like federal income taxation, is based on discrete periods. It is concerned primarily with measuring and recording the economic activity of an organization for a given time interval. See generally G. WELSCH, C. ZLATKOVICH & J. WHITE, *INTERMEDIATE ACCOUNTING* 18-19 (1972).

⁷³ See note 20 *supra*.

⁷⁴ See notes 15-18 and accompanying text *supra*.

⁷⁵ Cost depletion of natural resources serves the same purpose as depreciation. It allows a mine owner, for example, to recover the cost of minerals without taxation. IRC § 611. See generally CHOMMIE § 68. Percentage depletion, however, allows a percentage of income as a deduction regardless of the amount invested in the asset. IRC § 613. Using this method, expenses in excess of actual costs may be recovered by the taxpayer. See generally CHOMMIE § 69.

⁷⁶ Net income is the dominant concept in accounting, and all conventions are necessarily directed toward accurately ascertaining net income. R. JAEDICKE & R. SPROUSE, *ACCOUNTING FLOWS: INCOME, FUNDS, AND CASH* 6 (1965).

⁷⁷ The extent to which financial and tax accounting should conform has sparked a lively debate. See REPORT OF THE PRESIDENT'S TASK FORCE ON BUSINESS TAXATION 60 (1970); Barrett & Holtz, *The Case Against One Set of Books for Financial and Tax Accounting*, 40 *FINANCIAL EXECUTIVE*, Dec. 1972, at 30; Nolan, *supra* note 10; Roby & Richter, *Conformity of Tax and Financial Accounting*, 139 *J. OF ACCOUNTANCY*, Jan. 1975, at 42.

⁷⁸ This point was stressed by the government in an attempt to frame the issue without regard to the economic consequences of its resolution: "Whether such capitalized items could . . . be amortized . . . or whether such costs are recoverable only by way of return of basis on sale, or by way of a loss deduction . . . is a question which is not presented in the instant case . . ." Reply Brief for Appellant at 4, *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974).

⁷⁹ The useful life of an intangible asset must be "known from experience or other factors to be of use in the business . . . for only a limited period, the length of which can be estimated

tions effectively presume that the asset has an indefinite useful life, and, therefore, no deduction is allowed. Typical of such an expenditure is the \$10,000 membership fee paid by the Colorado Springs National Bank to enable it to participate in the regional Master Charge credit card operation.⁸⁰ That expenditure was partially responsible for the current income from the Master Charge program. The remainder contributed to income earned in subsequent years. The supposedly indeterminable nature of the latter portion's useful life⁸¹ precludes a deduction for any part of that fee either as a current expense or as an amortizable capital expenditure.⁸² To the extent that the fee produces income currently, denial of the deduction artificially inflates the bank's income.⁸³ A current deduction for the entire amount would understate income in the year it is taken.⁸⁴ The court in *Colorado Springs National Bank* explicitly recognized this taxpayer dilemma and found that the taxpayer's position represented a more equitable approach:

The government suggests no way in which [the start-up expenditures] could be amortized. The government's theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation. If an expenditure, concededly of

with reasonable accuracy." Treas. Reg. § 1.167(a)-3 (1956), as amended, T.D. 6,452, 1960-1 CUM. BULL. 127. No allowance for depreciation is permitted where "in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life." *Id.* Thus, the burden of proving a specific useful life with reasonable accuracy is on the taxpayer. When the Commissioner finds that the taxpayer has not met this burden, the taxpayer is not entitled to any deduction. This formulation has been criticized as undesirable when "a deduction may . . . be preferable if it avoids distortion of income." Comment, *supra* note 43, at 290.

⁸⁰ See note 46 and accompanying text *supra*.

⁸¹ See text accompanying notes 16-18 *supra*.

⁸² Modern accounting practice recognizes this distortion and permits the taxpayer to make an estimate of the useful life of intangible assets. See notes 88-91 and accompanying text *infra*.

⁸³ The district court's allowance in *Colorado Springs Nat'l Bank* of a current deduction despite its specific ruling that the Master Charge operation for all expenses excepting the membership fee was a new line of business (and therefore presumably not deductible) can be explained only on these grounds. 73-2 U.S. Tax Cas. ¶ 9,795, at 82,580. The court added that the nondeductible \$10,000 membership fee should be amortized over a reasonable period despite unanimous authority to the contrary. *Id.*

⁸⁴ The court in *Colorado Springs Nat'l Bank*, in treating deductibility and amortization as a single issue rather than as two separate questions, as urged by the government, chose the more desirable alternative from an accounting standpoint. The principle of conservatism indicates that between two conflicting alternatives, the one that shows the least favorable result in the short term should be chosen. G. WELSCH, C. ZLATKOVICH & J. WHITE, *supra* note 72, at 22. Moreover, the continuity assumption recognizes the business entity as a going concern and presumes its indefinite existence. *Id.* at 8. This premise is completely contrary to the government's suggestion that these expenditures should not be recognized until the bank's sale or liquidation.

temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.⁸⁵

An "all-or-nothing" rule for deductibility not only distorts the taxpayer's net income but also encourages the misdescription of expenditures. The banks⁸⁶ in *Colorado Springs National Bank* and *First Security Bank* each had to pay \$25,000 to the credit card licensor for the right to participate and to receive support and training services. The Colorado bank was unable to deduct \$10,000 of this fee because it was denominated a license fee. First Security, however, was able to deduct the entire \$25,000 because it allocated the entire amount to specific services received from the national credit card operation. Apparently, the court was not troubled by the fact that no value was attributed to the right to participate in the program or use the BankAmericard trademark.⁸⁷ Hence, identical expenditures were taxed differently in the two cases *solely* because the second taxpayer used a self-serving label to describe the expenditure. Under this approach, deductibility depends on formal definitions which encourages taxpayer manipulation. Adoption of a substantive rule that followed generally accepted accounting practice would make deductibility turn on the substance of the transaction rather than the label attached.

Although the Code presumes that many intangible assets have an unlimited useful life, modern accounting practice is to the contrary.⁸⁸ The American Institute of Certified Public Accountants requires that businesses amortize all intangible assets "over the period estimated to be benefited."⁸⁹ The estimate must be reason-

⁸⁵ 505 F.2d at 1192. Even the government seemed grudgingly to admit the importance of accounting principles, and consequently attempted to justify its position in those terms: "[T]he cost of acquiring such intangibles having a useful life beyond one year has long been considered capital in nature . . . for the purpose of financial accounting . . ." Reply Brief for Appellant at 6. The government also argued that a current deduction would mismatch expenditures and revenues and understate income. Brief for Appellant at 20. It would appear, however, that the government is not willing to follow accounting principles in situations where their application decreases taxable income.

⁸⁶ See note 64 *supra*.

⁸⁷ The court did not include the right to use the "service marks" and the BankAmericard logo in the list of expensable services received. *First Security Bank of Idaho v. Commissioner*, 63 T.C. 644, CCH 1975 TAX CT. REP. Dec. No. 33,081, at 2,347 (1975).

⁸⁸ Compare Treas. Reg. § 1.167(a)-3 (1956) with *A.P.B. Opinion No. 17*, 2 A.P.B. ACCOUNTING PRINCIPLES 6661 (1973). The tax section of the American Bar Association has recently recommended that the Code be amended to allow amortization of the adjusted basis of intangible assets ratably over the class life of such assets as prescribed by regulation. This provision would apply to all intangibles that are currently not amortizable. The Commissioner would have discretion to prescribe class lives of from 60 to 480 months; the upper limit is the same as that now required by *A.P.B. Opinion No. 17*.

⁸⁹ *A.P.B. Opinion No. 17*, *supra* note 88, at 6662, ¶ 9.

able in light of certain specified factors,⁹⁰ but in no event may the period be longer than forty years.⁹¹ Thus, accounting practice has adopted a more logical presumption than has the Commissioner—the value of intangible assets is eventually exhausted.

The issue of the relevance of accounting principles to tax questions is not new.⁹² Generally, this inquiry is made only when a particular accounting method is required by a state or federal regulatory agency.⁹³ Since the goal of sound financial accounting is to portray accurately the economic result of current operations and the avowed purpose of the federal income tax is to determine net income as a basis for levying the tax,⁹⁴ there is every reason to resolve tax questions by reference to accounting practice.

The usefulness of sound accounting practice has long been recognized by the Supreme Court.⁹⁵ This policy was recently reaffirmed in *Commissioner v. Idaho Power Co.*⁹⁶ The specific issue in

⁹⁰ Among the factors that should be considered in making a reasonable estimate of an asset's useful life are:

- a. Legal, regulatory, or contractual provisions may limit the maximum useful life.
- b. Provisions for renewal or extension may alter a specified limit on useful life.
- c. Effects of obsolescence, demand, competition, and other economic factors may reduce a useful life.
- d. A useful life may parallel the service life expectancies of individuals or groups of employees.
- e. Expected actions of competitors and others may restrict present competitive advantages.
- f. An apparently unlimited useful life may in fact be indefinite and benefits cannot be reasonably projected.
- g. An intangible asset may be a composite of many individual factors with varying effective lives.

Id. at 6665, ¶ 27.

⁹¹ *Id.* at 6665, ¶ 29.

⁹² See, e.g., *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 562 (1932). In that case, the Supreme Court held that it was not bound by the accounting methods imposed on the taxpayer by the Interstate Commerce Commission. See also *Schlude v. Commissioner*, 371 U.S. 884 (1963); *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961).

⁹³ The taxpayer in *Colorado Springs Nat'l Bank* argued that the tax authorities should defer to the requirement of the Comptroller of the Currency that the contested expenditures be deducted rather than capitalized. 505 F.2d at 1188. The government attempted to distinguish this required treatment on the ground that the requirement's purpose was "to insure the liquidity and solvency of national banks and the concurrent protection of the depositors and shareholders." Brief for Appellant at 20 n.10.

To the extent that this purpose is consistent with the broader purpose of clearly reflecting income, the taxpayer's argument is sound. The court followed the well-established rule that the mandated accounting treatment "is not determinative, [but] it is a factor for consideration." 505 F.2d at 1188. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974). See notes 96-101 and accompanying text *infra*.

⁹⁴ See note 7 *supra*.

⁹⁵ *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 562 (1932); *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 355-56 (1971).

⁹⁶ 418 U.S. 1 (1974).

that case was whether depreciation expenses of trucks used in constructing a hydro-electric dam were currently deductible or whether those charges had to be capitalized as part of the cost of the project.⁹⁷ The Court announced its intention to resolve this issue "in a manner that comports with accounting and taxation realities."⁹⁸ It noted that the Federal Power Commission, the Idaho Public Utilities Commission, and generally accepted accounting practice⁹⁹ all required that these expenses be capitalized. Starting with the long-accepted principle that agency-imposed accounting practices do not necessarily dictate tax consequences,¹⁰⁰ the Court concluded that:

where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency *and* that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences.¹⁰¹

In several instances, lower courts have gone one step further and relied exclusively on the taxpayer's accounting method in determining whether to allow a current deduction. For more than twenty years, the taxpayer in *Fort Howard Paper Co.*¹⁰² deducted certain indirect overhead costs associated with the construction of tangible assets as current, section 162 business expenses.¹⁰³ The government contended that section 263 of the Code required that they be capitalized along with the direct costs of labor and material.¹⁰⁴ The Tax Court ruled that section 446,¹⁰⁵ which requires that a

⁹⁷ The narrow issue was one of timing, that is, whether the construction-related depreciation was to be "amortized and deducted over the *shorter* life of the equipment or . . . over the *longer* life of the [dam]." *Id.* at 10 (emphasis in original).

⁹⁸ *Id.*

⁹⁹ *Id.* at 5-6, 12.

¹⁰⁰ *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 562 (1932).

¹⁰¹ 418 U.S. at 15 (emphasis in original) (footnote omitted).

¹⁰² 49 T.C. 275 (1967).

¹⁰³ These construction projects were carried out by the taxpayer's normal maintenance crew only during slack periods. Thus, it is very appealing to argue that these overhead costs would have been incurred whether construction projects were undertaken or not. The taxpayer argued, and the court seemed to agree, that using the "incremental-cost" method of accounting does not require inclusion of overhead costs if such costs cannot be "directly identified" with the project. *Id.* at 283 n.4. This argument ignores the allocation to overhead of the costs of plans and drafting for these projects rather than their capitalization as part of the cost of creating the assets. *Id.* at 278-79.

¹⁰⁴ *Id.* at 283.

Section 263(a)(1) of the Code prohibits any deduction for amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." The government argued that § 263(a)(1) required all costs, including indirect ones, to be capitalized. The Tax Court found that this section was not dispositive, believing the true issue to be whether "petitioner's method of accounting 'clearly reflects income' pursuant to the provisions of section 446." 49 T.C. at 284.

¹⁰⁵ IRC § 446 provides in part:

taxpayer's accounting method clearly reflect income, is "inextricably intertwined" with the substantive provisions of the Code.¹⁰⁶ According to the court, therefore, where a taxpayer has consistently treated certain expenditures in a manner that clearly reflects net income and that also comports with generally accepted accounting principles,¹⁰⁷ the taxpayer's accounting practice should be allowed to dictate tax treatment despite the contrary result arguably required by section 263.

The Court of Claims¹⁰⁸ considered and adopted this rule in *Cincinnati, New Orleans and Texas Pacific Railway Co. v. United States*,¹⁰⁹ by upholding the taxpayer's use of a de minimis rule that required charging all expenditures of less than \$500 to current operating expenses without regard to their capital or noncapital nature.¹¹⁰ The government contended that many outlays deductible under that rule were capital in nature because they were "created" assets with useful lives longer than one year.¹¹¹ Nevertheless, the court approved of the practice because it clearly reflected the taxpayer's income,¹¹² and was in accordance with generally accepted accounting principles.¹¹³ In discussing the relationship between sections 263 and 446,¹¹⁴ the court concluded that "[t]he determinative question

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

(b) EXCEPTIONS. If . . . the method used does not clearly reflect income, the computation of taxable income shall be made under such method as . . . does clearly reflect income.

This section, although constructed in the negative, appears to permit the taxpayer to defend virtually any accounting decision as one that results in a clear reflection of income.

¹⁰⁶ 49 T.C. at 283.

¹⁰⁷ *Id.* at 286. The court also noted that the government had in previous years not only acquiesced in the taxpayer's method but actively employed it in making adjustments to its returns. *Id.* at 286-87. The court noted considerable expert testimony in favor of the taxpayer's position, and cited six standard accounting texts. *Id.* at 285.

¹⁰⁸ The Court of Claims had previously demonstrated its willingness to decide cases in light of economic realities and sound accounting principles in *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965). At one point, it described the government's narrowly framed contentions as requiring that "a very small tail [wag] a very large dog." *Id.* at 283.

¹⁰⁹ 424 F.2d 563 (Ct. Cl. 1970).

¹¹⁰ This method of accounting was required by the Interstate Commerce Commission on the ground that detailed and expensive bookkeeping could be eliminated without adversely impairing the ability of the financial statements to clearly reflect income. *Id.* at 565.

¹¹¹ *Id.* at 566-67.

¹¹² The court noted that over the 17-year period of its application, the de minimis-rule expenses disallowed by the Commissioner represented less than six-tenths of one percent of the year's operating expenses. *Id.* at 571.

¹¹³ *Id.* at 569-70.

¹¹⁴ Corresponding to INT. REV. CODE OF 1939, §§ 24, 41, respectively, under which the case was decided. The considerations involved under § 263 are identical to those under § 162. See note 4 *supra*.

. . . is not what is the useful life of the asset in question, . . . but does the method of accounting employed clearly reflect income."¹¹⁵

One might object that a standard of "clear reflection of income" as determined by generally accepted accounting principles is too amorphous a rule to be practical since generally accepted accounting principles represent a plurality of different and often inconsistent policies.¹¹⁶ Despite this difficulty, section 446 of the Code explicitly allows a taxpayer to choose his accounting method subject only to the condition that it clearly reflects income.¹¹⁷ When a particular practice comports with generally accepted accounting principles and is consistently followed, an accurate flow of income will be reported.¹¹⁸ Hence, the courts and the Commissioner have made,¹¹⁹ and continue to make, case-by-case determinations as to whether a particular taxpayer's method of accounting clearly reflects income. There is no reason to suspect that such a determination cannot also be made under substantive provisions of the Code such as section 162 in order to determine whether capitalization or deduction of a given expenditure will more accurately reflect current income.¹²⁰

A second argument against the proposed test is that a taxpayer's choice of an accounting technique is likely to be self-serving.¹²¹ This would not, however, give rise to any problems in addition to those that already exist under the Code's system of voluntary reporting; in fact, tying tax accounting more closely to financial accounting would have the salutary effect of decreasing a taxpayer's ability to manipulate his accounting records for tax purposes.

¹¹⁵ 424 F.2d at 568.

¹¹⁶ *A.P.B. Statement No. 4* ¶¶ 137-40, 2 A.P.B. ACCOUNTING PRINCIPLES 9083-84 (1973). The Council of the American Institute of Certified Public Accountants recognized that "accounting principles that differ from those accepted in Opinions of the Accounting Principles Board can have substantial authoritative support and, therefore, can also be considered to be generally accepted accounting principles." *Id.* at ¶ 140.

¹¹⁷ See note 105 *supra*.

¹¹⁸ It is important that an accounting method once chosen be consistently followed to ensure that income is accurately portrayed. For example, in the *Cincinnati Ry.* case it was found that treating small capital expenditures as expenses did not distort net income appreciably. Because the expenses were regularly made, the stream of expenses was comparable to yearly depreciation deductions. Section 446(e) of the Code recognized the importance of consistency by requiring a taxpayer to secure the permission of the Secretary of the Treasury or his delegate before changing his regular method of accounting.

¹¹⁹ See text accompanying notes 102-15 *supra*.

¹²⁰ Section 482 involves making such a substantive determination. That section empowers the Commissioner in certain instances to "distribute, apportion, or allocate gross income" among related taxpayers in order "clearly to reflect the income" of those persons. See generally CHOMMIE § 218.

¹²¹ Section 446(e) of the Code provides some protection against the use of self-serving accounting methods.

Because the federal income tax laws embody certain policy considerations that are not relevant to financial accounting,¹²² a direct correspondence between the two is neither possible nor desirable. However, if the capital-ordinary expense dichotomy were examined by reference to the clear-reflection-of-income test, the judicial interpretation of the federal income tax laws would more closely reflect economic realities.

CONCLUSION

Colorado Springs National Bank generates more questions than answers. Although the conclusion reached is clearly correct, the court's analysis is far from satisfying. First and most surprising is the failure of the court to refer to *Commissioner v. Idaho Power Co.*¹²³ In both cases, a government instrumentality mandated the taxpayer's method of accounting.¹²⁴ The opinion of the Supreme Court in *Idaho Power* states that if that method also clearly reflects income, the accounting convention should be presumptively controlling for income tax purposes.¹²⁵ The Tenth Circuit, in *Colorado Springs National Bank*, should have elected to focus only on whether deducting start-up expenses clearly reflected the taxpayer's net income. Significantly, the court at least tangentially considered this approach when it classified the government's approach as "theoretical" and as

¹²² The treatment of depreciation is an obvious example. The purpose of the pro-rata deduction of an asset's cost from gross income is to reflect the part that asset contributed to production of the year's output. For example, suppose a machine that required an initial \$1,000 investment must be replaced every ten years. Sound accounting practice would require that \$100 of that machine's cost be allocated to the income obtained from one year's production. The Code, however, in its effort to encourage business investment, provides for accelerated depreciation. IRC § 167(b). Rather than the pro-rata deductions used by accountants, this provision of the Code allows a taxpayer to deduct a larger portion of the asset's cost in the early years with correspondingly smaller deductions permitted in later years.

The Court of Claims recently suggested several possible reasons for differences between financial and tax accounting treatment of income received by a corporation before it actually rendered services to the payor. In holding that the commissioner abused its discretion under § 446 by not permitting the taxpayer to defer recognition of such prepaid income, the court commented that financial accounting and

well-known accounting principles . . . essentially focus on a conservative matching of income and expenses to the end that an item of income will be related to its correlative expenditure. Tax accounting, on the other hand, starts from the premise of a need for certainty in the collection of revenues and focuses on the concept of ability to pay. Thus, under this theory, where an item of income has been received even though as yet unearned, it should be subject to taxation because the taxpayer has in hand (or otherwise available) the funds necessary to pay the tax due.

Boise Cascade Corp. v. United States, Nos. 321-69, 81-71, at 8 (Ct. Cl., Jan. 28, 1976) (slip decision).

¹²³ 418 U.S. 1 (1974).

¹²⁴ See note 93 *supra*.

¹²⁵ See notes 95-101 and accompanying text *supra*.

one permitting "a distortion of taxpayer's financial situation."¹²⁶ It thus implicitly found that the bank's method of accounting provided a more accurate assessment of its income than did the method suggested by the government.

Second, *Colorado Springs National Bank* and *First Security Bank* show that judicious labelling can dictate tax consequences. The fees paid in these two cases were for the same purpose and for the same services. The tax treatment, therefore, should have been identical.

Finally, because courts are unwilling to adopt a more realistic rule based upon the clear-reflection-of-income concept, they are forced to deal with surrogate tests for deductibility—whether the costs were preoperating, whether they resulted in an ensuing benefit, or whether they created or enhanced an asset. These tests are misbased in theory and illogical in application. There are many significant aspects to the question of deductibility and all must be examined to reach a proper characterization of the taxpayer's income.¹²⁷ The courts in *Colorado Springs National Bank* and *First Security Bank* failed to articulate a broader approach that would provide guidance in the future. These decisions thus represent only another step in the still incomplete transition from one-dimensional tests to a more sophisticated, modern analysis that focuses on the ultimate issue—what classification most clearly reflects a taxpayer's net income.

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¹²⁶ 505 F.2d at 1192. See text accompanying notes 86-87 *supra*.

¹²⁷ Other factors would include those listed by Professor Shugerman and by the Accounting Principles Board. See Shugerman, *supra* note 21; note 90 *supra*.