Capitalization , Amortization, and Depreciation

Introduction

In general, expenses are deductible if allowed by a specific code section. Capital expenditures, in contrast, are not deductible; instead, they must be added to the basis of an asset. From there, they may – or may not – result in future depreciation or amortization, depending on the type of asset. For example, the cost of land must be capitalized and is never subject to depreciation or amortization recovery. In contrast, five years worth of pre-paid insurance must also be capitalized; however, it may then be amortized over the five-year life.

These very simple rules are subject to some controversy and require much refinement. The difference between an expense and a capital expenditure is sometimes obvious. For example, the replacement cost of a single shingle blown off a roof by a hurricane is clearly an expense – and thus not subject to capitalization - for two reasons. First it is minor – and thus not worth the process of capitalization and depreciation. Even though the shingle itself may actually last many years, depending on the remaining life of the roof, the minor cost is not worth the accounting trouble. Second, its replacement does little to change or extend the life of the main asset – the roof. Hence it is just a short-term, minor repair and gives rise to the allowance of a deduction under section 162 as an ordinary and necessary business expense (assuming, of course, the roof was on a building used for a trade or business). For accounting purposes, we would debit an expense account – repairs – and credit a payable or cash account to reflect the payment or the creation of a liability.

At the other extreme, an entire new roof will last some twenty years and its costs must surely be spread over that time frame. The process of doing so is called capitalization of the expenditure and depreciation of the asset. Technically, for accounting purposes, we would debit an asset account for the cost and credit either a payable or cash account to reflect the payment or creation of a liability. The asset account may be a separate asset - called new roof – or it may result in an adjustment to the basis of the building.

As illustrated below, however, many fact patterns do not so clearly involve a simple repair or an obviously new long-term asset. They can be very close to the line delineating repairs versus capital improvements. As we will see, that line can be both fuzzy and a moving target. Courts have mostly resolved it using a facts and circumstances method of analysis.

Other issues of capitalization involve the various accounting methods. As a general rule cash method taxpayers may deduct expenses when paid. As a general rule, accrual method taxpayers may deduct expenses at the later of incurrence under the “all events” test and economic performance pursuant to section 461(h). Each of these general rules, however, is subject to regulations under section 461 and 263 plus several important appellate decisions. Some of these authorities have been, at least historically, controversial.

An additional issue involves what to do with the allowed depreciation or amortization expense that follows initial capitalization. Typically, it is deductible. In some instance, however, it must itself be capitalized into the basis of another asset; or, it may be subject to one of many limitation provisions such as those limiting deductions due to passive activities or activities for which the taxpayer is not at risk.

Overview

This chapter first covers the historic rules involving cash accrual treatment of *intangible* assets. Although these historic rules have largely been replaced with new statutes and regulations, knowledge of the historic treatment is instructive in understanding current rules.

Second, the chapter covers the controversy regarding the difference between a repair and a capital expenditure. Promised new regulations may soon provide new guidance on this issue.

Third, the chapter covers the *Idaho Power* decision – an important deviation from provisions which otherwise permit current deductions. This case is essentially the father of current section 263A and the uniform capitalization rules.

Fourth, the chapter covers the recent historical (and arguably continuing) controversy regarding the Supreme Court's decisions in *Lincoln Savings* and *INDOPCO*. Essentially, *Lincoln Savings* focused on the existence of a separate and distinct asset as an important indicator of the need for capitalization. *INDOPCO* – arguably a huge government victory – focused instead on the future benefit of various expenditures, irrespective of whether they created a distinct asset. In partial resolution of this issue, the Treasury issued new regulations in 2004 under section 263, tending to favor the "distinct asset" analysis. Again, an understanding of the history of the rule will elucidate the new (and controversial) regulations.

Fifth, the chapter examines some large exceptions to capitalization. These include such sections as 173 (circulation expenses), and 175 (soil and water conservation costs). Each involves items that would be capital under the normal rules. Congress, however, permits early deduction. Also covered are important exceptions permitted by rulings and regulations.

Sixth, the chapter covers other important expense deferral rules – which have the effect of capitalization. These include sections 404 (dealing with non-qualified deferred compensation), 461(h) (economic performance), 465 (at risk), 469 (passive activity rules), and 163(e) (investment interest limitations). Full coverage is not included in this chapter; however, an overview is instructive in understanding capitalization as cost recovery deferral.

Seventh, the chapter covers amortization of intangibles, with specific emphasis on sections 195, 197, 174(b) and 467.

Lastly, the chapter covers depreciation of tangible property.

Section 1 Historic Capitalization Rules Governing *Intangible* Assets

1.01 Historic *Cash Method* Rules

Reg. § 1.461-1

Generally expenses are deductible under the cash method when paid. However, if the payment of the item creates an asset with a life that extends "substantially" beyond the close of the year, the amount must be capitalized and then amortized over the period to which it is applicable. At least that has long been the rule under Treasury Regulation 1.461-1(a)(1).[1] As

[1] If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. Reg. § 1.461-1(a)(1).

discussed below, Treasury Regulation 1.263(a)-4(f),[2] promulgated in January, 2004, casts serious doubt on the continued validity of the prior rule.

The historic critical issue was the meaning of the word "substantial." A clear implication of the section 461 regulation is that a pre-payment that extends for an "insubstantial" period beyond the end of the payment year is deductible when paid. Although the "substantial" test now appears clearly in the regulations, it has not always been there. Prior to 1942, some pre-paid expenses were deductible when paid. The First Circuit discarded those authorities in 1942 in the important *Boyston Market*[3] decision, discussed in Chapter ______. *Boylston Market*, while historically important, told us little about the meaning of the word "substantial." This is true because the pre-payment period extended at least two full years beyond the year of payment. That length of time would constitute a "substantial" period under almost any view.

Three more recent decisions provided clearer guidance about the meaning of the term substantial. They also illustrated a clear split of authority between the Tax Court and the Ninth Circuit. The Ninth Circuit view used a rule of easy application in the historically important *Zaninovich*[4] decision. The word "substantial" meant approximately one year. Thus if a taxpayer paid an expense and thereby created an asset with a life extending less than one year beyond the end of the year of payment, the entire expense would be deductible when paid and no portion need have been capitalized. If, in contrast, a taxpayer paid for a period extending more than one year beyond the end of the payment year, the entire amount must have been capitalized and then amortized pursuant to *Boylston Market.* Naturally, in such an event, the portion attributable to the year of payment would be deductible in that year. The entire remaining portion - including that attributable to the following year - must have been deferred till later.

Despite the apparent arbitrariness of the one-year rule, the Ninth Circuit noted in footnote six of *Zaninovich* that it was only a "guidepost" in cases involving a payment extending more than one year beyond the end of the payment year. A 1981 decision of the Ninth Circuit illustrated that "mere guidepost" proposition. The case - *Commissioner v. Van Raden*[5] - involved the December 1972 purchase of a one-year supply of feed corn and silage for $360,400. While the cattle consumed none of the feed during that year, they consumed 98 percent of the corn and 91 percent of the silage during 1973. This represented 98 percent of the cost.

The court sided with the taxpayer, finding that the leftover two percent - at the end of 1973 - did not amount to an expense which extended substantially beyond the end of 1972:

> We do not believe there is any legitimate basis for distinguishing feed payments from rental payments for the purposes of the "one-year rule." Moreover, an argument exists for applying that rule to feed which is not applicable in the case of rental payments. Treas. Reg. § 1.471-6(a) represents an historical concession to farmers which allows them to use the cash method of accounting. One of the major purposes of allowing farmers to use the cash method was to simplify their record-keeping requirements. See United States v. Catto, 384 U.S. 102, 111 n.15, (1966); Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*, 53 Texas L. Rev. 1119, 1148-49 (1975).

[2] Reg. § 1.263(a)-4, in general, requires capitalization of an asset with a life extending at all beyond the end of the year of creation.
[3] Commissioner v. Bolyston Market, 131 F.2d 966 (1st Cir. 1942).
[4] Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980).
[5] Commissioner v. Van Raden, 650 F.2d 1046 (9th Cir. 1981).

> Proration of feed expenses, unlike rental payments, requires the maintenance of consumption records. We hold that the "one-year rule" in Zaninovich applies to the prepayment of feed expense. In the present case, substantially all of the feed purchased was consumed within the one-year period (98 percent of the corn and 91 percent of the silage, representing 98 percent of the original value). In light of the Tax Court's uncontested finding that the feed purchased was calculated to meet the needs of the partnership for one year, and the insignificant amount of feed remaining at the end of the year, we hold that the extent to which the useful life of the feed purchase exceeded the one-year period was *de minimis*.[6]

Essentially, the difference between the cases was that *Zaninovich* involved a predictable term – a rental period – while *Van Raden* involved something far less determinable in advance: how much the cows would eat. This important distinction continues, considering the recent regulations under section 263(a). Those regulations replace the Ninth Circuit's twelve-month rule with a new (and less helpful) twelve-month rule. The new rule, however, applies only to *intangible* assets and has, *as yet*, no application to *tangible* assets such as cattle feed. As a result, this Zaninovich/Van Radan/Grynberg controversy survives for a cash method taxpayer's acquisition of tangible "supplies."

The Tax Court, defining the phrase "substantially beyond the end of the year," applied a three-part test, rather than the easy to use one-year rule used by several circuits. The case was *Grynberg v. Commissioner*.[7] The two tests are not necessarily inconsistent, as they can result in the same conclusion. The approach of the two tests, however, is significantly different. The Tax Court asked:

1. **Is the "payment" truly a "payment," or is it instead merely a "deposit?"** This factor is related to the similar issue distinguishing deposits from payments in terms of whether a recipient has income. In *Grynberg*, however, the focus is on the putative "payor" and whether he has a proper deduction.
2. **Is there a substantial business purpose for the advance payment?** The court did not fully explain what constituted a "substantial business purpose" and the effect of the modifier "substantial." It did, however, suggest that acceleration of a deduction would not normally satisfy the test.
3. **Would the deduction distort the clear reflection of income?** While "clear reflection of income" is always an overriding requirement of any accounting method, its application to the cash method is problematic: by definition the method does not clearly reflect income. It focuses on receipts and payments, rather than income and expenses. In any event, the Ninth Circuit test effectively considers an advance payment of one year as non-distorting. The Tax Court preferred to look at the facts on a case-by-case method to apply the requirement. It also noted that it would give great deference to the Commissioner's determination of distortion, and further, that the taxpayer had a heavy burden of proof to overcome a government determination of distortion.

Under this three-part test, any pre-payment that satisfied the factors was fully deductible when paid. This could theoretically be true even if the payment created an asset with a life

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[6] Id. at 1050.
[7] 83 T.C. 255 (1984).

extending more than one year beyond the end of the year of payment. Thus, the Tax Court test was not necessarily stricter than that of the Ninth Circuit; however, in practice it likely approved fewer and shorter pre-payments.

The controversy between the Ninth Circuit and Tax Court approach has apparently been *partially* resolved by the 2004 issuance of new regulations under section 263. To the extent a pre-payment creates an <u>*intangible*</u> asset with a life extending <u>*at all*</u> beyond the end of the payment year, it must now be capitalized. As explained below, exceptions for *de minimus* and short-term assets exist in the new regulation, but with significant limitations. For tangible assets, the Treasury has sought guidance on the development of new regulations dealing with repairs, improvements and rehabilitation expenditures. Perhaps this new guidance will draw on the historic *Zaninovich/Grynberg* controversy. Until we know, this bit of history is well worth knowing. It should also help the student understand the government's search/attempt at achieving simple/predicable rules in the new regulations.

1.02 Historic *Accrual Method* Rules

An understanding of capitalization of intangibles for accrual method taxpayers requires breaking the study into two parts:

1. True assets with lives extending beyond the current year
2. Deferred but incurred expenses

1.02(a) True assets with long lives

Some assets truly have a life extending beyond the end of the current year. Examples include copyrights, patents, pre-paid insurance, and start-up expenditures. As a general rule, all such costs must be capitalized and then amortized over the appropriate useful life. This has always been the case, subject to the nuances discussed below in relation to *Idaho Power, Lincoln Savings, and INDOPCO*.

Two sub-issues then arise: whether the amortization method is straight-line or otherwise and whether the useful life is based on reality or a specialized code provision. Section 5 below covers these amortization issues.

Pre-paid expenses, such as insurance or rent, would historically have been governed by the all-events test, which provides: Expenses are recognized when all events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy.[8] By tradition, they would then have been subject to straight-line amortization. Since 1985, however, section 461(h) has also governed such expenditures by deferring any deduction until the later of all events occurring or economic performance.[9] Arguably, most such expenses were not affected by the section 461(h) rules because the all events test already required capitalization and deferral. For pre-paid rent, section 467(f) provides further gloss – discussed below - on the deduction timing of such intangibles. It imposes economic reality into the equation, requiring – subject to operative regulations – economic amortization rather than straight-line.

1.02(b) Deferred but Incurred Expenses

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[8] Section 461(h)(4).

[9] The economic performance test is covered in Chapter _____.

Deferred but incurred expenses have historically been a quite different matter and present much more controversial issues. Examples are those items that have been incurred – and thus accrued – in an accounting or economic sense, but payment or performance of which has been deferred. For financial accounting purposes, such costs are merely expensed. For tax purposes, however, taxpayers must capitalize such costs and then deduct them pursuant to such sections as 404, 461(h), 467, 468, 468A, or 468B. This, however, was not always the case.

The historic treatment of such deferred but incurred costs is instructive because it helps one understand the current rules, both from an economic and statutory approach. Several historic cases are important.

1.02(b)(I) Historic Cases

1.02(b)(I)(A) Why study them?

Prior to the 1985 enactment of section 461(h), much confusion existed regarding tax accrual of deductions. While some courts permitted tax deductions generally consistent with financial accrual, other courts forced deferral of some deductions, pending payment. No significant judicial opinions discussed the time value of money implications resulting from tax deduction accounting differing from financial deduction accounting. Although some cases since 1985 have considered the time value implications, they have done so inconsistently.

Why are these cases important? They are important because they demonstrate the time value of money implications inherent in accrual accounting for deductions - and they illustrate what precipitated Congress' enactment of section 461(h), which might be regarded as an over-correction. Note two things:

1. The time value implications stemming from tax accrual of income are relatively simple: if you get the money early, you pay the tax early. Getting the money early will result in future investment income, which will be taxed in the future. Paying the tax early will result in a financial cost equal to the after-tax cost of the money. Because these implications flow from positive numbers and actual cash inflows (the receipts) and actual cash outflows (the tax payments), they are relatively simple to comprehend.

2. In contrast, the time value implications stemming from tax accrual of deductions are more esoteric: generally if you pay later, you get the deduction later. But this involves at least two negatives as well as imaginary cash flows. Not paying the item means not suffering the after tax cost of the money - perhaps for several periods. It also means not benefiting from the payment of the tax, and not earning the after tax income from the non-existent tax benefit. These negatives and imaginary cash flows are not obvious and do not mirror the implications flowing from tax accrual of income - although they exacerbate the problem.

Although a taxpayer may have little choice in his method of accounting, he likely has considerable choice in many factual details of his economic enterprises. Because, unlike financial accounting, tax accounting rules both for income as well as deductions are fact dependent, the well-advised taxpayer should consider alternative facts in light of those alternative tax rules. He may sometimes find that small economic changes can result in substantial tax changes. But he can never so find if neither he nor his advisors fully understand the economic consequences which flow from tax accounting. Such a full understanding requires knowledge of the history of the rules and the cases that prompted them.

Why is this an issue of capitalization? It is because capitalization is nothing but a method to defer expenses and cost recovery. In the case of *tanglible* property, we capitalize costs into basis and recover them over time through depreciation or upon sale. The same is true of *intangibles*, except that cost recovery is called amortization. Deferred but incurred costs are a different sort capitalization. For financial accounting purposes, they do not exist because they are incurred and thus deducted. For tax purposes, however, they are not deductible when incurred because they are subject to some type of deferral – either deferred performance or payment. They are thus effectively capitalized.

The process of capitalization for deferred but incurred costs for tax purposes is a bit odd because tax accounting generally lacks a full set of books comparable to financial accounting. Tax returns focus almost exclusively on the equivalent of an income statement and pay little notice to the equivalent of a balance sheet. Even if the tax system required a balance sheet, it would not necessarily reflect an entry for deferred but incurred costs.

For example, for financial accounting purposes, when airline flies a plane it must accrue an expense for future maintenance. The debit is to an expense and the credit is to a liability account. The expense is recognized currently, but the liability to perform needed maintenance is often deferred for several years. Similar costs exist for future oil rig dismantling costs, mining and solid-waste clean-up costs, and power plant decommissioning costs. Each results in small, incremental current expenses offset by credits to liability accounts. The ultimate repairs or dismantling or clean-up result in debits to the liability accounts and credits to cash – and thus does not affect the income statement.

For tax purposes, however, such deferred but incurred costs are not typically currently deductible. Instead, they must be generally be deferred until economic performance. No particular accounting entry is required for tax purposes to reflect this; however, it is nevertheless the equivalent of capitalization. For certain, it economically is the equivalent of capitalization in that deferral of a deduction is the equivalent of reducing the net after-tax benefit of the deduction.

1.02(b)(I)(B) The Cases and Economic Analysis

Author's Note: The ultimate lesson from the historic economic analysis is that the timing of deductions matters in an economic sense. This is what capitalization is all about: timing of deductions. Take the deduction too early – *i.e.*, no capitalization when it is otherwise appropriate – and the taxpayer has a windfall or government subsidy. Take the deduction too late – *i.e.*, unjustified capitalization – and the taxpayer suffers a harm, essentially a tax increase.

Unfortunately, capitalization rules – along with corresponding depreciation, amortization and other cost recovery rules – have not traditionally been based on economic reality. Hence, windfalls and harms have been and continue to be commonplace.

The financial/economic analysis can be tedious. The student may be tempted to skip the analysis and proceed immediately to an analysis of the rules. Indeed, the authors have chosen that route. Such an approach, however, has its risks. If counsel understands the rules, but does not understand the economic consequences of those rules, he or she risks designing transactions in ways that do not benefit the client. *Hence, those who choose to skip this analysis, for now, should return to it after completing the Chapters on Capitalization, Depreciation, Accounting Rules, and Time Value of Money.*

Section 2 Repair v. Long-term assets

Reg. § 1.162-4

For tangibles, the rules for capitalization tend to be subject to a different approach than that used for intangibles. The focus tends to be on whether the expenditure extends the life of an asset. Treasury Regulation section 1.162-4 provides historic guidance:

> The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

Perhaps the most famous Court decision involving the issue was Welch v. Helvering, 290 U.S. 111 (1933). The issue involved whether an expense met the “ordinary and necessary” requirement of the Code, not entrenched in section 162. The taxpayer had voluntarily paid discharged debts of his employer. He did so to maintain his reputation with future customers. Essentially, the government argued the expenditures created goodwill, then a capital item not subject to amortization. Today, of course, it would be amortizable under section 197. Eventually, the Court found the payments to be extrordiary and not currently deductible. Of importance - and what makes the case famous – was the poetic language of Justice Cardozo explaining the difference between a capital item and an expense:

> 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.[10]

Essentially, he said, there is no standard; instead, we must look at the facts case by case. More recent cases do not provide much help, but do provide some examples.

Two frequently cited cases illustrate Justice Cardozo’s difficulties. In *Midland Empire Packing v. Commissioner, 14 T.C. 635 (1950)*, the Tax Court found a significant expenditure to be an ordinary repair.

The Taxpayer was a meat packer that used its basement for curing hams and bacon and storing various meats. For many years, the basement was satisfactory and required little maintenance. A nearby refinery, however, created a problem with oil seeping into ground water and eventually into the basement. Fearing fire and fumes, plus faced with a situation

[10] 290 U.S. at 114-15.

inappropriate for storage and curing of meat, the taxpayer undertook extensive renovations to line the basement walls and floors. The government argued for capitalization, but the Court sided with the taxpayer:

After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations.[11]

Often contrasted with Midland Empire, is the case of *Mt. Morris Drive-In Theater Co. v. Commissioner, 25 T.C. 272 (1955), aff'd 238 F.2d 85 (6th Cir. 1956).* The taxpayer herein cleared land for a drive-in movie theater. In so doing, it caused serious drainage problems for neighboring property. Fearing lawsuits, the owners installed substantial drainage systems. A dissent argued somewhat persuasively that the system "did not improve, better, extend, increase or prolong the useful life of the property." The majority, however, required the taxpayer to capitalize the costs.

2.01 Questions:

1. Can you distinguish *Midland Empire* from *Mt. Morris*?
2. Should the land improvement costs in *Mt. Morris* be capitalized as a separate and distinct asset subject to depreciation or amortization? Or, should the costs be capitalized as part of the basis of the land and thus not subject to cost recovery other than on sale?
3. Suppose Midland Empire, in its renovations, had decided not only to restore the basement to its traditional use, but also decided to improve it substantially? Should all the costs be capitalized or only the portion for extra improvements? You may receive some guidance from the following decision.

2.02 Norwest Corporation

The following Tax Court decision illustrates a common problem of asbestos and whether its removal is a repair or a capital expenditure.

NORWEST CORPORATION v. COMMISSIONER
108 T.C. 265
April 28, 1997, Filed

JACOBS, Judge:

The first issue is whether petitioner is entitled to deduct the costs of removing asbestos-containing materials from its Douglas Street bank building. Petitioner argues that the expenditures constitute section 162(a) ordinary and necessary expenses. Respondent, on the other hand, contends that the expenditures must be capitalized pursuant to section 263(a)(1). Alternatively, respondent contends that the expenditures must be capitalized pursuant to the "general plan of rehabilitation" doctrine.

[****]

In October 1985, petitioner's general liability and property damage insurer, the St. Paul Property and Liability Insurance Co. (St. Paul), tested a bulk sample of fire-retardant material

[11] 14 T.C. at 642.

from the Douglas Street building's steel I-beams to determine whether the building contained asbestos. The results indicated that the material contained 8 to 10 percent chrysotile asbestos, the most common type of asbestos. [****]

After considering the circumstances, petitioner decided to remove the asbestos-containing materials from the Douglas Street building (other than the parking garage) in coordination with the overall remodeling project. Indeed, the remodeling could not have been undertaken without disturbing the asbestos-containing fireproofing. Thus, because petitioner and Norwest Nebraska chose to remodel, it became a matter of necessity to remove the asbestos-containing materials. Petitioner essentially decided that "managing the asbestos in place" was not a viable option, given the extent of remodeling that would disturb the asbestos.

Removing the asbestos-containing materials from the Douglas Street building at the same time as, and in connection with, the remodeling was more cost efficient than conducting the removal and renovations as two separate projects at different times. It also minimized the amount of inconvenience to building employees and customers.[****]

Removing all the asbestos-containing materials from the Douglas Street building was a large project, entailing an enormous amount of work. Nearly every suspended ceiling and light fixture on all four levels of the building had to be taken down. Asbestos-containing materials were removed from the entire building. [****]

The removal of the asbestos-containing materials from the Douglas Street building did not extend the building's useful life. [****]

Petitioner intended to create a safer and healthier environment for the building employees by removing the asbestos-containing materials. The building indeed became safer after the asbestos-containing materials were removed. [****]

L. Capital Expenditures vs. Current Deductions

Section 263 requires taxpayers to capitalize costs incurred for permanent improvements, betterments, or restorations to property. In general, these costs include expenditures that add to the value or substantially prolong the life of the property or adapt such property to a new or different use. Sec. 1.263(a)-1(b), Income Tax Regs. In contrast, section 162 permits taxpayers to currently deduct the costs of ordinary and necessary expenses (including incidental repairs) that neither materially add to the value of property nor appreciably prolong its life but keep the property in an ordinarily efficient operating condition. See sec. 1.162-4, Income Tax Regs.

Deductions are exceptions to the norm of capitalization. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). An income tax deduction is a matter of legislative grace; the taxpayer bears the burden of proving its right to a claimed deduction. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933).

In Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926), which involved the cost of shoring up a wall and repairing a foundation needed to prevent a building from collapsing, the Board of Tax Appeals drew the following distinctions:

> To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. * * * Expenditures for that purpose are

> distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings. * * *

The distinction between repairs and capital improvements has also been characterized as follows:

> "The test which normally is to be applied is that if the improvements were made to 'put' the particular capital asset in efficient operating condition, then they are capital in nature. If, however, they were made merely to 'keep' the asset in efficient operating condition, then they are repairs and are deductible."

Moss v. Commissioner, 831 F.2d 833, 835 (9th Cir. 1987), revg. T.C. Memo. 1986-128 (quoting Estate of Walling v. Commissioner, 373 F.2d 190, 192-193 (3d Cir. 1967), revg. and remanding 45 T.C. 111 (1965)).

The Court in Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), articulated a test for determining whether an expenditure is capital by comparing the value, use, life expectancy, strength, or capacity of the property [*280] after the expenditure with the status of the property before the condition necessitating the expenditure arose (the Plainfield-Union test). Moreover, the Internal Revenue Code's capitalization provision envisions an inquiry into the duration and extent of the benefits realized by the taxpayer. [**27] See INDOPCO, Inc. v. Commissioner, supra at 88.

Whether an expense is deductible or must be capitalized is a factual determination. Plainfield-Union Water Co. v. Commissioner, supra at 337-338. Courts have adopted a practical case-by-case approach in applying the principles of capitalization and deductibility. Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1, 14 (1979). The decisive distinctions between current expenses and capital expenditures "are those of degree and not of kind." Welch v. Helvering, supra at 114.

M. General Plan of Rehabilitation Doctrine

Expenses incurred as part of a plan of rehabilitation or improvement must be capitalized even though the same expenses if incurred separately would be deductible as ordinary and necessary. United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968); Stoeltzing v. Commissioner, 266 F.2d 374 (3d Cir. 1959), affg. T.C. Memo. 1958-111; Jones v. Commissioner, 242 F.2d 616 (5th Cir. 1957), affg. 24 T.C. 563 (1955); Cowell v. Commissioner, 18 B.T.A. 997 (1930). Unanticipated expenses that would be deductible as business expenses if incurred in isolation must be capitalized when incurred pursuant to a plan of rehabilitation. California Casket Co. v. Commissioner, 19 T.C. 32 (1952). Whether a plan of capital improvement exists is a factual question "based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done". United States v. Wehrli, supra at 689-690.

An asset need not be completely out of service or in total disrepair for the general plan of rehabilitation doctrine to apply. For example, in Bank of Houston v. Commissioner, T.C. Memo. 1960-110, the taxpayer's 50-year-old building was in "a general state of disrepair" but still serviceable for the purposes used (before, during, and after the work) and was in good structural condition. The taxpayer hired a contractor to perform the renovation (which included nonstructural repairs to flooring, electrical wiring, plaster, window frames, patched brick, and paint, as well as plumbing repairs, demolition, and cleanup). Temporary barriers and closures were erected during work in progress. The Court recognized that each phase of the remodeling project, removed in time and context, might be considered a repair item, but stated that "The Code, however, does not envision the fragmentation of an over-all project for deduction or capitalization purposes." The Court held that the expenditures were not made for incidental repairs but were part of an overall plan of rehabilitation, restoration, and improvement of the building.

N. The Parties' Arguments

Petitioner contends that the costs of removing the asbestos-containing materials are deductible as ordinary and necessary business expenses because: (1) The asbestos removal constitutes "repairs"[12] within the meaning of section 1.162-4, Income Tax Regs.; (2) the asbestos removal did not increase the value of the Douglas Street building when compared to its value before it was known to contain a hazardous substance--a hazard was essentially removed and the building's value was restored to the value existing prior to the discovery of the concealed hazard;[13] (3) although performed concurrently, the asbestos removal and remodeling were not part of a general plan of rehabilitation because they were separate and distinct projects, conceived of independently, undertaken for different purposes, and performed by separate contractors; and (4) using the principles of section 213 (which allows individuals to deduct certain personal medical expenses that are capital in nature) and section 1.162-10, Income Tax Regs. (which allows a trade or business to deduct medical expenses paid to employees on account of sickness), the cost of removing a health hazard is deductible under section 162.

Respondent, on the other hand, contends that the costs of removing the asbestos-containing materials must be capitalized because: (1) The removal was neither incidental nor a repair; (2) petitioner made permanent improvements that increased the value of the property by removing a major building component and replacing it with a new and safer component, thereby improving the original condition of the building; (3) petitioner permanently eliminated the asbestos hazard that was present when it built the building, creating safer and more efficient operating conditions and reducing the risk of future asbestos-related damage claims and potentially higher insurance premiums; (4) the asbestos removal and the remodeling were part of a single project to rehabilitate and improve the building; (5) the purpose of the expenditure was not to keep the property in ordinarily efficient operating condition, but to effect a general restoration of the property as part of the remodeling; and (6) section 213 and section 1.162-10, Income Tax Regs., are not analogous to the present case.

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[12] [7]Petitioner states in its opening brief that "The law recognizes that removing an unsafe condition is a repair rather than an improvement", citing Schmid v. Commissioner, 10 B.T.A. 1152 (1928).

[13] [8]Petitioner introduced the reports and testimony of two expert witnesses concerning the impact of the asbestos removal costs on the value of the Douglas Street building. These experts opined that the discovery of asbestos as a health hazard in combination with the extent of asbestos present in the building resulted in an immediate diminution in the value of the building. (One of the experts testified that the building would be appraised as if it did not contain asbestos, and then the amount it would cost to repair the condition would be deducted from the appraisal.) The expert testimony supports petitioner's argument that the asbestos removal merely restored the original value of the building (i.e., without hazardous fireproofing) but did not enhance its value.

The parties also disagree as to whether the Plainfield-Union test is appropriate for determining whether petitioner's asbestos removal expenditures are capital. Petitioner contends that it is the appropriate test because the condition necessitating the asbestos removal was the discovery that asbestos is hazardous to human health. Accordingly, until the danger was discovered, petitioner argues that the physical presence of the asbestos had no effect on the building's value. Only after the danger was perceived could the [contamination affect the building's operations and reduce its value.

Petitioner points to Rev. Rul. 94-38, 1994-1 C.B. 35, which cites Plainfield-Union in addressing the proper treatment of costs to remediate soil and treat groundwater that a taxpayer had contaminated with hazardous waste from its business. The ruling treats such costs (other than those attributable to the construction of groundwater treatment facilities) as currently deductible.

Respondent, on the other hand, argues that the discovery that asbestos is hazardous and that the Douglas Street building contained that substance is not a relevant or satisfactory reference point. Respondent contends that the Plainfield-Union test does not apply herein because a comparison cannot be made between the status of the building before it contained asbestos and after the asbestos was removed; since construction, the building has always contained asbestos. In cases where the Plainfield-Union test has been applied (such as Oberman Manufacturing Co. v. Commissioner, 47 T.C. 471, 483 (1967); American Bemberg Corp. v. Commissioner, 10 T.C. 361, 370 (1948), affd. 177 F.2d 200 (6th Cir. 1949); and Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103 (1926)), respondent continues, the condition necessitating the repair resulted from a physical change in the property's condition. In this case, no change occurred to the building's physical condition that necessitated the removal expenditures. The only change was in petitioner's awareness of the dangers of asbestos. Accordingly, respondent argues that the Plainfield-Union test is inapplicable, and the Court must examine other factors to determine whether an increase in the building's value occurred.

Respondent also disagrees with petitioner's reliance on Rev. Rul. 94-38, supra, arguing that the present facts are distinguishable. The remediated property addressed in the ruling was not contaminated by hazardous waste when the taxpayer acquired it. The ruling permits a deduction only for the costs of remediating soil and water whose physical condition has changed during the taxpayer's ownership of the property. Under this analysis, the taxpayer is viewed as restoring the property to the condition existing before its contamination. Thus, respondent contends, unlike Rev. Rul. 94-38, petitioner's expenditures did not return the property to the same state that existed when the property was constructed because there was never a time when the building was asbestos free. Rather, the asbestos-abatement costs improved the property beyond its original, unsafe condition.

O. Analysis

We believe that petitioner decided to remove the asbestos-containing materials from the Douglas Street building beginning in 1987 primarily because their removal was essential before the remodeling work could begin. The extent of the asbestos-containing materials in the building or the concentration of airborne asbestos fibers was not discovered until after petitioner decided to remodel the building and a budget for the remodeling had been approved. Because petitioner's extensive remodeling work would, of necessity, disturb the asbestos fireproofing, petitioner had no practical alternative but to remove the fireproofing. Performing the asbestos removal in connection with the remodeling was more cost effective than performing the same work as two separate projects at different times. (Had petitioner remodeled without removing the asbestos first, the remodeling would have been damaged by subsequent asbestos removal, thereby creating additional costs to petitioner.) We believe that petitioner's separation of the removal and remodeling work is artificial and does not properly reflect the record before us.

The parties have stipulated that the asbestos removal did not increase the useful life of the Douglas Street building. We recognize (as did petitioner) that removal of the asbestos did increase the value of the building compared to its value when it was known to contain a hazard. However, we do not find, as respondent advocates, that the expenditures for asbestos removal materially increased the value of the building so as to require them to be capitalized. We find, however, that had there been no remodeling, the asbestos would have remained in place and would not have been removed until a later date. In other words, but for the remodeling, the asbestos removal would not have occurred.

The asbestos removal and remodeling were part of one intertwined project, entailing a full-blown general plan of rehabilitation, linked by logistical and economic concerns. "A remodeling project, taken as a whole, is but the result of various steps and stages." Bank of Houston v. Commissioner, T.C. Memo. 1960-110. In fact, removal of the asbestos fireproofing in the Douglas Street building was "part of the preparations for the remodeling project." See id. Before remodeling could begin, nearly every ceiling light fixture in the building was ripped down and crews removed all the asbestos-containing materials that had been sprayed on the columns, I-beams, and decking between floors, as well as the floor tiles in the customer lobbies. Only then could the remodeling contractor perform its work. As described above, the entire project required close coordination of the asbestos removal and remodeling work.

Clearly, the purpose of removing the asbestos-containing materials was first and foremost to effectuate the remodeling and renovation of the building. Secondarily, petitioner intended to eliminate health risks posed by the presence of asbestos and to minimize the potential liability for damages arising from injuries to employees and customers.

In sum, based on our analysis of all the facts and circumstances, we hold that the costs of removing the asbestos-containing materials must be capitalized because they were part of a general plan of rehabilitation and renovation that improved the Douglas Street building.

2.03 Notice 2004-6

As explained below, Treasury Regulations section 1.263(a)-4, promulgated in 2004, answers many questions about the capitalization of *intangibles*. Thus far, regulatory authority on *tangibles* capitalization has been thin. The Treasury, however, is working on the issued and issued the following notice in 2004 filled with intriguing questions:

Notice 2004-6
January 20, 2004

The Internal Revenue Service and Treasury Department intend to propose regulations that clarify the application of §§ 162 and 263 of the Internal Revenue Code to expenditures paid or incurred to repair, improve, or rehabilitate tangible property. This notice identifies issues the Service and Treasury Department may address in the regulations. The Service and Treasury Department want to provide clear, consistent and administrable rules that will reduce the uncertainty and controversy in this area, while also preventing the distortion of income.

Accordingly, the Service and Treasury Department request public comments on whether these or other issues should be addressed in the regulations and, if so, what specific rules and principles should be provided.

ISSUES ON WHICH COMMENTS ARE REQUESTED

1. **What general principles of capitalization should apply to expenditures to repair or improve tangible property?** The regulations currently require capitalization for expenditures that materially increase the value of property, substantially prolong the useful life of property, or adapt property to a new or different use. Sections 1.162-4; 1.263(a)-1(b) of the Income Tax Regulations. Are these the appropriate tests for capitalization? If so, how should the forthcoming guidance clarify the application of these standards? Alternatively, should different standards apply? If so, what different standards?

2. **In applying the general principles, what is the appropriate "unit of property"?** Should any of the following factors be determinative or relevant in analyzing what is the appropriate unit of property: (1) whether the property is manufactured, marketed, or purchased separately; (2) whether the property is treated as a separate unit by a regulatory agency, in industry practice, or by the taxpayer in its books and records; (3) whether the property is designed to be easily removed from a larger assembly, is regularly or periodically replaced, or is one of a fungible set of interchangeable or rotable assets; (4) whether the property must be removed from a larger assembly to be fixed or improved; (5) whether the property has a different economic life than the larger assembly; (6) whether the property is subject to a separate warranty; (7) whether the property serves a discrete purpose or functions independently from a larger assembly; or (8) whether the property serves a dual purpose function, (e.g., inventory)? See Smith v. Commissioner, 300 F.3d 1023 (9th Cir. 2002); Hawaiian Indep. Ref. Inc. v. United States, 697 F.2d 1063 (Fed. Cir. 1983), cert. denied, 464 U.S. 816 (1983); Electric Energy, Inc. v. United States, 13 Cl. Ct. 644 (1987); FedEx Corp. v. United States, No. 01-2200 (W.D. Tenn. August 28, 2003); Ingram Indus., Inc. v. Commissioner, T.C.M. 2000-323; LaSalle Trucking Co. v. Commissioner, T.C.M. 1963-274. Are there other facts or circumstances that should be taken into account?

3. **In determining whether an expenditure materially increases the value of property or substantially prolongs the useful life of property, what is the proper starting point for comparison?** Should the forthcoming guidance adopt the test in Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq. 1964-2 C.B. 8, which looks at "whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure"? Should the starting point be different depending on whether the expenditure was necessitated by a single event, such as a casualty, or from gradual wear and tear? See Ingram Indus.; Rev. Rul. 2001-4, 2001-1 C.B. 295. If the expenditure relates to a component part, does the relative importance of the component part to the functionality of the underlying asset affect the starting point? See Smith, 300 F.3d at 1031-32. Should the test in Plainfield-Union apply as well to expenditures incurred upon acquisition of the property and, if so, how would the test apply?

4. **What is "value" for purposes of the "material increase in value" rule?** Does "value" refer solely to the fair market value of the property? Alternatively, should any "enhanced functionality" of the property in the taxpayer's business (e.g., an enhancement to capacity, productivity, quality, or efficiency) be treated as an additional basis for capitalization? See

Vanalco, Inc. v. Commissioner, T.C.M. 1999-265, aff'd sub nom., Smith v. Commissioner, 300 F.3d 1023 (9th Cir. 2001).

5. **How should it be determined whether there has been a "material increase" in value?** Should an increase in the fair market value of property after the expenditure be compared to the fair market value of the property before the expenditure or the cost of equivalent new property? Should the regulations create a presumption that an addition to fair market value is material (or immaterial) if it exceeds (or is less than) a certain percentage of the fair market value of the property or the cost of equivalent new property?

If enhanced functionality constitutes a basis for requiring capitalization, should the regulations require a certain percentage of improvement before the expenditures are required to be capitalized (e.g., an X% increase in capacity, productivity, or efficiency)? If the enhanced functionality cannot be measured by a percentage of improvement (e.g., enhancements to safety) how should a "material increase" be determined?

6. **What is "useful life" for purposes of the "substantially prolongs useful life" rule?** Is "useful life" the period the taxpayer may reasonably expect to use the property in its trade or business (see § 1.167(a)-1(b)) or the period of use inherent in the property? Should the following factors be considered in determining a property's useful life: (1) wear and tear or decay and decline from natural causes; (2) normal progress of art, economic changes, inventions, and current developments within the industry or the taxpayer's trade or business; (3) climatic and other local conditions specific to the taxpayer's trade or business; (4) the taxpayer's policy as to repairs, renewals, and replacements; and (5) whether the asset was subject to unusual wear and tear, for example, heavy or extraordinary use. See § 1.167(a)-1(b). Should the recovery periods under § 168 be relevant to the determination of "useful life" for capitalization purposes?

7. **How should it be determined whether an expenditure "substantially prolongs" the useful life of the property?** If the expenditure prolongs the useful life of property for a fixed number of years is that sufficient to require capitalization? Alternatively, does the expenditure need to prolong the property's initial or remaining useful life by a relative amount (e.g., by a certain percentage)? Should the test be whether the expenditure essentially results in a rebuilding? See Ingram Indus.; Vanalco. Is it relevant at what point in the useful life of the property the expenditure is incurred? Are there presumptions or safe harbors that would be useful, for example, a presumption that an expenditure that prolongs the useful life of the property for less than *X* months or by less than *Y*% is not "substantial"?

8. **Is § 263(a)(2) a different test from the "substantially prolongs the useful life of the property" test?** If so, what rules should be provided for determining whether an expenditure "restores property or makes good the exhaustion thereof for which an allowance is or has been made" within the meaning of § 263(a)(2)?

9. **What factors are relevant in determining whether an expenditure adapts property to a new or different use?**

10. **What other factors should be considered in determining whether an expenditure must be capitalized?** For example, should the following factors affect the analysis of whether an expenditure increases the value of property, prolongs the useful life, or adapts the property to a new or different use and, if so, how: (1) the nature and extent of the work performed (e.g., the time and effort required to perform the work, whether the property had to be taken out of

service for the work, and the portion of the property affected by the work); (2) the use of materials that reflect product enhancements, improved materials, or technological improvements; (3) the existence of regulatory mandates; (4) the frequency of the expenditure (e.g., whether the expenditure is incurred once or every couple of years); (5) the taxpayer's knowledge of pre-existing defects at the time the property was acquired; (6) whether a substantial percentage of the parts of the property or large or significant parts of the property are replaced; (7) whether the property was functioning immediately before the expenditure; (8) the absolute or relative amount of the expenditure; (9) the relative importance of a component and the "essential functional nature" of a component (see Smith, 300 F.3d at 1031-32); and (10) whether the expenditure is for an activity described in a manufacturer's suggested maintenance program?

11. **Should the regulations provide "repair allowance" type rules?** For example, should the regulations provide rules similar to the percentage repair allowance system, since repealed, that is described in § 1.167(a)-11(d)(2)? If so, should the allowance be an annual amount based on a percentage of the unadjusted basis of the asset or should the allowance be an annual amount based on gross receipts or net income? Should a repair allowance be structured as a safe harbor? Should a safe harbor apply to both personal property and real property? See Alacare Home Health Serv. Inc. v. Commissioner, T.C.M. 2001-149.

12. **Should the regulations provide a de minimis rule?** If so, what should the de minimis amount be (e.g., a fixed amount, a percentage of the fair market value of the property, a percentage of the unadjusted or adjusted basis of the property, or a percentage of the cost of equivalent new property)? Should a de minimis rule be structured as a safe harbor? Should a de minimis rule apply to both personal property and real property? Should the de minimis amount be periodically increased (or decreased), and if so, how? See Cincinnati, New Orleans and Texas Pac. Ry. Co. v. United States, 424 F.2d 563 (Ct. Cl. 1970); Alacare.

13. **What facts are relevant in determining whether a repair must be capitalized under the "plan of rehabilitation" doctrine?** Should the regulations adopt a facts and circumstances analysis that looks to the purpose, nature, extent, and value of the work done? See United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968). What connection is required between the repairs and the capital improvements for the plan of rehabilitation doctrine to apply? That is, must repairs be incident to, integral to, contemporaneous with, or because of the capital improvements? How extensive do the capital improvements have to be to result in a plan of rehabilitation (e.g., is at least one capital expenditure required before the doctrine applies and may a single capital expenditure cause the doctrine to apply)? Are repairs part of a plan of rehabilitation when the repairs are done in preparation for or as part of a remodeling project? See Norwest Corp. v. Commissioner, 108 T.C. 265 (1997). If so, what constitutes a remodeling project? Does the doctrine apply if the work is part of a continuous or ongoing process of replacing an asset over time (e.g., if normal operation requires ongoing repainting and repapering, do repainting and repapering costs become capital if they correspond with a capital remodeling project)? See Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987). Should the regulations establish a bright-line test that repairs of property are considered part of a plan of rehabilitation if the property is, at the time the repairs are made, not suitable for its intended use, in a general state of disrepair, or at the end of its useful life? Should the regulations address other issues, such as whether a written plan is required and whether the existence of a written plan indicates a plan of rehabilitation?

14. **Should the regulations provide specific rules for any particular type or category of expenditure?**

15. **Are there any situations in which the tax treatment of an expenditure to repair, improve, or rehabilitate tangible property should follow the financial or regulatory accounting treatment for that expenditure?**

2.04 Questions:

1. Prepare sample comments in response to the questions asked in Notice 2004-6.
2. What are the economic consequences of a repair versus an expense?

Section 3 Idaho Power and Capitalization of Current expenses

§§ 263(a)(1); 263A (a), (b), (c), (f), (h)

Reg. § 1.263A-1(a), (c), (d), (e); 1.263A-2(a)(2); 1.263A-8; 1.263A-9(a) – (c)

Section 263A requires capitalization of both direct and indirect costs allocable to property. Indirect costs include taxes, depreciation on equipment used to produce the property, and interest on indebtedness incurred to produce the property. The rules for farming businesses can be intricate and inconsistent. For example, the costs of producing animals is generally not a capital expenditure; however, the costs (such as fertilizer, water, and trimming) of producing fruit bearing trees must be capitalized. The impetus for section 263A arose from the famous Supreme Court decision in *Idaho Power*.

COMMISSIONER v. IDAHO POWER CO.
418 U.S. 1
June 24, 1974, Decided

MR. JUSTICE BLACKMUN delivered the opinion of the Court. This case presents the sole issue whether, for federal income tax purposes, a taxpayer is entitled to a deduction from gross income, under § 167 (a) of the Internal Revenue Code of 1954, *26 U. S. C. § 167* (a), [****] for depreciation on equipment the taxpayer owns and uses in the construction of its own capital facilities, or whether the capitalization provision of § 263 (a)(1) of the Code, *26 U. S. C. § 263* (a)(1), [****] bars the deduction. [****]

Nearly all the relevant facts are stipulated. The taxpayer-respondent, Idaho Power Company, is a Maine corporation organized in 1915, with its principal place of business at Boise, Idaho. It is a public utility engaged in the production, transmission, distribution, and sale of electric energy. The taxpayer keeps its books and files its federal income tax returns on the calendar year accrual basis. The tax years at issue are 1962 and 1963.

For many years, the taxpayer has used its own equipment and employees in the construction of improvements and additions to its capital facilities. [****] The major work has consisted of transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

During 1962 and 1963, the tax years in question, taxpayer owned and used in its business a wide variety of automotive transportation equipment, including passenger cars, trucks of all descriptions, power-operated equipment, and trailers. Radio communication devices were affixed to the equipment and were used in its daily operations. The transportation equipment was used in part for operation and maintenance and in part for the construction of capital facilities having a useful life of more than one year.

[****] On its books, in accordance with Federal Power Commission-Idaho Public Utilities Commission prescribed methods, the taxpayer capitalized the construction-related depreciation, but for income tax purposes that depreciation increment was claimed as a deduction under § 167 (a). [****]

Upon audit, the Commissioner of Internal Revenue disallowed the deduction for the construction-related depreciation. He ruled that that depreciation was a nondeductible capital expenditure to which § 263 (a)(1) had application. He added the amount of the depreciation so disallowed to the taxpayer's adjusted basis in its capital facilities, and then allowed a deduction for an appropriate amount of depreciation on the addition, computed over the useful life (30 years or more) of the property constructed. A deduction for depreciation of the transportation equipment to the extent of its use in day-to-day operation and maintenance was also allowed. [****]

> The taxpayer asserts that its transportation equipment is used in its "trade or business" and that depreciation thereon is therefore deductible under § 167 (a)(1) of the Code. The Commissioner concedes that § 167 may be said to have a literal application to depreciation on equipment used in capital construction, [****]

The issue, thus comes down primarily to a question of timing, as the Court of Appeals recognized, *477 F.2d, at 692,* that is, whether the construction-related depreciation is to be amortized and deducted over the shorter life of the equipment or, instead, is to be amortized and deducted over the longer life of the capital facilities constructed.

II Our primary concern is with the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities. Over a period of time a capital asset is consumed and, correspondingly over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted. As the process of consumption continues, and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. The Court stated in Hertz Corp. v. *United States, 364 U.S. 122, 126 (1960):* "[The] purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." See also *United States v. Ludey, 274 U.S. 295, 300-301 (1927);* Massey Motors, Inc. v. *United States, 364 U.S. 92, 96 (1960);* Fribourg Navigation Co. v. *Commissioner, 383 U.S. 272, 276-277 (1966).* When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.[****]

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162 (a)(1) of the

1954 Code, *26 U. S. C. § 162* (a)(1). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired. Briarcliff Candy Corp. v. *Commissioner, 475 F.2d 775, 781 (CA2 1973); Perlmutter v. Commissioner, 44 T.C. 382, 404 (1965),* aff'd, *373 F.2d 45 (CA10 1967); Jaffa v. United States, 198 F.Supp. 234, 236 (ND Ohio 1961).* See Treas. Reg. § 1.266-1 (e).

Construction-related depreciation is not unlike expenditures for wages for construction workers. 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. Construction-related depreciation on the equipment is not an expense to the taxpayer of its day-to-day business. It is, however, appropriately recognized as a part of the taxpayer's cost or investment in the capital asset. The taxpayer's own accounting procedure reflects this treatment, for on its books the construction-related depreciation was capitalized by a credit to the equipment account and a debit to the capital facility account. By the same token, this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. See, e. g., *Coors v. Commissioner, 60 T.C., at 398;* Southern Natural Gas Co. v. *United States, 188 Ct. Cl., at 373-374, 412 F.2d, at 1265.* An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost, of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals' holding would lead to disparate treatment among taxpayers because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost including depreciation charged to it by the contractor. Some, although not controlling, weight must be given to the fact that the Federal Power Commission and the Idaho Public Utilities Commission required the taxpayer to use accounting procedures that capitalized construction-related depreciation. Although agency-imposed compulsory accounting practices do not necessarily dictate tax consequences, Old Colony R. Co. v. *Commissioner, 284 U.S. 552, 562 (1932),* they are not irrelevant and may be accorded some significance. *Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345, 355-356 (1971).* The opinions in American Automobile Assn. v. *United States, 367 U.S. 687 (1961),* and *Schlude v. Commissioner, 372 U.S. 128 (1963),* urged upon us by the taxpayer here, are not to the contrary. In the former case it was observed that merely because the method of accounting a taxpayer employs is in accordance with generally accepted accounting procedures, this "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *367 U.S., at 693.* See also Cincinnati, N.O.&T.P.R. Co. v. *United States, 191 Ct. Cl. 572, 583-584, 424 F.2d 563, 570 (1970).* Nonetheless, 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.

The presence of § 263 (a)(1) in the Code is of significance. Its literal language denies a deduction for "[any] amount paid out" for construction or permanent improvement of facilities. The taxpayer contends, and the Court of Appeals held, that depreciation of construction equipment represents merely a decrease in value and is not an amount "paid out," within the meaning of § 263 (a)(1). We disagree. The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing. The regulations state that the capital expenditures to which § 263 (a) extends include the "cost of acquisition, construction, or erection of buildings." Treas. Reg. § 1.263 (a)-2 (a). This manifests an administrative understanding that for purposes of § 263 (a)(1), "amount paid out" equates with "cost incurred." The Internal Revenue Service for some time has taken the position that construction-related depreciation is to be capitalized. *Rev. Rul. 59-380, 1959-2 Cum. Bull. 87; Rev. Rul. 55-252, 1955-1 Cum. Bull. 319.* There is no question that the cost of the transportation equipment was "paid out" in the same manner as the cost of supplies, materials, and other equipment, and the wages of construction workers. [****] The taxpayer does not question the capitalization of these other items as elements of the cost of acquiring a capital asset. We see no reason to treat construction-related depreciation differently. In acquiring the transportation equipment, taxpayer "paid out" the equipment's purchase price; depreciation is simply the means of allocating the payment over the various accounting periods affected. As the Tax Court stated in *Brooks v. Commissioner, 50 T.C., at 935,* "depreciation -- inasmuch as it represents a using up of capital -- is as much an 'expenditure' as the using up of labor or other items of direct cost." [****]

We hold that the equipment depreciation allocable to taxpayer's construction of capital facilities is to be capitalized.

3.01 Questions:

1. Suppose Taxpayer uses a large truck for two purposes: hauling bricks used in the construction of a new building to be use by the Taxpayer, and also for delivering products sold to customers of the taxpayer. How might the Taxpayer apportion the depreciation expenses of the truck between the two uses? See, Reg. §§ 1.263A-1(e)(3)(i);1.263A-1(e)(4)(ii)(C) and 1.263A-1(g).

2. During the three-year production period of a building for Taxpayer’s use, Taxpayer incurred interest expenses of $4,000,000. Only one-fourth of the interest is on debt directly traceable to the production expenses: *i.e.*, it was expressly incurred for the purpose of construction and is labeled a construction loan. The construction loans, however, paid only part of the construction costs. The remaining costs were paid from existing cash reserves. Must some of the remaining, non-traceable, interest expenses be capitalized? If so, under what standards or allocation methods? See, § 263A(f), Reg. §§ 1.163-8T(c); 1.263A-9.

3. Author works four years on a new novel. During the writing period, he incurs substantial costs for supplies, utilities, secretarial help, and uses furniture and equipment normally subject to section 179. Which costs, if any, must he capitalize and then recover against the income from the ultimate book sales? See, Reg. § 1.263A-2(a)(2)(ii)(A)(I).

4. Farmer decides to plant pecan trees, which will not yield a significant crop for approximately ten years. During the initial ten years, he incurs substantial costs for fertilizer, water, interest, and from the use of equipment, including depreciation. What costs, if any must be capitalized? Suppose Farmer makes a section 263A(d)(3) election?

5. The majority opinion and the dissent in *Idaho Power* seem to diverge on their interpretation of an amount “paid out” as that term is used in § 263(a)(1). However, the two also seem to diverge on the underlying theory of the tax depreciation system. The majority opinion focuses on “accounting and taxation realities” in deciding the case. In so doing, it quotes an excerpt from The Committee on Terminology of the American Institute of Certified Public Accountants concerning the theory that depreciation is a system of cost recovery over the property’s useful life and that the cost of the item should be depreciated over the time period in which it produces income. See, *Idaho Power*, footnote 7 and surrounding text. The dissent on the other hand quotes the legislative history of the tax depreciation provisions stating that a faster write-off of plant and equipment will spur economic growth and encourage investment in capital. Do financial accounting and tax accounting systems have the same goals? How much deference should be given to the economic reality of a transaction or financial accounting theory when deciding a tax case? *See*, Reg. § 1.446-1(a)(2), (c)(2)(C).

Section 4 Is A Separate Asset Required for Capitalization?

The short answer is no – a separate distinct asset is not required for capitalization. The controversy arose because of what some authorities viewed as confusing language in the 1971 Supreme Court decision in *Lincoln Savings*.[14] That case found the existence of a separate asset created by the payment of federal insurance premiums by savings and loan associations. It then required capitalization of the costs. A later case in 1990 involved professional expenses incurred by a target corporation in a friendly takeover. The Tax Court[15] and Third Circuit[16] required capitalization despite the non-existence of a separate, distinct asset. The reasoning centered on the long-term benefits resulting from the expenditures.

The Supreme Court granted certiorari to resolve the arguable conflict between *National Starch* and *Lincoln Savings*. The 1992 case became known as *Indopco v. Commissioner*.[17] It involved over two million dollars in investment banking fees paid by National Starch in its friendly takeover by Unilever. National Starch deducted the expenses and the Commissioner disallowed them.

INDOPCO, Inc., v. Commissioner
503 U.S. 79
February 26, 1992, Decided

JUSTICE BLACKMUN delivered the opinion of the Court.

In this case we must decide whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that corporation as "ordinary and necessary" business expenses under § 162(a) of the Internal Revenue Code. [***]

National Starch claimed a deduction for the $ 2,225,586 paid to Morgan Stanleyp [****] Upon audit, the Commissioner of Internal Revenue disallowed the claimed deduction and issued a notice of deficiency. Petitioner sought redetermination in the United States Tax Court,

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[14] Lincoln Savings & Loan Assn. 403 U.S. 345 (1971).
[15] National Starch and Chemical Corp. v. Comm’r, 93 T.C. 67 (1989).
[16] National Starch & Chemical Corp. v. Comm’r, 918 F.2d 426 (3d Cir. 1990).
[17] Indopco, In.c v. Comm’r. 503 U.S. 79 (1992). National Starch and Chemical Corporation changed its name to INDOPCO.

asserting, however, not only the right to deduct the investment banking fees and expenses but, as well, the legal and miscellaneous expenses incurred.

The Tax Court, in an unreviewed decision, ruled that the expenditures were capital in nature and therefore not deductible under § 162(a) in the 1978 return as "ordinary and necessary expenses." *National Starch and Chemical Corp.* v. *Commissioner*, 93 T.C. 67 (1989). The court based its holding primarily on the long-term benefits that accrued to National Starch from the Unilever acquisition. *Id.*, at 75. The United States Court of Appeals for the Third Circuit affirmed, upholding the Tax Court's findings that "both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch." *National Starch & Chemical Corp.* v. *Commissioner*, 918 F.2d 426, 432-433 (1990). In so doing, the Court of Appeals rejected National Starch's contention that, because the disputed expenses did not "create or enhance . . . a separate and distinct additional asset," see *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354, 29 L. Ed. 2d 519, 91 S. Ct. 1893 (1971), they could not be capitalized and therefore were deductible under § 162(a). 918 F.2d at 428-431. We granted certiorari to resolve a perceived conflict on the issue among the Courts of Appeals.[18] 500 U.S. 914 (1991).

II

Section 162(a) of the Internal Revenue Code allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U. S. C. § 162(a). In contrast, § 263 of the Code allows no deduction for a capital expenditure -- an "amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." § 263(a)(1). The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. See 26 U. S. C. §§ 167(a) and 336(a); Treas. Reg. § 1.167(a), 26 CFR § 1.167(a) (1991). Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, *e. g.*, *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 16, 41 L. Ed. 2d 535, 94 S. Ct. 2757 (1974); *Ellis Banking Corp.* v. *Commissioner*, 688 F.2d 1376, 1379 (CA11 1982), cert. denied, 463 U.S. 1207, 77 L. Ed. 2d 1388, 103 S. Ct. 3537 (1983).

In exploring the relationship between deductions and capital expenditures, this Court has noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593, 87 L. Ed. 1607, 63 S. Ct. 1279 (1943);

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[18] [3]Compare the Third Circuit's opinion, 918 F.2d at 430, with *NCNB Corp.* v. *United States*, 684 F.2d 285, 293-294 (CA4 1982) (bank expenditures for expansion-related planning reports, feasibility studies, and regulatory applications did not "create or enhance separate and identifiable assets," and therefore were ordinary and necessary expenses under § 162(a)), and *Briarcliff Candy Corp.* v. *Commissioner*, 475 F.2d 775, 782 (CA2 1973) (suggesting that *Lincoln Savings* "brought about a radical shift in emphasis," making capitalization dependent on whether the expenditure creates or enhances a separate and distinct additional asset). See also *Central Texas Savings & Loan Assn.* v. *United States*, 731 F.2d 1181, 1184 (CA5 1984) (inquiring whether establishment of new branches "creates a separate and distinct additional asset" so that capitalization is the proper tax treatment).

Deputy v. *Du Pont*, 308 U.S. 488, 493, 84 L. Ed. 416, 60 S. Ct. 363 (1940); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440, 78 L. Ed. 1348, 54 S. Ct. 788 (1934). The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," *Lincoln Savings*, 403 U.S. at 358, § 263 serves as a general means of distinguishing capital expenditures from current expenses. See *Commissioner* v. *Idaho Power Co.*, 418 U.S. at 16. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor." *New Colonial Ice Co.* v. *Helvering*, 292 U.S. at 440; *Deputy* v. *Du Pont*, 308 U.S. at 493.[19]

The Court also has examined the interrelationship between the Code's business expense and capital expenditure provisions.[20] In so doing, it has had occasion to parse § 162(a) and explore certain of its requirements. For example, in *Lincoln Savings*, we determined that, to qualify for deduction under § 162(a), "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." 403 U.S. at 352. See also *Commissioner* v. *Tellier*, 383 U.S. 687, 689, 16 L. Ed. 2d 185, 86 S. Ct. 1118 (1966) (the term "necessary" imposes "only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business,'" quoting *Welch* v. *Helvering*, 290 U.S. 111, 113, 78 L. Ed. 212, 54 S. Ct. 8 (1933)); *Deputy* v. *Du Pont*, 308 U.S. at 495 (to qualify as "ordinary," the expense must relate to a transaction "of common or frequent occurrence in the type of business involved"). The Court has recognized, however, that the "decisive distinctions" between current expenses and capital expenditures "are those of degree and not of kind," *Welch* v. *Helvering*, 290 U.S. at 114, and that because each case "turns on its special facts," *Deputy* v. *Du Pont*, 308 U.S. at 496, the cases sometimes appear difficult to harmonize. See *Welch* v. *Helvering*, 290 U.S. at 116.

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[19] [4]See also Johnson, The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization are Dividends to the Shareholders, 53 Tax Notes 463, 478 (1991) (noting the importance of a "strong law of capitalization" to the tax system).

[20] [5]See, *e. g.*, *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 41 L. Ed. 2d 535, 94 S. Ct. 2757 (1974) (equipment depreciation allocable to construction of capital facilities is to be capitalized); *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298, 31 L. Ed. 2d 217, 92 S. Ct. 908 (1972) (cooperatives' required purchases of stock in Bank for Cooperatives are not currently deductible); *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345, 29 L. Ed. 2d 519, 91 S. Ct. 1893 (1971) (additional premiums paid by bank to federal insurers are capital expenditures); *Woodward* v. *Commissioner*, 397 U.S. 572, 25 L. Ed. 2d 577, 90 S. Ct. 1302 (1970) (legal, accounting, and appraisal expenses incurred in purchasing minority stock interest are capital expenditures); *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580, 25 L. Ed. 2d 585, 90 S. Ct. 1307 (1970) (consulting, legal, and other professional fees incurred by acquiring firm in minority stock appraisal proceeding are capital expenditures); *Commissioner* v. *Tellier*, 383 U.S. 687, 16 L. Ed. 2d 185, 86 S. Ct. 1118 (1966) (legal expenses incurred in defending against securities fraud charges are deductible under § 162(a)); *Commissioner* v. *Heininger*, 320 U.S. 467, 88 L. Ed. 171, 64 S. Ct. 249 (1943) (legal expenses incurred in disputing adverse postal designation are deductible as ordinary and necessary expenses); *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 87 L. Ed. 1607, 63 S. Ct. 1279 (1943) (payment by parent company to cover subsidiary's operating deficit is not deductible as a business expense); *Deputy* v. *Du Pont*, 308 U.S. 488, 84 L. Ed. 416, 60 S. Ct. 363 (1940) (expenses incurred by shareholder in helping executives of company acquire stock are not deductible); *Helvering* v. *Winmill*, 305 U.S. 79, 83 L. Ed. 52, 59 S. Ct. 45 (1938) (brokerage commissions are capital expenditures); *Welch* v. *Helvering*, 290 U.S. 111, 78 L. Ed. 212, 54 S. Ct. 8 (1933) (payments of former employer's debts are capital expenditures).

National Starch contends that the decision in *Lincoln Savings* changed these familiar backdrops and announced an exclusive test for identifying capital expenditures, a test in which "creation or enhancement of an asset" is a prerequisite to capitalization, and deductibility under § 162(a) is the rule rather than the exception. Brief for Petitioner 16. We do not agree, for we conclude that National Starch has overread *Lincoln Savings*.

In *Lincoln Savings*, we were asked to decide whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary expenses under § 162(a), as Lincoln Savings argued and the Court of Appeals had held, or capital expenditures under § 263, as the Commissioner contended. We found that the "additional" premiums, the purpose of which was to provide FSLIC with a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations, "serve to create or enhance for Lincoln what is essentially a separate and distinct additional asset." 403 U.S. at 354. "As an inevitable consequence," we concluded, "the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a)." *Ibid.*

Lincoln Savings stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance . . . a separate and distinct" asset should be capitalized under § 263. It by no means follows, however, that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. We had no occasion in *Lincoln Savings* to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure. See *General Bancshares Corp.* v. *Commissioner*, 326 F.2d 712, 716 (CA8) (although expenditures may not "result in the acquisition or increase of a corporate asset, . . . these expenditures are not, because of that fact, deductible as ordinary and necessary business expenses"), cert. denied, 379 U.S. 832, 13 L. Ed. 2d 40, 85 S. Ct. 62 (1964).

Nor does our statement in *Lincoln Savings*, 403 U.S. at 354, that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure.[21] Although the mere presence of an incidental future benefit -- "*some* future aspect" -- may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. See *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298, 310, 31 L. Ed. 2d 217, 92 S. Ct. 908 (1972) (expense that "is of value in more than one taxable year" is a nondeductible capital expenditure); *Central Texas Savings & Loan Assn.* v. *United States*, 731 F.2d 1181, 1183 (CA5 1984) ("While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item"). Indeed, the text of the Code's capitalization provision, § 263(a)(1), which refers

[21] [6]Petitioner contends that, absent a separate-and-distinct-asset requirement for capitalization, a taxpayer will have no "principled basis" upon which to differentiate business expenses from capital expenditures. Brief for Petitioner 37-41. We note, however, that grounding tax status on the existence of an asset would be unlikely to produce the bright-line rule that petitioner desires, given that the notion of an "asset" is itself flexible and amorphous. See Johnson, 53 Tax Notes, at 477-478.

to "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.

III

In applying the foregoing principles to the specific expenditures at issue in this case, we conclude that National Starch has not demonstrated that the investment banking, legal, and other costs it incurred in connection with Unilever's acquisition of its shares are deductible as ordinary and necessary business expenses under § 162(a).

Although petitioner attempts to dismiss the benefits that accrued to National Starch from the Unilever acquisition as "entirely speculative" or "merely incidental," Brief for Petitioner 39-40, the Tax Court's and the Court of Appeals' findings that the transaction produced significant benefits to National Starch that extended beyond the tax year in question are amply supported by the record. For example, in commenting on the merger with Unilever, National Starch's 1978 "Progress Report" observed that the company would "benefit greatly from the availability of Unilever's enormous resources, especially in the area of basic technology." App. 43. See also *id.*, at 46 (Unilever "provides new opportunities and resources"). Morgan Stanley's report to the National Starch board concerning the fairness to shareholders of a possible business combination with Unilever noted that National Starch management "feels that some synergy may exist with the Unilever organization given a) the nature of the Unilever chemical, paper, plastics and packaging operations . . . and b) the strong consumer products orientation of Unilever United States, Inc." *Id.*, at 77-78.

In addition to these anticipated resource-related benefits, National Starch obtained benefits through its transformation from a publicly held, freestanding corporation into a wholly owned subsidiary of Unilever. The Court of Appeals noted that National Starch management viewed the transaction as "'swapping approximately 3500 shareholders for one.'" 918 F.2d at 427; see also App. 223. Following Unilever's acquisition of National Starch's outstanding shares, National Starch was no longer subject to what even it terms the "substantial" shareholder-relations expenses a publicly traded corporation incurs, including reporting and disclosure obligations, proxy battles, and derivative suits. Brief for Petitioner 24. The acquisition also allowed National Starch, in the interests of administrative convenience and simplicity, to eliminate previously authorized but unissued shares of preferred and to reduce the total number of authorized shares of common from 8,000,000 to 1,000. See 93 T.C. at 74.

Courts long have recognized that expenses such as these, "'incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses.'" *General Bancshares Corp.* v. *Commissioner*, 326 F.2d at 715 (quoting *Farmers Union Corp.* v. *Commissioner*, 300 F.2d 197, 200 (CA9), cert. denied, 371 U.S. 861, 9 L. Ed. 2d 99, 83 S. Ct. 117 (1962)). See also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 5-33 to 5-36 (5th ed. 1987) (describing "well-established rule" that expenses incurred in reorganizing or restructuring corporate entity are not deductible under § 162(a)). Deductions for professional expenses thus have been disallowed in a wide variety of cases concerning changes in corporate structure.[22] Although support for these

[22] [7]See, *e. g., McCrory Corp.* v. *United States*, 651 F.2d 828 (CA2 1981) (statutory merger under 26 U. S. C. § 368(a)(1)(A)); *Bilar Tool & Die Corp.* v. *Commissioner*, 530 F.2d 708 (CA6 1976) (division of corporation into two parts); *E. I. du Pont de Nemours & Co.* v. *United States*, 432 F.2d 1052 (CA3 1970) (creation of new subsidiary to hold assets of prior joint venture); *General Bancshares Corp.* v. *Commissioner*, 326 F.2d 712, 715 (CA8) (stock

decisions can be found in the specific terms of § 162(a), which require that deductible expenses be "ordinary and necessary" and incurred "in carrying on any trade or business,"[23] courts more frequently have characterized an expenditure as capital in nature because "the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." *General Bancshares Corp.* v. *Commissioner*, 326 F.2d at 715. See also *Mills Estate, Inc.* v. *Commissioner*, 206 F.2d 244, 246 (CA2 1953). The rationale behind these decisions applies equally to the professional charges at issue in this case.

IV

The expenses that National Starch incurred in Unilever's friendly takeover do not qualify for deduction as "ordinary and necessary" business expenses under § 162(a). The fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling; the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.

The judgment of the Court of Appeals is affirmed.

It is so ordered.

4.01 Treasury Regulations in response to INDOPCO

Reg. §§ 1.263(a)-1 to -4

Finalized in January 2004, these regulations essentially replaced the *INDOPCO* decision. In some ways, they adopt the Supreme Court's view; however, in many ways, they reject it. In particular, they decline to adopt fully the "significant future benefit" standard. The regulations have been subjected to significant academic attack. Some have argued that the executive (through the Treasury) has no constitutional authority to reject Supreme Court interpretation of statute.[24] Others have argued that the regulations are too costly.[25]

The 2002 preamble to the regulations explained:

> A fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expenditures relating to the production of income in future years. Thus, in determining whether an expenditure should be capitalized, the Supreme Court has considered whether the expenditure produces a significant future benefit. INDOPCO, inc. v. Commissioner, 503 U.S. 79, 112 S.Ct. 1039 (1992). A "significant future

dividends), cert. denied, 379 U.S. 832, 13 L. Ed. 2d 40, 85 S. Ct. 62 (1964); *Mills Estate, Inc.* v. *Commissioner*, 206 F.2d 244 (CA2 1953) (recapitalization).

[23] [8]See, *e. g., Motion Picture Capital Corp.* v. *Commissioner*, 80 F.2d 872, 873-874 (CA2 1936) (recognizing that expenses may be "ordinary and necessary" to corporate merger, and that mergers may be "ordinary and necessary business occurrences," but declining to find that merger is part of "ordinary and necessary business activities," and concluding that expenses are therefore not deductible); Greenstein, The Deductibility of Takeover Costs After *National Starch*, 69 Taxes 48, 49 (1991) (expenses incurred to facilitate transfer of business ownership do not satisfy the "carrying on [a] trade or business" requirement of § 162(a)).

[24] Gregg D. Polsky, "Can Treasury Overrule the Supreme Court?", 84 B.U. L.R. 185 (2004).

[25] Calvin Johnson, "Destroying the Tax Base: The Proposed INDOPCO Capitalization Regulation," 99 Tax Notes 1381 (2003).

> benefit" standard, however, does not provide the certainly and clarity necessary for compliance with, and sound administration of, the law. Consequently the IRS and Treasury Departmet believe that simply restating the significant future benefit test, without more, would lead to continued uncertainly on the part of taxpayers and continued controversy between taxpayers and the IRS. Accordingly, the IRS and Treasury Department have initially defined the exclusive scope of the significant future benefit test through the specific categories of intangible assets for which capitalization is required in the proposed regulations. [now finalized]. The future benefit standard underlies many of these categories.

Treasury Regulation section1.263a-4, dealing with amounts paid to acquire or create intangibles is particularly noteworthy. Section 1.263a-4(b)(1)(iii) includes the separate and distinct asset language for capitalization. It then excludes from the definition of separate and distinct assets, such things as computer software and package design. In general, section 1.263a-4(c) requires capitalization of intangibles acquired from another. It excludes from this requirement, however, intangibles acquired from an employee.

In general, section 1.263a-4(d) requires capitalization of created intangibles. This specifically includes various financial interests such as stock, bonds, letters of credit, futures contracts, covenants not to compete, and pre-paid expenses. These rights are then subject to two important exceptions: a *de minimus* rule found in section 1.263a-4(d)(6)(v),[26] and a 12-month rule found in section 1.263a-4(f):

While the 12-month rule may appear generous, it is then subjected to three substantial limitations.

1. Section 1.263a-4(f)(3) excludes from the rule amounts paid for section 197 intangibles.

2. Section 1.263(a)-4(f)(5) excludes from the 12-month rule rights which exceed the 12-month limitation when considering any renewals of the contract. This would appear to exclude most rental agreements.

3. Section 1.263a-4(f)(6) effectively precludes the 12-month rule from applying to accrual method taxpayers.

4.02 Questions:

1. On December 1, 2005, ABC Corporation pays a $10,000 insurance premium to obtain a property insurance policy with a 1-year term that begins on February 1, 2006. How much may ABC deduct in 2005 or 2006?

    (i) Assume the same facts as in Problem 1, except that the policy has a term beginning on December 15, 2005.

    (ii) Is your answer affected by whether ABC uses the cash or accrual method of accounting?

    (iii) Suppose, for part (ii), the dollar amount is $5000?

[26] This important exception specifically applies to amounts paid for the use of tangible or intangible property, payments for the right to provide or receive services, a covenant not to compete, and insurance.

2. On January 3, 2006, XYZ Corporation pays $10,000 to State Government for a license to conduct its particular line of business. The license period extends through December 31, 2010. When may XYZ deduct the cost of the license?

   a. Assume that State Government requires an annual additional fee of $500 to maintain the license. XYZ regularly pays this cost in December for the following year. When may it deduct the cost of the renewals?

   b. Assume, instead, the $10,000 was paid to a private corporation for a franchise to conduct a particular business.

3. On December 20, 2005, Taxpayer pays $18,000 rent for calendar year 2006. How much may Taxpayer deduct in 2005 or 2006?

   a. Does you answer depend upon Taxpayer's method of accounting?

   b. Would your answer change if the amount were paid on July 1, 2005?

   c. Would your answer change if the amount involved were $36,000 and it covered both 2006 and 2007?

   d. Would your answer to (c) change if the amount involved were $360,000?

Section 5 Exceptions to Capitalization Rules

5.01 Advertising Expenses

Reg. §§ 1.162-1(a); 1.162-20(a)(2)

Advertising is of two types – which may occur separately or together. Type One has as its purpose, creating current sales. For example, a beer producer may advertise during a football game with a commercial showing the product and including the sound of it being poured. This would tend to encourage a watcher/listener to get and grab a beer from his refrigerator. The product, of course, would need to be replaced soon; hence, the current sales. This sort of advertising would not likely be memorable.

Type Two advertising, in contrast, is for the long-term. The same beer producer might have a separate commercial featuring flags and horses and other items (even frogs!) intended to associate the product with positive (or at least memorable) images. Such advertising might be part of a long-term campaign spanning years. It would not necessarily include the goal of prompting current or immediate consumption of the product; instead, it would be intended to promote long-term good feelings toward the product. In other words, it creates goodwill.

Properly accounted for, advertising of Type One would be a current expense, as it would have little impact, if any, beyond the current year. Type Two advertising, however, would properly be capitalized as an intangible asset. Its costs would then be amortized over the period it would reasonably be expected to produce significant goodwill (hence, sales).

Alas, the U.S. tax system does not properly account for advertising costs. Indeed, no advertising need be capitalized so long as it pertains to a current trade or business or activity for the production of income. Despite the following ruling, advertising during a start-up period would presumably be capital in nature, subject to section 195 expensing or amortization.

Rev. Rul. 92-80
1992-2 C.B. 57

September 28, 1992

Does the Supreme Court's decision in *Indopco, Inc. v. Commissioner,* 503 U.S. 79 , 112 S. Ct. 1039 (1992), affect the treatment of advertising costs as business expenses which are generally deductible under section 162 of the Internal Revenue Code? [****]

Section 1.162-1(a) of the Income Tax Regulations expressly provides that "advertising and other selling expenses" are among the items included in deductible business expenses under section 162 of the Code.

Section 1.162-20(a)(2) of the regulations provides, in part, that expenditures for institutional or goodwill advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future.[****]

In *Indopco, Inc. v. Commissioner,* 503 U.S. 79 , 112 S. Ct. 1039 (1992), the Supreme Court concluded that certain legal and professional fees incurred by a target corporation to facilitate a friendly acquisition were capital expenditures. The Court stated that the acquisition costs created significant long-term benefits for the taxpayer. In reaching this decision, the Court specifically rejected the argument that its decision in *Commissioner v. Lincoln Savings & Loan Association,* 403 U.S. 345 (1971), should be read as holding "that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263." *Indopco* at 1044. (Emphasis in original.)

The *Indopco* decision does not affect the treatment of advertising costs under section 162(a) of the Code. These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. *See* section 1.162-1(a) and section 1.162-20(a)(2) of the regulations. Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized. *See, e.g., Cleveland Electric Illuminating Co. v. United States,* 7 Cl. Ct. 220 (1975) (capitalization of advertising costs incurred to allay public opposition to the granting of a license to construct a nuclear power plant). [****]

5.02 Employee Training Costs

In the spirit of Revenue Ruling 92-80, the Service also excluded from the reach of the controversial *INDOPCO* decision, most employee training costs.

REV. RUL. 96--62
1996-2 C.B. 9
December 30, 1996

Does the Supreme Court's decision in *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79 (1992), affect the treatment of training costs as business expenses, which are generally deductible under § 162 of the Internal Revenue Code?[****]

The *INDOPCO* decision does not affect the treatment of training costs under § 162. Amounts paid or incurred for training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses under that section even though they may have some future benefit. *INDOPCO* at 87. *See, e.g., Cleveland Electric Illuminating*

Co. v. United States, 7 Cl. Ct. 220 (1985) (deduction for costs of training employees to operate new equipment in an existing business); REV. RUL. 58--238, 1958--1 C.B. 90, 91 (deduction for costs of training employees that relate to the regular conduct of the employer's business); *see also Ithaca Industries, Inc. v. Commissioner,* 97 T.C. 253, 271 (1991) (deduction for costs of training new employees to keep the assembled workforce unchanged), *aff'd,* 17 F.3d 684 (4th Cir.), *cert. denied,* 115 S. Ct. 83 (1994). Training costs must be capitalized only in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. *See, e.g., Cleveland Electric,* 7 Cl. Ct. at 227--29 (capitalization of costs for training employees of an electric utility to operate a new nuclear power plant, which were akin to start-up costs of a new business).[****]

5.03 Question

1. ISO 9000 is a series of international standards for quality management systems that was developed by the International Organization for Standardization (ISO). The ISO 9000 series of standards is comprised of several specific requirements intended to ensure a quality process in providing services or products to an organization's customers. To obtain certification, an organization may incur internal and external costs to assess its current quality processes, create a quality manual, train its employees, and implement the new quality system. In addition, the organization incurs costs to obtain formal certification from an independent auditor that its quality management system conforms to a specific ISO 9000 standard. This certification generally lasts from two to four years. Are costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification deductible as ordinary and necessary business expenses under section 162, or must they be capitalized under sections 263 or 263A?

5.04 Other Exceptions

§§ 173, 175, 180, 181

Section 173 permits the current deduction of circulation expenses. As an alternative, it allows a taxpayer to elect to capitalize such costs and amortize them over three years. Section 175 permits the current deduction of soil and water conservation expenditures. Clearly, the intent of Congress was to subsidize such expenditures; hence, the rapid deduction despite the long-term effect. Similarly, section 180 permits a current deduction for some farming expenditures such as fertilizer even though they might affect future years. And, section 181 permits immediate expensing for “qualified film and television production” expenditures.

Section 6 Miscellaneous Deferral Rules

§§ 163(e), 404, 461(h), 465, 469

Each of the above sections is an important example of expense deferral, which effectively amounts to capitalization. Coverage of the section 163(e) investment interest limitations and the section 461(h) economic performance test appear elsewhere in this text. Sections 404 (which defers compensation deductions until inclusion by the recipient), 465 (which defers some deductions until a taxpayer is at risk as to the activity), and section 469 (which defers certain passive activity deductions until the taxpayer has passive income) are covered in other courses.

Section 7 Amortization

§§ 167(f), 174(b), 195, 197, and 467(f) (glance at this)

Reg. §§ 1.167(a)-3; 1.197-2; 1.263(a)-5

Costs capitalized into *tangible* assets are covered by the depreciation provisions of sections 167, 168, and 179. Intangibles, in contrast, have less unified treatment. Section 174 covers research and experimentation expenses. Section 195 covers start-up expenditures for new businesses. Section 197 covers miscellaneous intangible rights. Treasury Regulations under section 167 cover other intangibles.

Other than 467(f), each of these provisions provides for straight-line amortization. Section 195 permits an immediate deduction of $5000 followed by ratable amortization over a 180-month period for the remaining costs. Section 197 similarly permits ratable amortization over a 15-year period. Section 174(b) allows for 60-month amortization.

Section 467(f) provides for economic amortization of pre-paid rent for contracts involving $250,000 or more. Operative regulations, however, do not yet exist for this section. As a result, it does not currently apply. The section, if applicable, would put both the payor and the recipient of pre-paid rent on the accrual method of accounting and then would provide for economic amortization. As such, it would greatly improve the tax situation for recipients of pre-paid rent, effectively reversing the *Schlude* rule of accrual accounting. Payors of pre-paid rent would be hurt by the section, but to a much lesser extent than the benefit given recipients. In a net sense, application of the section would result in significant revenue loss for the government; as a result, the 18-year lack of operative regulations is no surprise.

7.01 Start-up costs

Section 195 requires the capitalization of start-up expenditures for new trades or business, transactions for profit, and activities for the production of income. Section 195(c) defines start-up expenses generally as those that occur in the investigation of an activity. They must be of a type that would be otherwise deductible if incurred in the *carrying on* of a trade or business.

Regulation section 1.263(a)-5, in contrast, requires the capitalization of costs incurred to facilitate the acquisition of a trade or business. Simplifying conventions in section 1.263(a)-5(d) permit the expensing of *de minimus* costs (generally those under $5000) and amounts paid as compensation to employees of the taxpayer. The regulation does not provide for amortization of capitalized costs; however, it refers specifically to Regulation 1.446-5 for amounts incurred to facilitate a borrowing.

Revenue Ruling 99-23 generally discussed the differences between amortizable "start-up" expenditures and non-amortizable acquisition costs under section 263.

Rev. Rul. 99-23
May 17, 1999

Situation 1

In April 1998, corporation *U* hired an investment banker to evaluate the possibility of acquiring a trade or business unrelated to *U*'s existing business. The investment banker conducted research on several industries and evaluated publicly available financial information relating to several businesses. Eventually, *U* narrowed its focus to one industry. The investment banker evaluated several business within the industry, including corporation *V* and several of *V*'s competitors. The investment banker then commissioned appraisals of *V*'s assets and an in-depth review of *V*'s books and records in order to determine a fair acquisition price. On November 1, 1998, *U* entered into an acquisition agreement with *V* to purchase all the assets of *V*. *U* did not prepare and submit a letter of intent, or any other preliminary agreement or written document evidencing an intent to acquire *V* prior to executing the acquisition agreement.

Situation 2

In May 1998, corporation W began searching for a trade or business to acquire. In anticipation of finding a suitable target to acquire, *W* hired an investment banker to evaluate three potential businesses and a law firm to begin drafting regulatory approval documents for a target. Eventually, *W* decided to purchase all the assets of corporation *X*. *W* and *X* entered into an acquisition agreement on December 1, 1998.

Situation 3

In June 1998, corporation Y hired a law firm and an accounting firm to assist in the potential acquisition of corporation Z by performing certain services that the parties labeled as "preliminary due diligence." These "due diligence" services included conducting research on Z's industry (including information relating to competitors of Z), and analyzing financial projections for Z for 1998 and 1999. In September 1998, at *Y*'s request, the law firm prepared and submitted a letter of intent to Z. The offer contained in the letter of intent resulted from prior discussions between *Y* and Z, and specifically stated that a binding commitment with respect to the proposed transaction would result only upon execution of an acquisition agreement. Thereafter, the law firm and accounting firm continued to provide services labeled as "due diligence," including a review of Z's internal documents relating to insurance policies, employee agreements, and lease agreements, an in-depth review of Z's books and records, and preparation of an acquisition agreement. On October 10, 1998, *Y* entered into an acquisition agreement with Z to purchase all the assets of Z.

In each of the three situations, the trades or businesses of the targets are active trades or businesses unrelated to the trades or businesses of *U*, *W*, and *Y*. *U*, *W*, and *Y* each use an accrual method of accounting and a calendar taxable year. Each of the acquisition agreements entered into by *U*, *W*, and *Y* were subject to customary conditions of closing. Finally, *U*, *W*, and *Y* each completed the acquisitions in 1998 and timely elected on their 1998 federal income tax returns to amortize start-up expenditures [****] under § 195(b).

LAW AND ANALYSIS

[****]

Section 195(c)(1) defines "start-up expenditure," in part, as any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred. Thus, in order to qualify as start-up expenditures under § 195(c)(1), a taxpayer's "investigatory costs" must satisfy the requirements in both § § 195(c)(1)(A) and (B). In addition, the term "start-up expenditure" does not include any amount with respect to which a deduction is allowable under § 163(a), 164, or 174.

Sections 162 and 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. *See Commissioner v. Lincoln Savings and Loan Ass'n*, 403 U.S. 345 (1971).

Sections 263 and 1.263(a)-1(a) provide that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-2(a) provides that capital expenditures include 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.

Through provisions such as §§ 162(a) and 263(a), the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. *See, e.g., INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

In describing the law prior to § 195, Congress explained that "investigatory expenses," which were "costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business," normally were not deductible because they were not incurred in carrying on a trade or business within the meaning of § 162. *See* H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9 (1980) (House Report); S. Rep. No. 1036, 96th Cong., 2d Sess 10 (1980) (Senate Report). The "carrying on a trade or business" requirement was not met where investigatory expenses were incurred by a taxpayer who was not yet carrying on any trade or business, or where a taxpayer was carrying on a trade or business but incurred costs to investigate the creation or acquisition of another, unrelated trade or business. *Id.* However, a taxpayer incurring costs to investigate the expansion of an existing business generally could deduct those costs under § 162, assuming the other requirements of that section were met. This disparity in the tax treatment of investigatory expenses resulting from the "carrying on a trade or business" requirement discouraged taxpayers from investigating the creation or acquisition of new trades or businesses. Section 195 was enacted, in part, to minimize this disparity and thereby encourage formation of new businesses by providing an amortization deduction for eligible investigatory expenses.

Accordingly, under § 195(c)(1)(B), expenditures described in § 195(c)(1)(A) that are incurred before the establishment of an active business are deemed to be paid or incurred in the operation of an existing active trade or business (in the same field as the business that the taxpayer is investigating whether to create or acquire), *i.e.*, they are deemed to satisfy the carrying on a trade or business requirement. However, because § 195(c)(1)(B) also requires that an expenditure described in § 195(c)(1)(A) be allowable as a deduction for the taxable year in which paid or incurred, the expenditure still must meet all the other requirements of § 162. Thus, the expenditure must be an ordinary expense under § 162, and not a capital expenditure, to be a start-up expenditure under § 195. "Section 195 did not create a new class of deductible expenditures for existing businesses. . . . In order to qualify under section 195(c)(1)(B), an expenditure must be one that would have been allowable as a deduction by an existing trade or business when it was paid or incurred." *FMR Corp. v. Commissioner*, 110 T.C. No. 30 (June 18, 1998). *See also* § § 161 and 261 (deductions are allowed, subject to capitalization provisions). Whether an expenditure is an ordinary expense or is capital in nature is a question of fact that depends on the context in which the expenditure is incurred. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974); *Deputy v. DuPont*, 308 U.S. 488 (1940); *Welch v. Helvering*, 290 U.S. 111 (1933).

The legislative history of § 195 provides the following guidance regarding whether an expenditure is an ordinary investigatory cost that is an [eligible start-up expenditure, or a capital acquisition cost:

Eligible expenses consist of investigatory costs incurred prior to reaching a final decision to acquire or enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc.

Start-up expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowed to an existing trade or business for the taxable year in which the expenditure was paid or incurred. . . . In addition, the amortization election for start-up expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, start-up expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life. . . Whether an amount is consideration paid to acquire a business depends upon the facts and circumstances of the situation.

House Report at pages 10-11; Senate Report at pages 11-12.

Rev. Rul. 77-254, 1977-2 C.B. 63, which is [specifically referenced by the legislative history of § 195 (House Report at 9, Senate Report at 10), considers which costs incurred in the potential acquisition of a new business are capital acquisition costs for purposes of § § 165 and 263. That ruling provides that expenses incurred in the course of a general search for, or an investigation of, a business that relate to the decisions *whether* to purchase a business and *which* business to purchase are investigatory costs. However, once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital in nature. Thus, the "final decision" referred to in the legislative history of § 195 is the point at which a taxpayer makes its decision *whether* to acquire a business, and *which* business to acquire, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction.

Courts have long held that legal, brokerage, accounting, appraisal, and similar costs incurred to acquire a capital asset are capital expenditures under § 263. *Woodward v. Commissioner*, 397 U.S. 572 (1970) (when property is acquired by purchase, nothing is more clearly a part of the process of acquisition than the establishment of a purchase price); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Beneficial Industrial Loan Corp. v. Handy*, 16 F. Supp. 110, 112 (D. Del. 1936), aff'd, 92 F.2d 74 (3d Cir. 1937); Rev. Rul. 73-580, 1973-2 C.B. 86.

For example, in *Ellis Banking Corp. v. Commissioner*, T.C. Memo, 1981-123, *aff'd in part & rem'd in part*, 688 F.2d 1376 (11th Cir. 1982), the taxpayer incurred expenses for office supplies, filing fees, travel, and accounting services in connection with its examination of target's books and records. The examination was performed pursuant to an acquisition agreement for the purchase of target's stock that was contingent on several terms and conditions, such as regulatory approval. The Tax Court concluded that the expenses were nondeductible capital expenditures incurred in the acquisition of a capital asset. The Court of Appeals for the Eleventh Circuit substantially affirmed, noting that the requirement that costs be capitalized extends beyond the price payable to include any costs incurred by the buyer in connection with the purchase, such as appraisals of the property or the costs of meeting any conditions of sale.

Accordingly, expenditures incurred in the course of a general search for, or an investigation of, an active trade or business, *i.e.*, expenditures paid or incurred in order to determine *whether* to enter a new business and *which* new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation), are investigatory costs that are start-up expenditures under § 195. Alternatively, costs incurred in the attempt to acquire a specific business are capital in nature and thus, are not start-up expenditures under § 195. The nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the *whether* and *which* decisions, or an acquisition cost incurred to facilitate consummation of the acquisition. The label that the parties use to describe the cost and the point in time at which the cost is incurred do not necessarily determine the nature of the cost.

In *Situation 1*, an examination of the nature of the costs incurred indicates that *U* made its decision to acquire *V* after the investment banker conducted research on several industries and evaluated publicly available financial information. The costs incurred to conduct industry research and review public financial information are typical of the costs related to a general investigation. Accordingly, the costs incurred to conduct industry research and to evaluate publicly available financial information are investigatory costs eligible for amortization as start-up expenditures under § 195. However, the costs relating to the appraisals of *V*'s assets and an in-depth review of *V*'s books and records to establish the purchase price facilitate consummation of the acquisition, and thus, are capital acquisition costs. The costs incurred to evaluate *V* and *V*'s competitors also may be investigatory costs, but only to the extent they were incurred to assist *U* in determining whether to acquire a business and which business to acquire. If the evaluation of *V* and *V*'s competitors [occurred after *U* had made its decision to acquire *V* (for example, in an effort to establish the purchase price for *V*), such evaluation costs are capital acquisition costs.

In *Situation 2*, the costs incurred to evaluate potential businesses are investigatory costs eligible for amortization as start-up expenditures under § 195 to the extent they relate to the *whether* and *which* decisions. However, the costs incurred to draft regulatory approval documents prior to the time *W* decided to acquire *X* are not start-up expenditures under § 195. The costs related to such activities, even if the activities occurred during the period *W* is engaged in a general search for a business, were not incurred in order to investigate whether to acquire a business and which business to acquire, but rather to facilitate an acquisition.

In *Situation 3*, an examination of the nature of the costs incurred by *Y* indicates that *Y* made its decision to acquire Z in September 1998, around the time that *Y* instructed the law firm to prepare and submit the letter of intent. The costs related to the "preliminary due diligence" services provided prior to that time (including the costs of conducting research on Z's industry and in reviewing financial projections of Z) are typical of the costs incurred during an investigation to determine whether to acquire a new business and which new business to acquire. Thus, these costs are investigatory costs that are eligible for amortization as start-up expenditures under § 195. The costs related to "due diligence" services provided after that time, however, relate to the attempt to acquire the business and must be capitalized under § 263 as acquisition costs. Thus, the "due diligence" costs incurred to review *T*'s internal documents, books and records, and to draft the acquisition agreements are not eligible for amortization under § 195.

HOLDING

Expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine *whether* to enter a new business and *which* new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation) qualify as investigatory costs that are eligible for amortization as start-up expenditures under § 195. However, expenditures incurred in the attempt to acquire a specific business do not qualify as start-up expenditures because they are acquisition costs under § 263. The nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the *whether* and *which* decisions, or an acquisition cost incurred to facilitate consummation of an acquisition.

7.02 Questions:

1. Taxpayer is entering the trade or business of operating burger franchises. As a result, he has incurred $20,000 in legal fees, $15,000 in travel fees searching for opportunities, $30,000 in employee training costs prior to opening, and $100,000 in franchise fees. Which costs must be capitalized and how might they be expensed or amortized? Does your answer change depending on whether Taxpayer purchases a new franchise or an existing corporation to be held as a subsidiary?

2. Taxpayer purchased new computer software for use in its business. The cost was $50,000. The software is expected to be used for four years. How should Taxpayer treat the cost?

3. Taxpayer pre-paid rent for office space for his business. The term of the lease is five years and the amount paid on January 2, 2006, was $300,000. When does Taxpayer receive a deduction and for what amount? Would your answer differ if regulations for section 467(f) existed? How would you amortize the pre-paid rent under that section, assuming an applicable federal rate of 5%?

4. On January 2, Taxpayer received a quote for property insurance of $12,000 per year for three years. The company offered him a discount for advance payment, using a nominal annual interest rate of 10% compounded annually. Taxpayer thus paid $32,826.45. How should Taxpayer amortize this pre-payment? Consider the possible application of section 7872.

5. What is the economic effect of straight-line amortization of intangibles? Is it effectively a subsidy of or an extra tax on taxpayers; or, is the policy economically neutral? Assume, for purposes of this analysis, a zero inflation rate in the utility value of the intangible. [hint, it is a subsidy]

Section 8 Depreciation

Depreciation – like its cousins amortization and depletion - differs from other deductions in two fundamental ways. First, depreciation affects multiple years, unlike most deductions, which affect only the year in which the underlying cost occurs. Exactly why it affects multiple years is the subject of some academic debate. One popular theory for deducting an item over time stems from the premise that an asset devalues, or depreciates, as it is used over time; hence, depreciation reflects that gradual loss in value. A competing theory suggests that depreciation – and amortization – are merely methods of cost allocation and are not rooted in devaluation. If an asset is used in multiple years, its cost should be recognized in multiple years. Later in this Chapter, we will discuss these competing theories.

But, foremost, depreciation differs from other deductions because it is artificial. The amount of the depreciation deduction _may_ generally approximate a true economic cost suffered by the taxpayer – be it part of the original cost or the loss in value; however, the amount is often far greater than the actual economic cost. Or, it may diverge from reality altogether in that the taxpayer may deduct depreciation even though the property involved actually gains value during the relevant period.

The artificiality of the depreciation is attractive both to taxpayers and to the government. Taxpayers use it to generate tax savings with little or no economic cost. The government uses it to grant tax savings to taxpayers entering favored transactions. In theory, at least, both win. Depreciation has its downside, as well. Depreciated assets – which generate those favorable tax benefits - are "tainted" with tax detriments. Such tainted property is less desirable than non-tainted property; as a result, taxpayers avoid it.

Both the artificiality and the timing of depreciation result in interesting accounting and other legal issues. For example, although depreciation is an expense, it does not result in a current cash flow: the expense lowers current income but does not cause a cash outlay. Hence it can result in accumulated reserves which are both useful and tempting to management. Theoretically, at least, the built-up reserves are needed to replace the deteriorating assets. But, to the extent depreciation expenses exceed actual costs, the reserves may be excessive. This is true for financial accounting and is even more true for tax accounting.

That last point prompts a second interesting notion of depreciation: tax depreciation differs substantially from financial accounting depreciation. Each is artificial and each is spread over time; however, tax depreciation tends to be much more rapid than financial depreciation. As a result, tax-based income statements typically show less income than do corresponding financial income statements. These differences become particularly important in many non-tax legal issues. For example, family law obligations are typically a function of the obligor's "income." To the extent the fact finder relies on tax-based income rather than financial income, the collateral consequences – such as child support and alimony – may be seriously distorted. High depreciation expenses may have no economic reality. Low income figures may partially disguise large built-up reserves invested elsewhere. Similarly, a contract may divide profits between two participants. Because of depreciation's artificiality, those "profits" may be artificially low in one year or high in another.

These collateral consequences bear remembering. Tax lawyers tend to think of the tax savings from various deductions – an appropriate concern, considering that such savings (both state and federal) may amount to 40% or more of an asset's costs. When coupled with other collateral consequences of depreciation – such as family law effects and contract allocations – the potential consequences of depreciation are huge.

Before we can discuss the theory of depreciation and its collateral consequences, we must first learn to compute it. In computing depreciation, many questions arise.

1. What items are depreciable?
2. What basis is used to determine the amount of depreciation?
3. How is the amount of depreciation determined?
4. Over what time period is an item depreciable?
5. What methods are used for determining the amount of depreciation?
6. Once the amount of the depreciation is determined for each time period, when is the taxpayer permitted to begin depreciating the property?
7. Once depreciation is taken and an asset is disposed of, does a taxpayer's previous allowance of a deduction have any impact on any gain or loss that is realized or recognized?
8. If the taxpayer never claims depreciation, is the basis of the property still affected?
9. What happens to the "taint" on the asset if it is transferred in a non-taxable exchange?

Each of these questions must be answered in order. To illustrate each, assume the following basic hypothetical:

> Taxpayer, a calendar-year taxpayer, purchases and places into service $450,000 of office furniture on October 4, 2005, to be used in Taxpayer's law office. In 2005, Taxpayer generates $50,000 of taxable business income without any consideration of depreciation.

8.01 Depreciable Items

§ 167(a)

Reg. § 1.167(a)-2

Per Section 167(a), depreciable property must (1) be subject to exhaustion, wear and tear, or obsolescence and (2) be used either in a trade or business or for the production of income.[27] The hypothetical furniture purchase satisfies both requirements. Common knowledge supports the conclusion that office furniture is subject to wear and tear. The assumed facts suggest the use of the furniture in the trade or business of practicing law. In not all cases, however, will the requirements be so obviously met.

8.01(a) Property Subject to Exhaustion, Wear and Tear, or Obsolescence

Depreciation is not allowed for all property. Specifically excluded from the definition of depreciable property are inventory, land, and its improvements.[28] Land, for example, is not depreciable because its use over time does not subject the property to wear and tear or obsolescence. In fact, the very nature of land lends itself to appreciation, so a depreciation deduction for its use would be inappropriate, at least under the academic theory that depreciation reflects loss in value. Landscaping expenditures, however, *may* be deductible depending on the nature of the expenditures.[29]

8.01(a)(I) Exhaustion, Wear and Tear

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[27] § 167(a).
[28] Reg. § 1.167(a)-2.
[29] Rev. Rul. 74-265, 1974-1 C.B. 56 (1974).

Exhaustion and wear and tear can most easily be thought of as a machine that manufactures products but that eventually produces so many products that it wears out and must be abandoned. A depreciation deduction should be allowed for such an item in each time period in which the machine is used to produce these products, subjecting the property to "wear and tear" or a theoretical loss in value. However, what is the protocol for items that may be subject to exhaustion because they are used in a trade or business, but which also have intrinsic value because of their unique nature? Consider the famous violin bow case.

8.01(a)(I)(A) Simon v. Commissioner

Simon v. Commissioner
103 T.C. 247
August 22, 1994

Laro, *Judge:* [****]

Petitioners claimed depreciation on two 19th-century violin bows that they used in their trade or business as full-time professional violinists. As discussed below, we hold that petitioners may depreciate their violin bows during the year in issue. [****]

During the year in issue, petitioners were both full-time performers with the Philharmonic, playing locally, nationally, and internationally in the finest concert halls in the world. In 1989, petitioners performed four concerts per week with the Philharmonic, playing over 200 different works, and attended many rehearsals with the Philharmonic that were more demanding and more time-consuming than the concerts. Petitioners also carried out the busy schedules connected with their second careers. [****]

Old violins played with old bows produce exceptional sounds that are superior to sounds produced by newer violins played with newer bows. The two violin bows in issue were made in the 19th century by Francois Xavier Tourte (1747-1835). Francois Tourte is considered the premier violin bow maker. In particular, he is renowned for improving the bow's design. (Hereinafter, the two bows in issue are separately referred to as bow 1 and bow 2, and are collectively referred to as the Tourte bows.) [****]

On November 13, 1985, petitioners purchased bow 1 for $ 30,000; the bow was purchased from Moes & Moes, Ltd., a dealer and restorer of violins and violin bows. On December 3, 1985, petitioners purchased bow 2 from this dealer for $ 21,500. The sticks, frogs, and screws were originals of Francois Tourte at the time of each purchase. No cracks or other defects were apparent in the sticks at the time of each purchase. The frogs and screws, however, were not in playable condition. Therefore, petitioners replaced them.

Petitioners acquired the Tourte bows for regular use in their full-time professional employment as violinists. Petitioners purchased the Tourte bows for their tonal quality, not for their monetary value. In the year of acquisition, petitioners began using the Tourte bows with the original sticks in their trade or business as full-time professional violinists. Petitioners continued to use the Tourte bows with the original sticks during the year in issue.[****]

Conditions Affecting the Wear and Tear of Violin Bows

Playing with a bow adversely affects the bow's condition; when a musician plays with a bow, the bow vibrates up, down, sideways, and at different angles. In addition, perspiration from a player's hands enters the wood of a bow and ultimately destroys the bow's utility for playing.

Cracks and heavy-handed bearing down while playing certain pieces of music also create wear and tear to a bow. A player who has a heavy hand may cause the stick to press against the horsehair; in turn, this may cause the bow to curve and warp. [****] Petitioners' use of the Tourte bows during the year in issue subjected the bows to substantial wear and tear.

Frequent use of a violin bow will cause it to be "played out", meaning that the wood loses it ability to vibrate and produce quality sound from the instrument. From the point of view of a professional musician, a "played out" bow is inferior and of limited use. The Tourte bows were purchased by petitioners, and were playable by them during the year in issue, only because the Tourte bows were relatively unused prior to petitioners' purchase of them; the Tourte bows had been preserved in pristine condition in collections. At the time of trial, the condition of the Tourte bows had deteriorated since the dates of their purchase. Among other things, the sticks on the Tourte bows were worn down.

Value of the Tourte Bows

On November 21, 1985, bow 1 was appraised for insurance purposes as having a fair market value of $ 35,000. On December 3, 1985, bow 2 was appraised for insurance purposes as having a fair market value of $ 25,000. Petitioners obtained both appraisals from Moes & Moes, Ltd.

In 1994, at the time of trial, the Tourte bows were insured with the Philharmonic for $ 45,000 and $ 35,000, respectively. These amounts are based on an appraisal dated May 14, 1990, from Yung Chin Bowmaker, a restorer and dealer of fine bows. The record does not indicate whether these appraised amounts were the fair market values of the Tourte bows or were their replacement values.

An independent market exists for the Tourte bows and other antique bows. Numerous antique bows (including bows made by Francois Tourte) are regularly bought and sold in this market. The Tourte bows are unadorned; they are not as lavish or decorative as some other bows (including other bows made by Francois Tourte) that are sold in the independent market. Adornments on other bows include engravings, gold, silver, ivory, and mother-of-pearl.

One factor that adds value to the Tourte bows is the fact that Pernambuco wood, the wood that was used to make the sticks, is now very scarce. The wood that is currently used to make the sticks of violin bows is inferior to Pernambuco wood.

[****]

Taxpayers have long been allowed asset depreciation deductions in order to allow them to allocate their expense of using an income-producing asset to the periods that are benefited by that asset. The primary purpose of allocating depreciation to more than 1 year is to provide a more meaningful matching of the cost of an income-producing asset with the income resulting therefrom; this meaningful match, in turn, bolsters the accounting integrity for tax purposes of the taxpayer's periodic income statements. *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960); *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960). Such a system of accounting for depreciation for Federal income tax purposes has been recognized with the approval of the Supreme Court for over 65 years; as the Court observed in 1927: "The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it." *United States v. Ludey*, 274 U.S. 295, 301 (1927); see also *Massey Motors, Inc. v. United States, supra* at 104. In this sense, an allocation of depreciation to a given year represents that year's reduction of the underlying asset through wear and tear. *United States v. Ludey, supra* at

300-301. Depreciation allocations also represent a return to the taxpayer of his or her investment in the income-producing property over the years in which depreciation is allowed. *Virginian Hotel Corp. v. Helvering*, 319 U.S. 523, 528 (1943); *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943).

> Prior to [****] 1981 [****] regulations [****] expanded on the text of section 167 by providing that personal property was only depreciable [****] if the taxpayer established the useful life of the property. See sec. 1.167(a)-1(a) and (b), Income Tax Regs.

The "useful life" of property [****] was the period over which the asset could reasonably be expected to be useful to the taxpayer in his or her trade or business, or in the production of his or her income. [****] This useful life period was not always the physical life or maximum useful life inherent in the asset. [****]. A primary factor to consider in determining an asset's useful life was any "wear and tear and decay or decline from natural causes" that was inflicted upon the asset. Sec. 1.167(a)-1(b), Income Tax Regs.

Before ERTA, the primary method that was utilized to ascertain the useful life for personal property was the asset depreciation range (ADR) system. Under the ADR system, which was generally effective for assets placed in service after 1970 and before 1981, property was grouped into broad classes of industry assets, and each class was assigned a guideline life. See, e.g., sec. 1.167(a)-11, Income Tax Regs.; Rev. Proc. 83-35, 1983-1 C.B. 745, superseded by Rev. Proc. 87-56, 1987-2 C.B. 674; see also ERTA sec. 209(a), 95 Stat. 226. A range of years, i.e., the ADR, was then provided for each class of personal property; the ADR extended from 20 percent below to 20 percent above the guideline class life. For each asset account in the class, the taxpayer selected either a class life or an ADR that was utilized as the useful life for computing depreciation. See, e.g., sec. 1.167(a)-11(a), Income Tax Regs.; Rev. Proc. 83-35, *supra*. If an asset was not eligible for ADR treatment, or if the taxpayer did not elect to use the ADR system, the useful life of that asset was generally determined based on either the particular facts and circumstances that applied thereto, or by agreement between the taxpayer and the Commissioner. *[****]*

In enacting ERTA, the Congress found that the pre-ERTA rules for determining depreciation allowances were unnecessarily complicated and did not generate the investment incentive that was critical for economic expansion. The Congress believed that the high inflation rates prevailing at that time undervalued the true worth of depreciation deductions and, hence, discouraged investment and economic competition. The Congress also believed that the determination of useful lives was "complex" and "inherently uncertain", and "frequently [resulted] in unproductive disagreements between taxpayers and the Internal Revenue Service." [****] Accordingly, the Congress decided that a new capital cost recovery system would have to be structured which, among other things, lessened the importance of the concept of useful life for depreciation purposes. [****]

Thus, through ERTA, the Congress minimized the importance of useful life by: (1) Reducing the number of periods of years over which a taxpayer could depreciate his or her property from the multitudinous far-reaching periods of time listed for the ADR system to the four short periods of time listed in ERTA (i.e., the 3-year, 5-year, 10-year, and 15-year ACRS periods), and (2) basing depreciation on an arbitrary statutory period of years that was unrelated to, and shorter than, an asset's estimated useful life. [****]

With respect to the pre-ERTA requirement of useful life, the Commissioner had initially taken the position that a taxpayer generally could not deduct depreciation on expensive works of art and curios that he purchased as office furniture. See A.R.R. 4530, II-2 C.B. 145 (1923). This position was superseded by a similar position that was reflected in Rev. Rul. 68-232, 1968-1 C.B. 79. That ruling states:

A valuable and treasured art piece does not have a determinable useful life. While the actual physical condition of the property may influence the value placed on the object, it will not ordinarily limit or determine the useful life. Accordingly, depreciation of works of art *generally* is not allowable. [Emphasis added.]

In the instant case, respondent determined that petitioners were not entitled to deduct depreciation for the Tourte bows. On brief, respondent supports her disallowance with two primary arguments. First, respondent argues that the useful lives of the Tourte bows are indeterminable because the bows are treasured works of art for which it is impossible to determine useful lives. According to respondent, the Tourte bows are works of art because the Tourte bows have existed for more than 100 years and have increased in value over that time; the presence of an independent market for the Tourte bows also gives them a value independent of their capacity to be used to play music, and serves to extend their useful lives indefinitely.

As an alternative to this first argument, respondent argues that the Tourte bows are depreciable under section 168 only if petitioners first prove that each bow has a determinable useful life within the meaning of section 167. In this regard, respondent contends that petitioners must prove a specific or reasonable estimate of the number of years that the Tourte bows will be useful in order to depreciate them under ACRS. Given that the Tourte bows have existed for more than 100 years, respondent concludes, petitioners may not depreciate the Tourte bows because petitioners cannot determine the number of remaining years during which the Tourte bows will continue to be useful.

Petitioners' argument is more straightforward. According to petitioners, they may claim depreciation on the Tourte bows because the Tourte bows: (1) Were necessary to their profession as full-time professional violinists, and (2) suffered wear and tear attributable to their use in that profession. In this regard, petitioners contend, the Tourte bows can be used to produce beautiful sounds superior to those produced by any newer bow, and the Tourte bows harmonize this beautiful music with the reputation of the Philharmonic as one of the most prestigious orchestras in the world.

We agree with petitioners that they may depreciate the Tourte bows under ACRS. ERTA was enacted partially to address and eliminate the issue that we are faced with today, namely, a disagreement between taxpayers and the Commissioner over the useful lives of assets that were used in taxpayers' trades or businesses. With this "elimination of disagreements" purpose in mind, the Congress defined five broad classes of "recovery property", and provided the periods of years over which taxpayers could recover their costs of this "recovery property". [****]

Inasmuch as section 168(a) allows a taxpayer to deduct depreciation with respect to "recovery property", petitioners may deduct depreciation on the Tourte bows if the bows fall within the meaning of that term. The term "recovery property" is defined broadly under ERTA to mean tangible property of a character subject to the allowance for depreciation and placed in service after 1980. Accordingly, property is "recovery property" if it is: (1) Tangible, (2) placed in service after 1980, (3) of a character subject to the allowance for depreciation, and (4) used in the trade or business, or held for the production of income. [****]

The Tourte bows fit snugly within the definition of recovery property. First, it is indisputable that the Tourte bows are tangible property, and that they were placed in service after 1980. Thus, the first two prerequisites for ACRS depreciation are met. Second, petitioners regularly used the Tourte bows in their trade or business as professional violinists during the year in issue. Accordingly, we conclude that petitioners have also met this prerequisite for depreciating the Tourte bows.

The last prerequisite for depreciating personal property under section 168 is that the property must be "of a character subject to the allowance for depreciation". The term "of a character subject to the allowance for depreciation" is undefined in the 1954 Code. Comparing the language that the Congress used in section 167(a) of the 1954 Code immediately before its amendment by ERTA, *supra* p. 254, with the language that it used in section 168(a) and (c)(1) as added to the 1954 Code by ERTA, *supra* pp. 255-257, we believe that the Congress used the term "depreciation" in section 168(c)(1) to refer to the term "exhaustion, wear and tear (including a reasonable allowance for obsolescence)" that is contained in section 167(a). See *Noyce v. Commissioner*, *supra* at 689. Accordingly, we conclude that the term "of a character subject to the allowance for depreciation" means that property must suffer exhaustion, wear and tear, or obsolescence in order to be depreciated. Accordingly, petitioners will meet the final requirement under section 168 if the Tourte bows are subject to exhaustion, wear and tear, or obsolescence.

We are convinced that petitioners' frequent use of the Tourte bows subjected them to substantial wear and tear during the year in issue. Petitioners actively played their violins using the Tourte bows, and this active use resulted in substantial wear and tear to the bows. Indeed, respondent's expert witness even acknowledged at trial that the Tourte bows suffered wear and tear stemming from petitioners' business; the witness testified that the Tourte bows had eroded since he had examined them 3 years before, and that wood had come off them. Thus, we conclude that petitioners have satisfied the final prerequisite for depreciating personal property under section 168, and, accordingly, hold that petitioners may depreciate the Tourte bows during the year in issue. Allowing petitioners to depreciate the Tourte bows comports with the text of section 168, and enables them to match their costs for the Tourte bows with the income generated therefrom. Refusing to allow petitioners to deduct depreciation on the Tourte bows, on the other hand, would contradict section 168 and vitiate the accounting principle that allows taxpayers to write off income-producing assets against the income produced by those assets.

With respect to respondent's arguments in support of a contrary holding, we believe that respondent places too much reliance on the fact that the Tourte bows are old and have appreciated in value since petitioners acquired them. Indeed, respondent believes that this appreciation, in and of itself, serves to prevent petitioners from claiming any depreciation on the Tourte bows. We disagree; section 168 does not support her proposition that a taxpayer may not depreciate a business asset due to its age, or due to the fact that the asset may have appreciated in value over time. *[****]* Respondent incorrectly mixes two well-established, independent concepts of tax accounting, namely, accounting for the physical depreciation of an asset and accounting for changes in the asset's value on account of price fluctuations in the market. Accord *Fribourg Navigation Co. v. Commissioner*, 383 U.S. at 277; *Macabe Co. v. Commissioner*, 42 T.C. 1105, 1109 (1964). Moreover, we find merit in petitioners' claim that they should be able to depreciate an asset that receives substantial wear and tear through frequent use in their trade or business. Simply stated, the concept of depreciation is appropriately designed to allow taxpayers to recover the cost or other basis of a business asset through annual depreciation deductions.

We also reject respondent's contention that the Tourte bows are nondepreciable because they have value as collectibles independent of their use in playing musical instruments, and that this value prolongs the Tourte bows' useful life forever. First, it is firmly established that the term "useful life" under pre-ERTA law refers to the period of time in which a particular asset is *useful to the taxpayer* in his or her trade or business. *Fribourg Navigation Co. v. Commissioner, supra* at 277; *Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960); sec. 1.167(a)-1(b), Income Tax Regs. Thus, the fact that an asset such as the Tourte bows may outlive a taxpayer is not dispositive of the issue of whether that asset has a useful life for depreciation purposes under pre-ERTA law. Second, the same argument concerning a separate, nonbusiness value can be made of many other assets. Such types of assets could include, for example, automobiles, patented property, highly sophisticated machinery, and real property. For the Court to delve into the determination of whether a particular asset has a separate, nonbusiness value would make the concept of depreciation a subjective issue and would be contrary to the Congress' intent to simplify the concept and computation of depreciation.

[****]

Although the taxpayer won this case, the Commissioner has nonacquiesced, again focusing on the indeterminable lives of the violin bows. *See 1997-1 I.R.B. 6.* Taxpayers should be careful taking an aggressive position in a similar circumstance.

8.01(a)(I)(B) Liddle v. Commissioner

Liddle[30] was a companion case to *Simon*. It involved an expensive Viol, also used by a professional musician. The Tax Court again permitted depreciation because the instrument was actually used in a trade or business. Several judges filed strong dissents to both cases. Judge Beghe's dissent in Liddle is particularly noteworthy:

> Having concurred in the result of the companion case, *Simon v. Commissioner*, 103 T.C. 247, 267 (1994) (Beghe, J., concurring), I respectfully dissent in this case. I believe the holdings of the trial judges in these two cases can be harmonized on a narrower ground, and I would uphold the findings and holdings of Judge Laro in *Simon* and of Special Trial Judge Powell in this case. The differences in the findings of fact in the two cases make it unnecessary to adopt either the broadly stated interpretation of section 168 set forth in the majority opinions, or the overly restrictive views espoused by the dissents.
>
> Judge Laro, the trial judge in *Simon*, found that the Tourte bows actually did and do suffer substantial wear and tear that will render them unplayable over some indeterminate time. The bows are therefore subject to exhaustion that arguably characterizes them as "property of a character subject to the allowance for depreciation." On the other hand, Special Trial Judge Powell, whose findings of fact in this case were adopted by Judge Laro and the majority that rejected Special Trial Judge Powell's proposed contrary holding, not only concluded that the bass viol did not have a "determinable useful life", but in so doing found that the bass viol had not suffered such

[30] 103 T.C. 285 (1984)

> wear and tear as would lead to any curtailment of its useful life as a playable instrument.[31]

8.01(a)(II) Questions

1. Taxpayer owns and operates golf courses. It expends substantial funds on landscaping. To what extend are such costs depreciable?

   a. Suppose the Taxpayer spends money improving and leveling the tee boxes and re-doing the greens. Would these be improvements to the land and thus non-depreciable?

   b. Suppose, instead, that Taxpayer operates an office building and plants trees and shrubbery near the building for beautification. Would any amount be depreciable?

2. The *Simon* majority opinion (and the Commissioner's argument) focuses a good deal on the useful lives of the violin bows. Is this the primary question in this case? Was it even in dispute whether the violins had a *determinable* useful life or was the primary question whether the violin bows were "subject to wear and tear?" How important and how different are the two questions.

3. How important to the *Simon* decision was the fact that the violin bows actually *appreciated* in value from the date of purchase to the time the dispute arose? Does this show that the bows are not subject to wear and tear?

8.01(b) Obsolescence

Reg. § 1.167(a)-9

Obsolescence can occur even if a piece of property's physical condition does not change but technological advances or changes in the economy make the item less valuable than when it was acquired.[32] This situation is most easily demonstrated in the fast-paced computer industry where a computer bought five years ago is nearly worthless because of the increased speed, decreased size, and other superior factors of computers than can be purchased today at lower costs than five years ago. What about property that normally would be subject to wear and tear if used for traditional purposes but because of a specialized nature of the business, the items are preserved? Would these items still be subject to an allowance for obsolescence even though the property has not been subject to the wear and tear that is normally associated with the property?

8.01(b)(I) Selig v. Commissioner

SELIG v. COMMISSIONER
T.C. Memo 1995-519

HALPERN, Judge: [****]

In 1983, petitioner opened a limousine leasing business under the name "Scott's Limo & Leasing" (Scott's Limo). [****] In 1987 and 1988, petitioner purchased the following exotic automobiles (the exotic automobiles) to be exhibited at car shows:

Year of Purchase	Type	Cost
1987	Lotus Pantera	$ 63,000

[31] Id. at 306 (Beghe, J. *dissenting*).
[32] Treas. Reg. § 1.167(a)-9.

Year of Purchase	Type	Cost
1987	Lotus Espirit	$ 48,000
1988	Gemballa Ferrari Testarossa	$ 290,453

During the years in issue, Scott's Limo displayed the exotic automobiles at car shows and earned fees for doing so. [****]

The exotic automobiles did not have license plates and were not set up to be used on the street. They were not driven and were used exclusively for car shows or related promotional photography.

Petitioners claimed the [****] depreciation deductions with regard to the exotic automobiles [*****].

Exotic automobiles are state-of-the-art, high technology vehicles with unique design features or equipment. Petitioner owned exotic automobiles that, during 1987 through 1990, he exhibited for a fee. The fees earned by petitioner for such exhibitions were substantially less than the depreciation deductions petitioner claimed with respect to such automobiles.

The parties do not dispute either that (1) the exotic automobiles are tangible property or (2) the exotic cars were used in petitioner's trade or business. Also, they do not dispute any aspect of applying section 168 to the exotic automobiles if we conclude that section 168 is applicable to the exotic automobiles. The dispute between the parties is whether a depreciation deduction is allowable under section 167(a) for automobiles held in a pristine condition and exhibited for a fee.

The long and the short of it is yes, provided the automobiles are subject to obsolescence. We have found that the exotic automobiles were state-of-the-art, high technology vehicles with unique design features or equipment. We have no doubt that, over time, the exotic automobiles would, because of just those factors, become obsolete in petitioner's business. The fact that petitioners have failed to show the useful lives of the exotic automobiles is irrelevant. Cf. Liddle v. Commissioner, 103 T.C. 285, 296-297 (1994), affd. 65 F.3d 329 (3d Cir. 1995); Simon v. Commissioner, 103 T.C. 247 (1994), affd. F.3d (2d Cir. 1995).[****]

[I]f petitioners can show that the exotic automobiles were subject to exhaustion, wear and tear, or obsolescence, they are entitled to the depreciation deductions that they claimed.

Petitioners do not seriously attempt to prove that the exotic automobiles were subject to wear and tear in the sense of physical deterioration. Indeed, they state that obsolescence is the principal basis for their claim of depreciation deductions. Respondent argues that petitioners have failed to prove that the exotic automobiles are subject to obsolescence. [****]

Under section 168(a), we need not concern ourselves with the second part of that test (when obsolescence would occur), since we need not determine the actual useful life of the property. As to the first part of the test, we assume that the "ordinary" useful life of the exotic automobiles in petitioner's trade or business (as show cars) was indeterminable. Petitioners have introduced no evidence from which we could find that the exotic automobiles were subject to wear and tear or exhaustion. Nevertheless, we are convinced that the exotic automobiles had a limited useful life as show cars. [****]

We do not need to determine the precise useful life of the exotic automobiles. Indeed, petitioner testified that some of the exotic automobiles might be shown for many years. Nevertheless, we are convinced that the exotic automobiles, precisely because of their nature as state-of-the-art, high technology vehicles, had a useful life as show cars shorter than their ordinary useful life and, thus, suffered obsolescence. We so find.

[****] In Simon v. Commissioner, 103 T.C. at 264, we acknowledged that, to qualify as recovery property, in the case of a passive business asset that suffered no wear and tear, a taxpayer would have to prove a determinable useful life. [****] Once a taxpayer establishes that an asset is subject to exhaustion, wear and tear, or obsolescence, however, we need not concern ourselves with the particular useful life of the asset. Liddle v. Commissioner, 103 T.C. at 296-297; Simon v. Commissioner, supra. It is of course possible that the exotic automobiles might some day become museum pieces. Respondent suggests that they were museum pieces, but she offers no evidence to support that claim. We are satisfied that the exotic automobiles were show cars, which, because of obsolescence, had a limited useful life, not museum pieces with an indeterminable useful life. [****]

8.01(b)(II) Harrah's Club

HARRAH'S CLUB v. THE UNITED STATES
1981 U.S. Ct. Cl. 1425
May 22, 1981

SCHWARTZ, Trial Judge:

The issue in this suit for a refund of income taxes is the propriety of the deduction from gross income, as a current expense or as an allowance for depreciation, of the taxpayer's costs of restoring antique automobiles.

The taxpayer, plaintiff Harrah's Club of Reno, operates hotels and gambling casinos in Reno, Nevada. To attract patrons, taxpayer maintains a museum of antique automobiles and other vehicles, known as Harrah's Automobile Collection (HAC). Approximately 1,000 antique vehicles are exhibited, many of them restored to original or near original condition. HAC employs 150 people, and is housed in a 10-acre complex which includes showrooms, restoration workshops and an extensive research library for use in restoration planning.

> The HAC is successful in its intended purpose. Almost 200,000 persons visited it during taxpayer's fiscal year 1971, the year involved. HAC vehicles, moreover, occasionally participate in antique auto races or are otherwise displayed in competitions for appearance and perfection in restoration. The 94 restored vehicles whose costs are involved in this case are often the subject of widely publicized photographs. All this brings much publicity for taxpayer's enterprises.

The restoration of antique autos seeks to replicate original appearance. The most elaborate restoration recreates the original automobile in every particular, including operational ability. The restorations whose costs are in issue are so detailed and painstaking, taxpayer says, that the total cost of the restored vehicle is greater than its market value. The Government does not dispute this proposition, and it is accepted, although the assumed market would seem to exclude those who might believe that the publicity value of such highly restored cars and the recognized premium value of HAC-restored cars compensate for their excess of cost over market value. If there are no such buyers, it may be that there is no market for cars restored in the HAC manner.

[****]

Taxpayer maintains that the excess restoration costs are current expenses of repair, deductible as ordinary and necessary expenses under section 162 of the Internal Revenue Code. The precise contention is that the difference between basis, i.e., original cost plus costs of restoration, and market value after restoration--which taxpayer calls "excess restoration costs"--is the cost of an ordinary repair and therefore a deductible business expense. This proposition is without support in tax code or case law.

Section 263 of the Code, on capital expenditures, prohibits deductions for "[a]ny amount paid out... for permanent improvements or betterments made to increase the value of any property." Deductible repair costs are defined in the regulations as "[t]he cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition." Conversely, "[r]epairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property" may not be deducted, but are to be capitalized and depreciated in accordance with section 167 of the Code. Treas. Reg. § 1.162-4 (1958). By the test of the foregoing descriptions of what is and what is not a deductible expense, the cost of the restorations here involved are not deductible costs of repair, but capital items, nondeductible except insofar as they are depreciable.

The HAC restorations involve extensive showroom-or-better quality replacements and additions of body, engine, upholstery, lights and paint. Each restoration is preceded by historical research into the specifications of the original vehicle. Restoration is then carried out with meticulous attention to every detail revealed in the research, at great cost. Upholstery and paint are reproduced as they were originally. Entire portions of the body and engine, down to individual engine parts, are renewed, to the extent of making castings, from borrowed samples of parts whose replacements cannot be found; the taxpayer's word for this last is "remanufactured." HAC restorations have such an excellent reputation for quality that they add a premium value to the HAC-restored vehicle.

These restorations are held to be "permanent improvements or betterments" which are made to increase the value (§ 263, I.R.C) and which in fact do "materially add to the value" of the vehicles. They are also "in the nature of replacements," for they "arrest deterioration and appreciably prolong the life" of the vehicles. Treas Reg. § 1.162-4, note 1. Better methods for arresting deterioration are used in the restoration than were used in the original manufacture.

By no stretch of imagination can the restorations be described as the "incidental repairs" deductible under section 1.162-4 of the regulations as intended to "keep" [the vehicle] in an ordinarily efficient operating [i.e., prerestoration] condition." Note 1. Before restoration, the vehicles are old cars in every state of dilapidation. On restoration they become strikingly handsome antiques in mint condition, in appearance or in every respect, mechanical and otherwise. Before restoration they were admittedly capital assets and on restoration they are doubly capital assets because they have been very substantially improved, bettered, increased in value and given a prolonged life.

Accordingly, the costs of restoration, whether bringing the vehicle's total cost above or below its value in the market, cannot be deducted, and must rather be capitalized.

[****]

If not deductible, the taxpayer argues alternatively, then the "excess restoration costs" should be held depreciable over the period in which the restoration can be estimated to be useful in the business of the taxpayer.

Depreciation, in tax law, is "the exhaustion, wear and tear, and obsolescence of property used in the trade or business" of the taxpayer. The depreciation deduction is the annual reasonable allowance for such exhaustion, wear and obsolescence. The aggregate of the depreciation deductions is the difference between cost or basis and salvage value at the end of the estimated useful life of the depreciable property. I.R.C. § 167(c); Treas. Reg. § 1.167(a)-1 (1964).

Taxpayer would separate the excess restoration costs, said to be a "separate and identifiable asset," from the remainder of the restoration costs and from the cost of the unrestored vehicle. Then, on the basis of testimony by its promotion manager, taxpayer ascribes to this identified asset an estimated useful life of five, or if not five, then ten years.

Only the first of several difficulties with this agreement is that the excess restoration costs are not an asset capable of separation from the rest of the costs or the unrestored vehicle. Costs, of course, are not an asset. As for the restoration itself, it pervades the vehicle. Moreover, each restoration is different. Some restorations replace body parts or frames, some, floor boards, some, upholstery, fenders, engine covers, lights, tires, paint. Most or all replace a unique combination of these elements.

Once accomplished, a restoration cannot be severed from the vehicle. Nor can it be separately identified. In this respect, a restoration is wholly unlike an identifiable component of a building such as a plumbing or electrical system, as in Shamberg v. Commissioner, 33 T.C. 241 (1959).

Further, neither the restored vehicle nor its restoration has a useful life, in taxpayer's business, capable of being estimated. Under the regulation on depreciation, a useful life capable of being estimated is indispensable for the institution of a system of depreciation. Treas. Reg. § 1.167(a)-1(b)(1964). Property with an indeterminate life is nondepreciable. Niagara Mohawak Power Corp. v. United States, 207 Ct. Cl. 576, 585, 525 F.2d 1380, 1386 (1975), reh. denied, 207 Ct. Cl. 594 (1976). Restoration increases indefinitely the life of an antique car. One vehicle restored 30 years ago is on display at HAC, without deterioration beyond the need for replacement of tires. No restored car in the Collection has ever needed re-restoration, been withdrawn from display because of deterioration or is likely to be so withdrawn. None has been sold, with one exception for a duplicate no longer desired. Even unrestored vehicles have without deterioration been on display at the Smithsonian Institution, in a harsher environment than HAC's showrooms, for 40 to 50 years.

Those few HAC cars occasionally entered in actual races are rarely so used and are, before and after the race, given ordinary repair and maintenance. Any damage to restored cars in connection with competitions of antique autos is a matter for repair, not depreciation. Taxpayer has stopped the occasional use of a few restored cars to transport important patrons to and from the Collection; findings cannot be made as to the duration of the practice or its effect.

The evidence establishes that there is no limit on the useful life of a restored car or other vehicle as a museum object. There is good reason to believe that the 94 restored vehicles involved in this case will, with only normal maintenance, have an indefinite life in the taxpayer's trade or business, a museum. The vehicles are kept in a humidity-controlled environment and need remarkably little repair or maintenance beyond occasional mending of a crack in wood part.

This is not to say that the vehicles will last forever. It is to say that no limit can be put on the use of the vehicles as museum objects, and thus that the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business is indefinite. See Treas. Reg. § 1.167(a)-1(b).

[****]

Recognition of both a short promotional life and a long museum life would presumably require a division into two parts of the basis of the restored vehicle, and different periods of depreciation for the same asset as useful in taxpayer's business for different purposes. Such a bifurcation would create a phenomenon unknown in tax law. Even if conceivably valid, there is no basis in the record for an allocation as between the asset as a museum display object and as a promotional object.

A variation on the assertion of a short life is that excess restoration cost is an intangible, to be depreciated over its five-year life as a promotional asset. In taxpayer's words, "This analysis reconstitutes the restoration costs into the price not for paint, leather, wheel bearings, etc., but for a promotional display with a useful life derived from novelty, perfection and other attributes appealing to the public for off-site and periodical promotion." The value, that is, the novelty, is said to be exhausted in five years "and then [taxpayer continues] the vehicle is reduced to a shopworn but otherwise authentic representation of the original version of nuts, bolts and paint comprising an operable vehicle."

No amount of such fanciful "reconstitution" can change a restored car or a restoration into an intangible. The tangible quality of the restoration is graphically described by taxpayer itself, in its argument for an investment credit: "The restoration... consists of placing new tangible property on old tangible property; viz., a new fender... on an old vehicle,...." etc. The assertion of a five-year life, even as a promotional device, has already been commented on. The vehicle is at no time, much less in five years, reduced to a shopworn condition.

Once the useful life of the vehicle as an asset used in taxpayer's business is seen to be indefinite, the asset of course cannot be given a salvage value as of the end of an estimated period of usefulness. Salvage is the amount realizable at the end of the useful life in taxpayer's business. These vehicles will have as much, if not more, value in the future as now. Without a salvage value, there can be no allowance for depreciation.

The taxpayer seeks to avoid the problem of a salvage value with the remarkable statement that "Since [the] excess restoration costs have no value when completed they can have none when exhausted ten years hence. Thus the salvage value of the excess restoration costs, constituting a separate and identifiable asset, is zero." Taxpayer has itself contradicted this assertion. Speaking of these same excess restoration costs, taxpayer says, "This is a value which [taxpayer] creates for its own use, which it does use, and which is usable particularly by itself." Again, "The value is a promotional value, of particular and unique use to a business which cannot advertise its principal source of revenue, gaming, in its principal markets."

The excess restoration costs have, indeed, a double value. As a part of the restoration costs, they matter-of-factly increase the value of the unrestored car by making it a more attractive display, better able to draw patrons to taxpayer's hotels and casinos. (The trial judge found the restored cars fascinating.) And by the very extravagance or excessiveness of their costs, the restorations add a cachet to the HAC vehicles and thereby further promote the taxpayer's business. Barnum was neither the first nor the last to exploit the drawing power of the phrase, "Brought to you at g-r-r-r-reat and untold cost."

Another contention of the taxpayer, mentioned and then seemingly withdrawn, is that the entire cost of restoration, not merely the excess restoration costs, is depreciable. The ground offered is that after five or ten years, the salvage value of the entire restored car is zero. This contention, if made, is rejected on the grounds already stated concerning the salvage value of the excess restoration costs.

Given the indefinite life of the restored vehicles, if a value at the end of the period of usefulness were to be stated, it would be the same value as at the beginning. Values of these restored vehicles, incidentally, have steadily increased to the tax year involved, 1971, and as of that time were expected by the expert witnesses to continue to increase.

For all these reasons, a depreciation allowance deduction for the excess restoration costs is out of the question. [****]

8.01(b)(III) Questions

1. *Selig* ruled in favor of the taxpayer while *Harrah's Club* ruled against the taxpayer. Both cases involved the display of unique cars. Are the cases distinguishable? Is the taxpayer's focus in *Harrah's Club* on "the excess restoration costs" above the fair market value at the time of restoration a primary difference between the two cases? Did the court dismiss this argument because the cars actually tended to appreciate in value or because this cost did not necessarily make the property of a depreciable nature? Is the difference that the cars in *Selig* decreased in value while the cars in *Harrah's Club* increased in value? Or is the difference the certainty in the cars determinable lives?

2. The Harrah's Club court was concerned that the excess restoration costs were not a separate, distinct asset. Would the INDOPCO decision alter this analysis?

8.01(c) Property Used in a Trade or Business or for the Production of Income

Although property may be subject to wear and tear, the taxpayer's use of the property may disqualify it from being depreciated. The property must be used in a trade or business or for the production of income. While not defined in the Code, the phrase "trade or business" generally connotes an activity that generates deductible expenses under section 162. In contrast, an "activity for the production of income" is one that generates deductions under section 212. A third type of activity – a "transaction for profit" – is one described in relation to section 165 losses. It does not generate depreciation expenses.

Items used solely for personal use are not depreciable. For example, automobiles, homes, and home furnishings are non-depreciable if used solely for personal-use.[33] However, if these items were used in a trade or business, a depreciation deduction could be allowed. Therefore, office furniture would be depreciable while home furniture would not.

8.02 Depreciable Basis

§§ 167(c)(1); 179; 1011; 1012;1016(a)(2)

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[33] Reg. § 1.167(a)-2.

Reg. § 1.167(g)-1

8.02(a)General Basis Rules

Once an item has been determined to be depreciable, the starting point for determining any deduction is the amount available for the deduction. The basis for determining the amount of deprecation is the property's adjusted basis for determination of gain or loss if the property were disposed of.[34] This adjusted basis is its cost basis under section 1012, with proper adjustments under section 1016 for any charges made against the property.[35] In the case of a purchased item, the depreciable basis would be the amount paid for the property, with adjustments made periodically for depreciation and other expendable charges. In the case of an item that has not previously been used in a trade or business or for the production of income, *e.g.* a gifted item or an item previously used by the taxpayer for personal use only, the depreciable basis is the lesser of the adjusted basis or the fair market value on the date the item is converted to business use.[36]

Therefore, the hypothetical office furniture purchased for $450,000 would have an adjusted basis of $450,000 at the time of purchase.

8.02(b) Section 179 Election to Expense Costs

Section 179 is another exception to capitalization. In contrast to those covered in Section 5 above, this exception applies to tangible property. Congress intended the deduction to ease the burden of smaller businesses of buying new property and thus encourage the development of capital. Taxpayers may elect to treat the cost of any section 179 property as an expense when the property is placed into service.[37]

Section 179 property is depreciable tangible personal property, certain depreciable real property, or depreciable computer software, all which must be purchased for the use in an active trade or business.[38] Since the property must be purchased, section 179 property does not include property acquired by gift, devise, or through certain related parties under section 267.[39] If property qualifies for section 179 treatment, the taxpayer must elect to have section 179 apply on the tax return for the year in which the property is placed in service and must specify the property to which the taxpayer is electing to have section 179 apply.[40]

Significant limitations apply to the amount a taxpayer may expense. Through 2008, the maximum expense is $100,000, increased by inflation adjustments under section 179(b)(5). After 2008, the limitation is scheduled to drop to $25,000. Other limitations apply based on the total amount of section 179 property placed into service and based on the taxpayer's income derived in any trade or business.

8.02(c) Questions:

1. Apply section 179 to the initial hypothetical listed above.

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[34] § 167(c)(1).
[35] § 1011(a).
[36] Reg. § 1.167(g)-1.
[37] § 179(a).
[38] § 179(d)(1).
[39] § 179(d)(2).
[40] § 179(c)(1).

2. Is property held for the production of income subject to section 179 treatment?
3. If a taxpayer's section 179 election is limited by the amount of his trade or business income, may he carry over the excess? For how long?
4. Does section 179 apply to used property or only to new property?

8.03 Amount of Depreciation

§ 168

8.03(a) General MACRS Depreciation—Tangible Property

The title to section 168 is "accelerated cost recovery system" or ACRS. Under the 1986 Act, this is generally referred to as MACRS (modified accelerated cost recovery system) because it modifies the ACRS under prior law. Tangible property is depreciated under this system. For example, the office furniture described above would fall under this general category. Under current law, the amount of depreciation for each time period is computed by using the applicable recovery period, the applicable depreciation method, and the applicable convention.[41]

8.03(a)(I) Determination of Depreciable Lives—the Applicable Recovery Period

The applicable recovery period is the period over which an item can be depreciated - in a rough sense the property's useful, or depreciable, life. For purposes of determining the applicable recovery period, section 168(c)(1) places is placed into different property classes.

The last four listed are fairly straight-forward in their meanings though one should be careful to ensure the words' plain meanings are the same as defined in the Internal Revenue Code.[42] The class definitions for the other categories is more arbitrary. The Code lists several pieces of property that are classified specifically within the 3- to 15-year property definitions.[43] Items not falling in these specific classifications must be classified according the property's class life, which is meant to be indicative of the property's expected useful life.[44] A further table in section 168(e)(1) lists this class life.

While the definition of class life is somewhat vague,[45] the Service has listed several assets in asset classes with corresponding class lives so that there is less confusion as to which class life each asset belongs.[46] When determining an asset's class life, one should be very careful to not assume that this is the asset's depreciable life. For example, office furniture in asset class 00.11 has a class life of 10 years. However, this is not 10-year property; it is 7-year property under the definition of the Code and therefore has a recovery period of 7 years. Note that if the class life is an actual reflection of the property's useful life, this methodology is consistent with Congress' goal of encouraging investment by depreciating assets over a period less than that of the property's actual economic life.[47]

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[41] § 168(a).
[42] See IRC § 168(e)(2), (4), and (5) for exact Code definitions.
[43] See IRC § 168(e)(3).
[44] General Explanation of the Tax Reform Act of 1986, (May 4, 1987), pg 103.
[45] §168(i)(1)
[46] These listings are available in Rev. Proc. 87-56, which is clarified and modified in only a very few specific assets by Rev. Proc. 88-22.
[47] General Explanation of the Tax Reform Act of 1986, (May 4, 1987), pg 103.

8.03(a)(II) Determining the Applicable Depreciation Method

The applicable depreciation method is the amount of the depreciable basis that the taxpayer may depreciate per year. For purposes of determining this amount, the property is generously assumed to have no salvage value.[48] The methods used are the 200% declining balance (DB) method, the 150% DB method, or the straight-line method.[49] The 200% DB method (switching to straight-line method when straight-line would produce a larger depreciation deduction) is the default method that applies to all property that does not fall into the two other groups.[50] This method provides a relatively large deduction in the beginning years that decreases over time. It is the most generous depreciation method available and was enacted in part to provide incentives for capital formation and to ease some of the impact of the repeal of the investment tax credit.[51]

The 200% DB method involves taking 200% of an annual straight-line depreciation based on the asset's class life and basing the deduction on the asset's unrecovered cost, not its original depreciable basis.[52] Therefore, the formula for such a system is:

$$D = (B - P) \times 2/T$$

where D is the current year's depreciation, B is the original basis of the property, P is all prior depreciation taken, and T is the applicable recovery period for the asset.

The 150% DB method applies to 15- and 20-year property, certain farming property, and property as to which the taxpayer elects.[53] The 150% declining balance is simply the 200% DB method inserting 1.5 for 2 in the above formula.

The straight-line method applies to residential rental property, non-residential rental property, any railroad grading or tunnel bore, water utility property, and fruit-bearing trees.[54] The straight-line method allows the same depreciation each year based on the asset's applicable recovery period and its original basis.[55] Thus, the formula for such a system is:

$$D = B/T$$

where D is the current year's depreciation, B is the original basis of the property, and T is the applicable recovery period of the asset.

8.01(a)(III) When to Begin Depreciating—the Applicable Convention

In a perfect system, the Code would allow depreciation only for the specific days a taxpayer used the property. For example, in the case of the hypothetical office furniture Taxpayer only had the furniture in service during 2005 from October 4 to December 31: a total of 88 days. Hence, ideally, Taxpayer would take 88/365ths of the depreciation otherwise allowed for the year 2005. Similarly, Taxpayers who dispose of property would ideally deduct depreciation in the year of disposition only for the days they actually used the assets.

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[48] § 168(b)(4).
[49] § 168(b).
[50] § 168(b)(1).
[51] General Explanation of the Tax Reform Act of 1986, (May 4, 1987), pg 98.
[52] Treas. Reg. § 1.167(b)-2(a).
[53] § 168(b)(2).
[54] § 168(b)(3).
[55] Treas. Reg. § 1.167(b)-1(a).

Such an ideal system has previously been used in the U.S. Currently, however, the Code offers applies a much simpler systerm: the applicable convention. This treats acquisitions and dispositions as having occurred on a different day than they may have actually occurred.[56]

The general rule is to apply the half-year convention: to treat all property placed into service or disposed of during the taxable year as having occurred at the midpoint of the taxable year.[57] In the case of nonresidential real property, residential rental property, and any railroad grading or tunnel bore, the applicable convention is the mid-month convention, treating all property placed into service or disposed of during a given month as having occurred at the midpoint of the month.[58]

8.01(a)(IV) Questions:

1. Create a section 168 depreciation schedule for the hypothetical office furniture.
2.
3.
4.

8.03(b) The Section 280F Limitation

§ 280F

Section 280F limits the amount of depreciation otherwise allowed for luxury automobiles. The title of the section states that it is a limitation on luxury automobiles but it limits depreciation on any passenger automobile, encompassing any 4-wheeled vehicle manufactured primarily for use on roadways which has a weight of 6,000 pounds or less.[59] The section also applies to "listed property."

8.03(b)(I) Questions:

1.
2.
3.

8.03(c) Alternative Depreciation System (ADS)

Certain properties may not use the general MACRS depreciation and instead must use the ADS. This involves the straight-line method of depreciation, the same applicable convention as determined in the case of MACRS property, and longer recovery periods, as provided in section 168(g)(2).

Taxpayers must adopt the ADS for tangible property used predominantly outside the United States, tax-exempt use property, tax-exempt bond financed property, and property imported from a country that the President deems by an Executive order to engage in unjustifiable restriction of U.S. commerce.[60] In addition, it applies to listed property (as defined

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[56] § 168(d).
[57] § 168(d)(1), (4)(A).
[58] § 168(d)(2), (4)(B).
[59] § 280F(d)(5)(A).
[60] § 168(g)(1)(A)-(D), (6).

in 280F(d)) not predominantly used in a trade or business.[61] Finally, taxpayers may irrevocably elect to use the ADS for any specific piece of nonresidential real property or residential rental property and any class of any other depreciable property placed into service for the taxable year.[62]

8.03(d) Depletion—Oil, Natural Gas, and Mines

A related concept to the allowance for depreciation is an allowance for depletion. When a machine is used in a trade or business, a reduction in value is caused by that machine's wear and tear over time. When an oil field is drilled or a mine is excavated, the reduction in value to the property is caused by the removal of those natural resources from the property. A different set of rules determines proper treatment in these cases of depletion.

A "reasonable allowance" for depletion and depreciation of improvements is allowed for mines, oil and gas wells, and other natural deposits.[63] In most cases, the allowance for depletion will be based upon the greater of the adjusted basis of the property ("cost depletion") or a certain percentage of gross income ("percentage depletion").[64] If the cost depletion method is used, the amount of depletion is roughly determined by dividing the adjusted basis of the property by the mineral units remaining as of the beginning of the taxable year and multiplying the result by the number of units sold for the year.[65] Depreciation of improvements is made in the same manner as allowed under section 167.[66] The percentage depletion method is computed by multiplying the gross income from the property (except for rents and royalties) by between 5% to 22%, depending on the specific property, but the deduction taken cannot exceed 50% of the taxpayer's taxable income from the property (100% in the case of oil and natural gas).[67]

8.03(e) AMT Adjustments

§§ 55, 56, 168(k)

Even though a very generous depreciation deduction may be allowed under the standard tax system, the alternative minimum tax (AMT) system may apply to subject taxpayers to a whole new set of rules where a previously-allowed deduction is now disallowed.[68] The AMT generally imposes a different set of rules for determining depreciation in the case of taxpayers subject to the AMT.[69] However, in the case of section 168(k) qualified property, the property is not subject to the AMT rules and the depreciation deduction is computed under the rules of section 168.

8.04 Adjustments to Basis

§ 1016(a)(2)

Reg. § 1016-3; 1.179-1(f)

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[61] § 280F(b)(1), (3).
[62] § 168(g)(1)(E), (7).
[63] § 611(a).
[64] Reg. § 1.611-1(a)(1).
[65] Reg. § 1.611-2(a)(1).
[66] Reg. § 1.611-5(a).
[67] § 613(a), (b). For actual percentages, see § 613(b).
[68] § 55, 56.
[69] § 56(a)(1).

Depreciation has an impact on the property's basis. This occurs for depreciable property whether depreciation is taken or not: per section 1016(a)(2) basis decreases by the greater of the amount allowed for depreciation or the amount allowable. The amount allowed includes the depreciation claimed on the taxpayer's tax return and which the Service takes no steps to challenge.[70] The amount allowable is the amount that the taxpayer could rightfully have taken for the year whether or not actually claimed and whether or not it would have reduced the taxpayer's taxable income.[71] If the taxpayer fails to take any depreciation, the amount allowable is determined under the straight-line method.[72]

8.04(a) Questions:

1. Compute the adjusted basis at the end of each period for the depreciation schedule created above.
2. Suppose the taxpayer failed to depreciate the office furniture. What would be his adjusted basis at the end of 2005?
3. Taxpayer's cost basis in machinery used in his trade or business was $100,000. Assume that proper depreciation under section 168 would be $60,000 through the end of the current year. Taxpayer, however, actually deducted $90,000 of depreciation through the end of the current year. What is taxpayer's adjusted basis under section 1016?
4. Taxpayer added substantial landscaping to its golf course at a cost of $250,000. It incorrectly depreciated this non-depreciable capital cost over a period of five years. What is its adjusted basis in the landscaping?

8.05 Depreciation Recapture

If property depreciates over a period of time but the depreciation method is either too generous in the beginning years compared to the actual reduction in value, or the recovery period is shorter than the useful life, the deductions taken will exceed the actual reduction in the value. If the asset were then sold, a gain would result. Section 1001 makes that gain taxable. However, without recapture provisions, the gain would section 1231 gain and often would be taxed at capital gains rates. This would be inconsistent with the ordinary depreciation deduction. This inequity between tax rates is what concerned Congress when it enacted section 1245 and other depreciation recapture provisions.[73]

8.05(a) Section 1245 property

§ 1245

Reg. §§ 1.1245-1(a)-(d); 1.1245-3; 1.1245-2; 1.1245-6

Depreciable property used in a trade or business is not a capital asset;[74] instead, it is a section 1231 asset. Gains and losses from the sale or exchange of such property are not automatically capital; however, section 1231 *may* ultimately treat them as capital gains and losses. Depreciable property used in an activity for the production of income is indeed capital in nature and thus generates capital gain or loss on its sale or exchange.

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[70] See Virginian Hotel Corp. v. Helvering, 319 U.S. 523, 527 (1941).
[71] Reg. § 1.1016-3(b)(2).
[72] § 1016(a)(2), flush.
[73] S. Rep. No. 1881, 87th Cong.., 2d Sess. (1962), 1962-3 C.B. 801.
[74] § 1221(a)(2).

In both instances, however, section 1245 steps in to provide additional characterization rules. Section 1245 property includes depreciable tangible personal property and some types of real and intangible property. Specifically, it includes "any property which is or has been property of a character subject to the allowance for depreciation provided in section 167."[75] That language prompts an interesting question: what if a taxpayer depreciates non-depreciable property? The answer is not entirely clear. On its face, section 1245 would not apply. As explained in Chapter ______ (dealing with changes of accounting method), the government would likely claim that the improper depreciation amounted to an accounting method. Then, any failure to apply section 1016 basis reduction and subsequent section 1245 recapture would amount to an impermissible change of accounting method.

When disposed of, the depreciable property is subject to depreciation recapture. While section 1245 applies to most dispositions, it specifically excludes dispositions by gift or inheritance, tax-free transactions involving transfers of property to corporations and partnerships, and involuntary conversions and like-kind exchanges to the extent that the section 1245 gain exceeds the gain recognized.[76]

On disposition, the taxpayer must recognize *as ordinary income* the amount by which the adjusted basis of the property is exceeded by the lower of (a) the recomputed basis or (b) <u>*either*</u> the amount realized in the case of a sale, exchange, or involuntary conversion <u>*or*</u> the fair market value of the section 1245 property.[77] Generally, a property's recomputed basis is its adjusted basis plus any amounts allowed or allowable for depreciation or amortization, and any amount allowed and allowable as an expense under section 179.[78] If the taxpayer shows that the amount of allowed is less than the amount allowable, the taxpayer is permitted to calculate the recomputed basis by the amount allowed.[79]

8.05(a)(I) Questions:

1. Assume that Taxpayer acquired the furniture as described above in 2005 and sold it on June 2, 2006 for $120,000, taking all allowable deductions and making all elections. What is the amount and character of his gain, if any?
    a. In the alternative, Taxpayer sold the property for $500,000. How would your answer change?
    b. In the alternative, Taxpayer sold the property for $100,000. How would your answer change?
    c. In the alternative, Taxpayer exchanged the property in 2006 for new furniture used in his trade or business. How would your answer change?
    d. In the alternative, Taxpayer gave the furniture to his Son in 2006. Son used the property for personal purposes and later alternatively sold the property for $

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[75] § 1245(a)(3).
[76] § 1245(b)(1)-(4).
[77] § 1245(a)(1).
[78] § 1245(a)(2)(A), (C).
[79] § 1245(a)(2)(B).

100,000, $120,000, and $500,000. What is the amount and character, if any, of Son's gain or loss? Would Taxpayer have any gain or loss?

e. In the alternative, Taxpayer died in 2006 when the furniture had the alternative values of $100,000, $120,000, and $500,000. Son inherited the property and used it for personal purposes. What would be son's basis in the property? Would section 1245 apply to any subsequent sale by Son?

2. Taxpayer purchased valuable artwork (or an antique car, or an expensive violin) for his trade or business at a cost of $50,000. He fully depreciated the property under section 168. All years in which depreciation deductions were taken are now closed. This year, Taxpayer sold the property for $150,000. What is the character and amount of any gain on the sale?

8.05(b) Section 1250 Property

§ 1250

Section 1250 property is any depreciable real property not covered by section 1245.[80] It includes three types of property: (1) intangible real property such as a leasehold of land (2) a building or its structural components and (3) any other real property other than agricultural or horticultural structures and certain types of tangible real property used in manufacturing, production, extraction, or in the business of transportation, communications, electrical energy, gas, water, or sewage disposal services.[81] Section 1250 does not apply to dispositions by gift or inheritance, in tax-free transactions involving transfers of property to corporations and partnerships, or to the extent that the section 1250 gain exceeds the gain recognized in the case of involuntary conversions and like-kind exchanges.[82]

Generally, the taxpayer must recognize as ordinary income the lower of (1) the difference between what depreciation was taken and what would have been taken under the straight-line method or (2) the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of the section 1250 property (in the case of any other disposition), over the adjusted basis of such property.[83] However, the application of section 1250 is somewhat limited since currently real property is required to be depreciated under the straight-line method.[84] Therefore, the difference between straight-line depreciation and actual depreciation will be zero in these cases.

8.05(c) Section 179 Property

§ 179(d)(10)

For many dispositions of section 179 property, section 1245 provides the mechanism for depreciation recapture. For example, if a Taxpayer elects section 179 on business property which cost $20,000, his basis would drop to zero under Reg. Section 1.179-1(f). If he were to sell the property for $15,000, he would recognize gain of $15,000, all of which would be characterized as ordinary income under section 1245.

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[80] § 1250(c).
[81] Treas. Reg. §§ 1.1245-3(c)(1); 1.1250-1(e)(3)(i).
[82] § 1250(d)(1)-(4).
[83] § 1250(a)(1)(A), (b)(1).
[84] § 168(b)(3)(A), (B).

If he gave the property away or otherwise ceased to use it predominantly in an active trade or business, however, section 1245 would not apply. This is because section 1245 applies only to specific dispositions – excluding gifts – and does not apply to mere changes of use. Section 179(d)(10), however, would be triggered by the change of use.

8.05(c)(I) Questions

1. Taxpayer acquired furniture for use in his busines in 2005 at a cost of $40,000. He elected section 179 for the full amount. In 2007, when the property was worth $30,000, he decided to take the furniture home for personal use. What is the amount, if any of his income as a result?
    a. In the alternative, the property was worth $55,000 when he took it home. Would your answer change?
    b. In the alternative, he gave the furniture to his son in 2007. How would your answer change? Do you need to know whether Son uses the property in a trade or business?
    c. In the alternative, he sold the property for $55,000. How would your answer change?
    d. In the alternative he contributed the property to a public charity described in section 170(b)(1)(A)(iii)[a school]. How would your answer change?
    e. In the alternative he contributed the property to a partnership with his Son. The partnership is involved in a trade or business, albeit a different business than the one for which Taxpayer purchased the furniture. How would your answer change?
    f. In the alternative, the property was destroyed by a tornado. Taxpayer received $25,000 in insurance proceeds and decided not to purchase replacement furniture. How would your answer change?
    g. In the alternative, Taxpayer died and Son inherited the furniture, which he then used for personal purposes. How would your answer change?
2. Taxpayer purchased valuable artwork (or an antique car, or an expensive violin) for his trade or business at a cost of $50,000. He improperly elected section 179 expense in a year now closed. This year, Taxpayer sold the property for $150,000. What is the character and amount of any gain on the sale?

Section 9 Relationship of Capitalization to Error Correction Rules

§§ 1016(a)(1) – (2); 1312(2); 1312(4); 1312(7)

Admittedly, the capitalization rules are not simple. Taxpayers will understandably make some mistakes: sometimes they will capitalize things that should be expensed and sometimes they will expense things that should be capitalized. An important, fundamental rule of tax law is that what happens in one year does not – unless specifically provided for in the Code or Regulations – affect any other year. Hence, the failure of a taxpayer to capitalize an item does not mean it is not capitalized. Likewise, a failure to expense an item does not mean it has been capitalized.

For example, suppose Taxpayer deducted a $100,000 cost that correctly should be capitalized. Several possible types of cost could be involved:

1. It could be a pre-paid item for which section 461(h) would defer a deduction because of the lack of economic performance or the failure to meet the all events test.
2. It could be a capital improvement mischaracterized as a repair.
3. It could be an item not subject to section 179 but for which Taxpayer improperly elected section 179.
4. It could involve non-depreciable or non-amortizable property – such as land or an antique car or INDOPCO-type stock-purchase costs, which the taxpayer incorrectly depreciated or amortized over a period of multiple years.

Each of these situations involves a somewhat difficult issue. In hindsight, Taxpayer may properly understand the correct tax treatment; however, at the time and in the context of filing a return, he may have reasonably misunderstood and may have reported it incorrectly. Indeed, capitalization-versus-expense mistakes are likely commonplace. Hence, understanding how to correct them is important. While the process of error correction arises in other Chapters and other texts, a brief summary of the options is instructive.

Remember, each situation involves the potential – if not the likelihood – of taxpayer inconsistent behavior. The pre-paid item may eventually satisfy section 461(h) and thus tempt taxpayer to deduct it correctly; or, economic performance may never occur and taxpayer may receive a refund. Taxpayer may sell the other items - the “repaired” property, the expensed property, or the depreciated/amortized property - and then be tempted to determine his basis as if he’d capitalized the costs and never recovered them.

Five approaches are available to handle these situations.

1. Taxpayer’s basis in the property (the prepayment, the improvement, or the asset) could drop to zero as a result of the incorrect treatment in the closed year. This would, through section 1001, trigger gain on the ultimate sale or recovery; or, in situation one, it would prevent a second deduction due to the lack of basis. If this approach were to apply, taxpayer would need to look carefully at section 1245 (for situations two, three, and four), which appears to be triggered only by prior proper deductions. Taxpayer would also want to pay very close attention to the language of section 1016(a)(2), which reduces basis for allowed and allowable deductions for wear, tear, and obsolescence – none of which appear to apply in the above cases.
2. The tax benefit rule may be available to trigger income as a result of the fundamentally inconsistent behavior. Taxpayer would want to pay close attention to the Tax Court’s historic application of the “erroneous deduction” exception to that rule.
3. If the incorrect behavior occurred in multiple years, the government would likely argue that it amounted to an accounting method. As a result, taxpayer would be forced to act consistently with that method unless he received permission to change accounting methods. Such permission would trigger section 481 adjustments.

4. Items deducted twice are the subject of a section 1312(2) circumstance of adjustment, which may re-open the closed year – if all the other mitigation factors are satisfied.
5. Property sold for which a taxpayer claims a basis inconsistent with prior erroneous expenses which should have been capitalized are the subject of a section 1312(7) circumstance of adjustment. The prior erroneous treatment must have been "in respect of" a transaction on which basis depended. If this and other factors are met, the year of the error will re-open.

Each approach has its drawbacks and complexity. The law is not settled as to which approach applies and when. A full analysis of these issues is beyond this chapter and text; however, a student should at least contemplate them now.

Furthermore, three of the possibilities could work in reverse:

1. Taxpayer might defer (capitalize) an item under section 461(h) when it should have been expensed.
2. Taxpayer might capitalize a cost that was actually a repair.
3. Taxpayer might fail to depreciate or amortize costs properly deductible.

Section 1312(4) – the double non-deduction of an item – is relevant to the first of these situations. Arguably, section 1312(7) is relevant to the second. And section 1016(a)(2) is certainly relevant to the third, although not in a way likely popular with the taxpayer.

9.01 Question

Consider the four mistakenly deducted costs hypothesized above. Then consider the various approaches to handle the possible inconsistent behavior. Which approaches work best? Which should apply? Which approach likely would apply?