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SPECIAL REPORT

TAX ANALYSTS

DESTROYING TAX BASE: THE PROPOSED *INDOPCO* CAPITALIZATION REGULATIONS

By Calvin H. Johnson

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Professor Johnson argues that proposed Treasury regulation section 1.263-4, on expensing or capitalization of intangibles, unnecessarily destroys precious tax base. The worst abuse sanctioned by the proposals is the accrual of prepayments of unlimited amounts. Johnson foresees multibillion dollar shelters for accrued prepayments blessed by the proposals. Johnson has 17 other comments and criticisms of the proposals, criticizing, for instance, the rule that treats employees and overhead as not part of cost, the unlawful "separate and distinct asset" rule, the rule allowing expensing of costs of a successful corporate takeover, and the rule that IRS audits may never capitalize investments under new facts. Johnson offers a guideline, based on sound economics, that investments that are not worthless at year-end may not be expensed.

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I. Introduction

Great empires decline and fall because they allow their tax systems to rot out at the top.[1] The Treasury Department has promulgated a set of proposed regulations that would allow taxpayers to expense intangible investments that have substantial future value, which should be capitalized under the Supreme Court's decision in *INDOPCO v. Commissioner*.[2] The regulations, if finalized as is, would themselves cause a material destruction of the tax base. This administration has a very serious problem in that the U.S. corporate tax base is rotting out at an alarming rate. The nominal statutory tax rate is 35 percent for large corporations, but the effective tax rate for all is under 10 percent of income, as evidenced by the price taxpayers are willing to pay for legally tax-exempt municipal bonds.[3] Two-thirds of the tax base, measured by tax rate, has already disappeared. We need to be worrying.

A. Guardian of the Tax Base

The Treasury Department seems to have lost its intellectual and moral compass with these proposed regulations. Tax base is squandered by the mile and with ease by the Treasury, but it can be replaced only by inches and with Herculean effort. A strong tax base is an inheritance that needs to be preserved and improved. Only the Treasury Department can protect our tax base. The secular, even sacred duty of the Treasury Department is to defend and strengthen the tax base against those who every day would destroy it, and these regulations are a breach of that duty.

B. Tax Base Yields Lower Rates

A healthy tax base means that tax rates can be lower, for whatever the level of government. A tax system with high rates and with loopholes like Swiss cheese is the worst of all worlds, one with economic damage from high marginal rates without collection of very much revenue. Good Republicans do not fight for bigger government or higher tax rates, but good Republicans who are responsible for their country do fight hard for a healthy tax base to avoid the high rates / big loophole tax systems that do our country the most harm. The important thing for the Treasury Department is to defend and broaden the base, so that the country can get the same revenue from lower tax rates.

C. Preview

The worst aspect of these proposed regulations is the allowance of expensing for accrued prepayments without any ceiling on the amount that can be expensed. That rule alone if exploited to its full limits has the capacity to destroy what is left of the corporate tax base. This report first discusses the proper legal guidelines for capitalization of intangibles. It then discusses the very destructive accrued prepayables allowed by the proposals. This report then makes 17 separate comments responding to the proposed regulations or to specific requests for comments in the Preamble.

II. The Guiding Light of Theory

A. The Purpose of Tax Accounting

The function of tax accounting is to measure income without subsidy or favor.[4] When tax accounting identifies the true income from an investment, then all taxpayers and all transactions will be treated, before the law, according the real tax rates of section 1 or section 11 of the code. For administrative feasibility, the tax system does need to rely on accounting conventions. But the accounting conventions are themselves judged by how well they maintain a level playing field, that is, neutrality of tax between one investment and its alternatives and between one investor and his or her competitors. Conventions that reduce tax below the statutory tax rate of section 11 or of section 1 as a matter of economics have no protective mandate from Congress. They unsettle the level playing field and drive firms away from better investments based on the pretax competition to worse investments, made according to the after-tax returns. Tax should never upset the order of investments set by their pretax return because the real demand for the investment product coming from what real people want is found in the pretax return, not in the post-tax returns affected by unlevel conventions.

B. The Supreme Law

The mandate given to this Treasury Department by the Supreme Court is to emphasize the importance of capitalization:

> Under the norms of an income tax, costs that constitute investments, generating future income for the taxpayer, are capitalized and may not be deducted so long as the costs continue to generate income. Investments in an income tax are normal-

[1] *See, e.g.,* Gail Bassenger, "Taxes," in *A Critical Dictionary of the French Revolution* 582-583 (Francois Furet and Mona Ozoup, eds. 1993) (concluding that the French *ancien regime* fell because it used a tax system so riddled with exemptions, privileges, and liberties that it could not reach the wealth of a prosperous country to solve the financial bankruptcy of the monarchy); Paul Kennedy, *The Rise and Fall of the Great Powers* 53 (1987) (saying that Spain fell because it relied on taxes only within Aragon to support its empire and even there the aristocracy did not pay tax).

[2] Guidance Regarding Deduction and Capitalization of Expenditures, 67 *Fed. Reg.* 77701 (Dec. 19, 2002). *INDOPCO v. Commissioner,* 503 U.S. 79, *92 TNT 44-1* (1992). Under section 263, capitalized expenditures are not deductible, but create basis instead. (Section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder, except as otherwise noted.)

[3] Calvin H. Johnson, "A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax," 56 *SMU L. Rev.* 13 (2003).

[4] *See Portland Golf Club v. Commissioner,* 496 U.S. 154 (1990) (saying that the statutory language "reflects an attempt to measure economic income — not an effort to use the tax law to serve ancillary purposes").

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> ly made and continued only with "hard-money," that is, with amounts that have been already subjected to tax. The opposite, or "soft-money" investing, is the opportunity to make or continue investments with costs that have been excluded or deducted from tax. Soft-money investing is a privilege that is ordinarily as valuable as not having to pay tax on the subsequent return from the investment. The thesis that expensing an investment, that is, deducting it immediately, is equivalent to exempting the subsequent income from the investment from tax, is one of the bulwarks of modern tax economics.[5]

Expenditures in the nature of investments because they produce future income need to be capitalized.

C. Prime Directive: Fix Basis

Financial economics measures income from all investments by identifying the "interest" that the investment gives, measuring all investments as if they were interest-bearing bank accounts. Financial economics gives us a guiding light, a prime directive, on the issue of section 263 capitalization, which is that costs need to be capitalized until basis equals the income-producing value of the investment. If basis gets higher than the real income-producing value, then the effective tax rate on the investment (measured by decline in internal rate of return due to tax) will be higher than the statutory tax rates that Congress intended, but if the basis is lower than the real income-producing value of the investment, then the real effective tax rate is lower than the statutory tax rate. The technology proving this is part of what is known as Samuelson or economic depreciation.[6] A simple convention that ends up with aggregate basis equal to the real income-producing value of the firm is better than an alternative convention that ends up with basis below the real value.

D. Violation of the Prime Directive

When tax law violates the prime directive and lets adjusted basis drop below the income-producing value of the firm's investments, several terrible things happen. First, tax-rate neutrality is violated: Either high-bracket taxpayers outbid lower-bracket taxpayers for the same goods and investments or high-bracket taxpayers achieve an effective tax rate lower than the statutory tax rate that Congress has mandated. Second, adjusted basis of less than income-producing value means that investors move out of meritorious high-basis investments and into worse low-basis investment, just to take advantage of the tax benefit of low basis. Thirdly, adjusted basis below value means that debt financing of these investments produce artificial losses and negative taxes. The negative taxes shelter unrelated income from tax. Both tangible and intangible investments need to follow the same rules, whatever they are, just so that the shelter value of expensed intangibles will not lead to inferior investments appearing to be better.[7]

III. The Terrible Accrued Prepayments

A. Making Tax Profit With No Cash Flow Cost

Proposed Treas. reg. section 1.463-4(f) allows immediate expensing of costs that will last for no more than 12 months after they are made. There is no ceiling on the amount that can be deducted. Even material expenditures that are trivially easy to account for correctly will disappear by reason of year-end deductions. The rule not only allows costs to be expensed that are paid in the tax year, but also allows costs to be expensed that are merely owed or accrued. Accrual and expensing of prepayments are inconsistent and in combination create a negative tax system for the richest corporations in which tax on profitable transactions *decreases* Treasury revenue. This strange new animal of "accrued prepayments" shelters have the capacity to strip out the tax base. On this watch, we will see the first multi-billion dollar accrued prepayment shelters in which electrons moving back and forth without any substance will shelter unrelated real income from tax.

B. AZ Inc. Example

1. Accrual fits with capitalization. The negative tax arises because of the inconsistency of accrual with the expensing of income-producing costs, but accrual *is* consistent with capitalization. Assume, for instance, a wash transaction in which AZ Inc. incurs a $1,000 cost for a program that will return 10 percent or $1,100 revenue in a year. If the transaction occurs all within a single tax year or if the $1,000 is capitalized, then borrowing at 10 percent to make the investment in the program generates no advantage. Borrowing $1,000 to pay the cost will mean that there is neither cash flow nor deduction when the cost is borrowed. The 10 percent interest and profit will mean that $1,100 will be returned in a year, which must be paid over in full to the lender. The interest deduction will offset the taxable income, so that repaying the loan also gives neither net tax nor net cash flow. When the costs are capitalized, the transaction is a wash for tax, as it is economically.

2. Expensing does not fit borrowing. If the same cost is expensed in a tax year before the return, however, the transaction produces not a wash, but a bonanza or negative tax for the taxpayer in the amount of the tax savings from the deducting interest. If the $1,000 is deducted within a 35 percent tax rate, that will mean that Uncle Sam will reimburse $350, probably in the form of tax saved, but sometimes in the form of a net

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[5]Calvin H. Johnson, "The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization Are Dividends to the Shareholders," *Tax Notes*, Oct. 28, 1991, p. 463, at 478, cited as showing the importance of a strong law of capitalization by *INDOPCO v. Commissioner*, 503 U.S. at 83 n. 4.

[6]Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," 72 *J. Pol. Econ*. 604 (1964), is the pioneering article. *See also* Warren, "Accelerated Capital Recovery, Debt, and Tax Arbitrage," 38 *Tax Law.* 549 (1985).

[7]*See, e.g,* Calvin H. Johnson, "Kahn Depreciation and the Mintax Baseline in Accounting for Government Cost," *Tax Notes*, Dec. 30, 1991, p. 1523.

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operating loss carryback and quick refund of old tax. To reach zero cash flow on a $1,000 investment at the start, AZ Inc. needs to borrow only $650 at the start. When the $1,100 revenue comes in, the interest of (10 percent of $650) or $65 is deducted, and the remaining $1,035 income yields tax due at 35 percent * $1,035 or $362. The lender gets back $650 + 10 percent or $715. The net is the $1,100 cash-in, less loan repayment out of $715 and tax out of $362, which leaves $22.75, which, not coincidentally, is the value of a deduction of the $65 interest at 35 percent tax. The $22.75 negative tax arises on a transaction that was a wash transaction pretax.

3. Generalized by algebra. The results of the AZ Inc. example can be generalized by algebra. Investment, *A*, gives return *A*r* that is $1,100. Amount borrowed, *B*, requires a payment of *B*i*, where *i* is interest. When *A* can be deducted, then only *A-tA* or *A*(1-t)* needs to be borrowed, where *t* is the tax rate. The interest cost will be *A*(1-t)*i*. The pretax return less interest will be *A*r - A*(1-t)*i*. Tax will reduce the pretax return by *t* and the post-tax return will be [*A*r - A*(1-t)*i*]*(*1-t*). Under the assumption that interest *i* and return *r* are equal, the formula becomes [*A*i - A*(1-t)*i*]*(*1-t*), which simplifies to *A*(1-t)*i*t*. Putting back in borrowed *B* for *A*(1-t)*, the formula becomes *B*i*t* or the value of deducting interest.[8]

The model can also be explained as akin to the target of section 265(a)(2). The ability to go into an investment with expensed or untaxed money (as in regular IRAs) is the same as tax exemption for the return (as in Roth IRAs).[9] Section 265(a)(2) disallows the deduction of expenses of section 103 exempt income, but not of income just effectively tax-exempt. Interest deduction should be disallowed, as section 103 disallows interest costs, when it buys effectively tax-exempt income. Deducting the costs of producing exempt revenue generates a negative tax or less than zero rate.

4. The cancer metastasizes. The inappropriate deduction of interest (value of $22.75) may not seem like much, but the transaction is zero net cash flow and hence entirely self-contained (and hence free to AZ Inc.). Given that it is free (self-contained), the transaction need not be merely $1,000 per year but can be allowed to grow to $1 billion a year. Tax otherwise expected from AZ Inc. is the only effective limit. Given that it is free (self-contained), the transaction can be a $22.8 million profit-producer for AZ Inc., completely independent of any business AZ Inc. engages in currently. Given that it is free, it can be cloned, growing exponentially, and it can be replicated every year. Given that it is free (self-contained), packagers called Final Four accountants or investment bankers will arise to satisfy the demand for tax destruction. Given that it is free (self-contained), AZ Inc. could care less about the business sense of the transaction. Since AZ Inc. does not care about a free (self-contained) transaction, the economic bargain will not limit or supervise or produce meaningful results. Indeed, bad money always drives out good, so the sham transactions will dominate and bad shelters will drive out those that have economic reality. The only way to contain the sham transactions is by hiring a plague of IRS agents to swarm over otherwise confidential board meetings to identify whether AZ Inc. had a profit motive, when AZ Inc. is an artificial entity that has no mind and could not care less about *pretax* profit. The worst-case scenario is pretty bad.

C. Can Consumption Tax Fix It?

It has been suggested that the accrued prepayment is a step toward consumption tax. A consumption tax, however, would fix the accrued prepayment shelter by doing something quite nasty to borrowing or to owing. The most common remedy under a consumption tax is to include borrowing in income. A corporation that accrues $1 billion would have $1 billion income. I do not think this Treasury has the constituency for that consumption tax remedy. An alternative remedy is to disallow any interest deduction, including cases in which interest must be identified by imputation. Consistently in theory, home mortgage interest would have to be made nondeductible. I doubt that the Treasury has a mandate for that result. The only remedy to stop the multibillion dollar abuse is to deny immediate deduction of prepayments.

D. Economic Performance

It has been suggested by some that the economic performance rules of section 461(h)(3) obviate any concern with abuses of the 12-month rule.[10] Section

[8]This model is from Calvin H. Johnson, "Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation," 61 *Texas L. Rev.* 1013 (1983), which became a part of the case for the cut back in ACRS in 1986. *See* Calvin H. Johnson, "Chapoton Calls for ACRS Cutback to Strengthen Corporate Base," *Tax Notes*, Apr. 23, 1984, p. 344 (Assistant Secretary for Tax Policy says that debt creates problems for the expensing regime because "You have to deal with the cases where there is no new savings because all of the investment was borrowed").

[9]The equivalence of expensing of an investment with a tax exemption of the subsequent income from the investment is sometimes known as the Cary Brown thesis. The thesis originates with Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson* 300 (1948).

Assume, to illustrate the Cary Brown thesis, that TP1 makes $100 income, pays tax at rate t and so has $100*(1-t) to invest. TP1 invests at rate R for n years and gets $100*(1-t)*$(1+R)^n$ pretax. If the profit is tax-exempt, then $100*(1-t)*$(1+R)^n$ is also TP1's post-tax return.

Now assume that TP2 avoids tax on the $100 investable income by deducting the $100 in the year when the investment is made. TP2 thus does not have $100 reduced by tax and thus can make a $100 investment, and will get $1,00*$(1+R)^n$ back pretax. TP2 has no basis, however, so tax at t leaves him with $100*$(1+R)^n$*(1-t), which is the same thing as TP1 results. As long as *t* is constant it does not matter whether the tax factor (1-t) is at the beginning or end of the formula. *See also, e.g.,* Calvin Johnson, "Soft Money Investing Under the Income Tax," 1989 *Illinois L. Rev.* 1019 (1990), for one lawyer's explanation of the idea.

[10]Ken Kempson and Ellen McElroy, "Counterpoint: The Proposed 12-Month Rule: A Solomonic Solution or a Victory for the Foxes?" 22 *ABA Tax Section Newsquarterly* 32 (Winter 2003).

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461(h)(3) allows an immediate expense for recurring items that cease to be prepaid within 8½ months. The "recurring" fallacy built into section 461(h)(3), however, is just that: a fallacy — a badge of fraud and not an antiabuse rule.[11] The accrued prepayment shelter need last only for a day — carrying income from December 31 of one tax year to the first day of the next tax year, to destroy tax base. Section 461(h)(3) has no materiality ceiling to it so that it allows recurring $10 billion year-end shelters.

E. Defining *De Minimis*

In a world of electronic accounting, capitalizing a cost for 12 months has the same accounting cost as an immediate deduction. The hard part is keeping track of the expense and getting it to the bookkeeper. From there, it is just a matter of debiting an expense or a separate asset — like pressing one button or the other — and the rest is taken care of by the accounting program. Thus, the zero extra cost of capitalizing cannot justify the multibillion dollar abuse the proposal would create.

F. Current Law

It has been suggested that the 12-month rule of proposed Treas. reg. section 1.263-4(f) is forced by current law. This is not true. The expert Tax Court properly rejects the 12-month rule, objecting that the rule would just allow next year's expenses to be deducted this year.[12] The Treasury Department in its role as guardian of the tax base cannot give in to bad decisions until after the Tax Court has given in, because the duty of the Treasury to preserve our tax base is higher than the duty of the Tax Court to preserve our tax base.

G. Can't Acquiesce to Nonsense

It is true that a nonexpert court has bought the one-year rule, but the opinion displays terrible misunderstandings of accounting and did not come to grips with the awesome abuses possible with $10 billion accrued prepayment shelters. In *U.S. Freightways Corp. v. Commissioner*,[13] the court distinguished prepaid expenses from examples of "expenses that become part of the basis of a capital good" and decided that prepaid business expenses "are too far away 'from the heartland of the traditional capital expenditure' — a 'permanent improvement or betterment' — to require capitalization." The court, undoubtedly wise in its ways, is ignorant of the science of accounting. A prepaid expense is the paradigm of a "deferred expense" and "deferred expense" is a synonym for separate and distinct "asset" and in turn a synonym for the tax term "basis." The word "prepayment" in the description of a prepaid expense means the payment occurs before the expense has expired and has been used up and that the payment occurs before the expenditure is properly recognized as an expense. Accounting, therefore, puts the expenditure on the balance sheet as an asset to be carried over to future years where the expense can be matched against the income it produces. Prepaid expenses are not deducted until they expire, that is, cease to be prepayments and become worthless. There is nothing closer to the heartland of capitalization within the discipline of accounting than the asset caused by a prepaid business expense. The court's understanding that capitalization of prepayment was strange or remote or different from capital goods cannot be defended with a straight face under professional accounting standards. The *Freightways* court also seems to have thought that capital expenditures were born different from current expenses; in fact, however, a current expense is nothing but a capital expenditure that has expired. All business expenses are born as capital expenditures and business expenses are just those born as capital expenditures that have expired.

H. Can't Balance Ignorance

The *Freightways* court, moreover, gave no sign of confronting the economics of capitalization to make a reasoned decision as to when capitalization was necessary or reasonable. The court, for example, showed no cognizance of the fundamental economic equivalence of early deduction of a deferred expense to an unauthorized tax exemption of the return from that early payment.[14] A decision reached in ignorance of an issue cannot be considered to be binding *stare decisis* on an issue the court did not even know existed and did not decide. The final regulations need to correct such extraordinary ignorance, best with the grace and politeness of ignoring it.

I. Worsens Enforceability of Tax

It has been suggested that the 12-month rule improves the administrability of the tax. This is exactly wrong. It is far easier to follow good theory and determine whether a cost has expired as of the end of the tax year than it is to try to determine whether a cost *might* expire within a year following the current year. The 12-month rule rests on facts that are 12 months away from closing of the books for the tax year. It is very difficult to ascertain the future at the time the books are closed by reason of the fact that the future has not happened yet. The future is very hard to audit. There is not even any such thing as fraud or lying about the future under the circumstances of it not having happened yet. One has to rely on phantom indicators that are never very accurate. Proposed Treas. reg. section 1.263-4(f)(6), for example, tries to figure out whether investment that might be terminable within the next year should fit within the 12-month rule by looking to similar rights terminated prior to renewal, when in fact nobody knows whether the rights will be terminated within 12 months or extend beyond that

[11]*See* discussion at note 24 *infra*, to the effect that "regular and recurring" is not a safeguard of equal tax treatment.

[12]*Sorrell v. Commissioner,* 53 T.C.M. (CCH) 1362 (1987), *rev'd on other grounds* 882 F.2d 484 (11th Cir. 1989); *Grynberg v. Commissioner,* 83 T.C. 255, 266-68 (1984).

[13]270 F.3d 1137, *Doc 2001-27961 (9 original pages), 2001 TNT 217-14* (7th Cir. 2001), *rev'g* 113 T.C. 329, *Doc 1999-35231 (15 original pages), 1999 TNT 212-2* (1999).

[14]*See* discussion at note 5, *supra*.

time. This is pure self-torture on Treasury's part, given that it is far easier to see whether the right has terminated by the end of the tax year and given that the future is under a taxpayer's control.

J. Lines Happen

Moving the line to create billion-dollar tax shelters does not, alas, obviate the need to draw lines. The apparent thinking of the Treasury is that ending the year-end line, by which deferred expenses or assets are now identified, would end administrative difficulty in drawing a line. This is a logical mistake and shortsighted. Erase one line and another one arises automatically to take its place.

K. If You Have a Pool, Do It Right

A one-year-hence line is apparently unenforceable and will soon be overrun by clever and vicious tax planners. Already the planners are showing signs of overrunning the one-year mark, as a matter of right. Proposed Treas. reg. section 1.263-4(f)(5)(iii), for example, sets forth an elaborate accounting pool method under which taxpayers will be allowed to expense costs if 80 percent of the pool expires a year after they are paid and no more than 20 percent is renewed. Why the 20 percent allowance? Is this Chamberlain at Munich or foxes in the henhouse? If a dollar has value beyond the 12 months, the pool needs to be capitalized in full if the 12-month rule is supposed to be enforced. Once you have a pool of this kind, moreover, it is far easier to check to see whether the costs have been renewed by year-end. If the costs still have value at the end of the tax year, as indicated by the pool, then they have basis and are not expired costs. Good theory is a grand simplification of the tax law compared to the Rube Goldberg machine that the regulations set up. This is the worst kind of tolerance rule: a rule in which the system will spend more time in determining whether the error is material or not than it would spend enforcing the obvious correct result in the first place.

L. Tolerances Cannot Be Stated

All law enforcement has to have a tolerance for disobedience that does not amount to a threat to the legal system. If the posted speed limit through the school zone is 15 mph, for example, we don't want to put in jail the minivan moms who go through at 17 mph. But the tolerance cannot be stated as a matter of taxpayer right or as a matter of law because then the tolerance has to be higher than a stated rule. If 17 mph is the stated allowance, then you need an unstated allowance of 20 mph. And if 20 mph is the restated right, then 24 mph needs to be the tolerated amount. And so forth so that there is no speed limit that can be enforced. Stating a tolerance for prepayments does not improve the enforceability of the law or end the need to draw lines and punish violators, it just moves the line to the point where it cannot be enforced. State the rule as good theory requires: Prepayments are not deductible until they have expired. Not every violation needs to lead to litigation, much less jail time, but enforcement tolerances lose all their value once made explicit.

M. 120 MPH Through the School Zone

These regulations, moreover, are not anything like tolerating a 17 mph speed in a 15 mph school zone. The accrued deduction of prepayments without a cap is like allowing the semitrailer to plow through the crossing guard at 120 mph, as a matter of right, all the time claiming that this is just an immaterial violation of the 15 mph limit.

N. In Conclusion

The final regulations allowing deduction of expenses that will expire within 12 months of the end of the tax year destroys tax base, are unprincipled, and need to be withdrawn. Instead, the regulations need to adopt a clean and clear simplification with a beautiful theory: Prepayments are not deductible if they are still prepayments at year-end.

IV. Specific Comments

A. Separate and Distinct Asset Is Not the Law

1. Stop the contempt for the Supreme Court. Proposed Treas. reg. section 1.263-4(b)(2) and (3) and the Preamble at II.B make up a rule that "separate and distinct asset" is a general requirement of capitalization.[15] This is legal error because in *INDOPCO v. Commissioner*,[16] the Supreme Court held that "separate and distinct asset" was not a requirement for capitalization. All of the cases cited by the Preamble as requiring separate and distinct asset were overruled by the Supreme Court's subsequent and paramount holding.[17] The taxpayer's core argument in *INDOPCO* was that its $2.7 million fees incurred in the course of a reorganization could not be capitalized because they did not create a "separate and distinct asset." Every judge who heard the case rejected the argument. Given the Supreme Court's rejection of a separate and distinct asset requirement, the proposed regulations are an unprincipled destruction of tax base. By its contempt for the Supreme Court, the Treasury Department undermines the rule of law and the respect properly accorded to our highest court.

2. Asset is conclusion, not an input. The Supreme Court's rejection of any rule requiring a separate and distinct asset for capitalization is also meritorious as a matter of accounting theory. A separate and distinct asset is an accounting debit that entails that the expenditure may not be deducted against income this year, but will be carried on the balance sheet to future years.

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[15]Preamble, 67 *Fed. Reg.* at 77704 (saying that unlisted contract costs are not capitalized because they do not create a separate and distinct asset); proposed Treas. reg. section 1.263-4(b)(2)(ii), 67 *Fed. Reg.* at 77713 (saying that payments to other parties for contract rights do not create separate and distinct assets).

[16]503 U.S. 79, 83, 87 (1992).

[17]Preamble, 67 *Fed. Reg.* at 77703, citing *Commissioner v. Lincoln Savings & Loan Ass'n,* 403 U.S. 345, 355 (1971); *Central Texas Savings & Loan Ass'n v. United States,* 731 F.2d 1181, 1184 (5th Cir. 1984); *Colorado Springs National Bank v. United States,* 505 F.2d 1185, 1192 (10th Cir. 1974); *Briarcliff Candy Corp. v. Commissioner,* 475 F.2d 775, 784 (2d Cir. 1973).

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"Separate and distinct asset" is a synonym for "capital expenditure" and for "basis." It represents an accounting conclusion as to how to treat an expenditure, and it is not logically a test as to what to require about the real world. "Asset" is not a statement about the real world, but about the accounting books. Finding an "asset" is not a barrier or bar to capitalization for every case. If you need an asset, all you need to say to a cost is "Poof, you're an asset" and the requirement is met.[18] It is indeed that simple. If costs are capitalized, the taxpayer will have a "separate and distinct asset" (aka "basis"), but prior "separate and distinct asset" cannot logically be a *prerequisite* for capitalization.

3. Start over. The proper general test for capitalization is to say that investments that are expected to produce future income are capital expenditures when made. Only expired costs are allowed as current expenses under section 162. Investments must represent claims on resources that have an expected value at least equal to the capitalized basis. The regulations can take the position that some investments are too squishy to capitalize if they do not represent claims to future resources. The regulations can defer to the state of book accounting on issues like self-made business intangibles and advertising for the time being until GAAP gets better, so long as they improve capitalization when GAAP capitalizes intangibles. What the regulations cannot do is show contempt for the Supreme Court and rely on an overruled concept like "separate and distinct asset" that is accounting gibberish. Abandoning current Treasury regulation section 1.463-4(b)(3) to avoid the illegal "separate and distinct asset" test will improve the regulations just by forcing Treasury to abandon the gibberish and to focus on what it is really talking about.

B. Contract Rights Are Investments

1. Contracts are investments, too. Proposed Treasury reg. section 1.463-4(b)(3) defines "separate and distinct asset" as a property interest, but ill-advisedly does not in general include a contract interest as an asset. This is unprincipled. There is no meaningful distinction between property rights and contract rights in determining whether the taxpayer has the protection of the courts so as to get paid. What the regulation may be getting at is for an expenditure to be an investment, there must be a commercially reliable assurance that the taxpayer has an expected income stream from the expenditure so the taxpayer has an economic resource and not a free good. Investments are those expenditures that will produce future income, and an expenditure is not a capitalized investment if it generates no future income. Court enforcement by contract-type remedies, however, is as effective as court enforcement of property-type remedies in ensuring that the taxpayer gets paid.

2. Where did they pull this one out of? Excluding contract interests from the category of investments or capital expenditures seems to be an import from some alien issue because it is unprecedented in defining whether an expenditure is an investment or not. Many contract interests are income-producing investments under the fabric of existing law. Professional football and baseball teams, for example, buy multiyear player contracts, which are capital expenditures made and not expired section 162 costs.[19] Purchase of a seat on the New York Stock Exchange is a capitalized investment, but it is fundamentally a contract right and not a property right.[20] Contract interests are in general quite wonderful investments if they have not expired by year-end.

3. Can't even stay consistent on that howler. Literally, the property-right rule prevents capitalization of any prepaid compensation, because people cannot be property since the Thirteenth Amendment's repeal of slavery. Literally, all receivables are written off at year-end, because receivables are contract rights, not property rights. Literally, therefore, the proposed contract rule repeals the accrual of all revenue by accrual method taxpayers. Proposed reg. section 1.463-4(b)(6), of course, undercuts the general contract rule of -4(b)(3) by providing that certain contracts, including contracts for services, are capitalized, but -4(b)(6) just falsifies -4(b)(3) and shows that the initial -4(b)(3) rule of no capitalization of contract rights was wrong in the first place.

4. Unenforceable assets in the commercial world. The regulations cannot, however, require that rights created by assets must be legally enforceable because many expenditures produce future income without the aid of court enforcement. Under Nevada law, for example, gambling markers are not enforceable in court, and yet the receivables of the casinos have bad-debt reserves well within commercial norms. A gambling marker is an asset — a receivable — because of the respect given to it by the commercial market even without legal enforcement.[21]

C. Separate and Distinct Asset Not Law

1. Expensing of nonsaleable investments? Proposed Treasury reg. section 1.463-4(b)(3) ill-advisedly defines "separate and distinct asset" to require that the taxpayer's legal interest be "intrinsically capable of being sold, transferred or pledged." The requirement of saleability is unprincipled and destroys precious tax base.

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[18]Calvin H. Johnson, note 12 *supra*, at 477-478, cited favorably by the Supreme Court, 503 U.S. at 88 n. 6.

[19]Rev. Rul. 67-379, 1967-2 C.B. 127 (requiring cost of a standard major league baseball player contract to be capitalized and amortized over its useful life); Rev. Rul. 71-137, 1971-1 C.B. 104 (accord, football players).

[20]Rev. Rul. 70-334, 1970-1 C.B. 56.

[21]*Flamingo Resort, Inc v. Commissioner,* 664 F.2d 1387 (9th Cir. 1982); *Desert Palace, Inc. v. Commissioner,* 72 T.C. 1033 (1979). *See also Georgia School-Book Depository, Inc. v. Commissioner*, 1 T.C. 463 (1943) (taxpayer selling books on commission had to accrue income and had receivable assets although it had no present enforceable legal right to collect the commission because the Georgia tax account that was supposed to fund the commissioner was bare).

2. Bad rule. Many investments are as good as income-producing bank accounts, but cannot be sold. Prepayments are not generally assignable to someone other than the taxpayer who made the prepayment, but as the name "prepayment" certifies, they have continuing value at year-end and need to be matched against future income. Bank deposits might be blocked from withdrawal, by operation of law, but they are still investments. Perhaps the widget machine or process can be exploited *only* by the taxpayer who uses it and cannot be sold to some other taxpayer. Still, even nonalienable income-producing intangible investments need to be capitalized in an income tax. The cost can be like a bank account, producing income internally for the taxpayer, even if the bank-account-like investment can not be transferred to another. The ability to expense an internally valuable investment is a bonanza as valuable as an exemption from tax of the return from the investment, which would be an inappropriate result even if the investment could not be sold. Under accounting theory, an expenditure that produces future income must be matched against that income by capitalization; even the expenditure cannot be sold to someone else.

3. Congress does not like this abuse. In the Tax Reform Act of 1969, Congress disapproved of the abuse set up by section 1.463-4(b)(3), by the adoption of section 83. Prior case law had held that an employer did not have income on the receipt of nonsaleable stock because in the absence of saleability, there was no fair market value.[22] Under the Cary Brown thesis, the deferral of taxation of the value of property is equivalent to a tax exemption of the subsequent income from the property,[23] and Congress ended the abuse of considering nonsaleable property as if it were worthless by ignoring the restrictions on the property that made it nonsaleable.[24] The proposed rule would resurrect the nonsaleability rule only for the benefit of abuses by aggressive tax planners.

4. Good collateral is not the issue. The rule requiring that a "separate and distinct asset" be saleable seems to be an alien import from some other field because it is unprecedented for tax purposes in defining whether an expenditure is an investment or not. A bank or other creditor cares about whether the debtor company has assets that can be liquidated, because that will determine whether the bank has collateral that is worth something if the debtor company goes bankrupt. But loan collateral has nothing to do with whether the company has an investment or, on the other hand, an expired section 162 cost for tax purposes. The job of tax accounting is to take away the extraordinary advantage of expensing investments even when the investment is for internal use only. An ongoing concern has many, many assets listed on its balance sheet that are worthless if the firm ceases to be an ongoing concern, but still those expenditures are treated as basis (aka "assets") to achieve the norms of an income tax and of accounting matching.

D. Delete the Prior Publication Rule

1. Audit frustration rule. Under proposed Treasury reg. section 1.263-4(b)(2)(D), nonlisted expenditures may be capitalized only after the IRS and Treasury Department have identified those expenditures in published guidance as significant enough to warrant capitalization. The rule requiring prior publication is erroneous and will destroy tax base. It will sometimes be used to justify expensing, when all judges would agree on the merits that expensing is a material abuse. When the IRS is overworked or slow to react and the taxpayer protects the secrecy of its abuses until the audit, the abuses will continue simply because the bureaucracy is slow to react. The prior publication rule frustrates all audits of previously unidentified abuses, moreover, because audit cannot correct an error not already identified and published.

2. Sneaky taxpayers win by mere stealth. The rule requiring prior publication for new cases is indeed an invitation to a taxpayer to create some new case in stealth and cover them in secrecy. Confidential corporate shelters are serious abuses that will fully exploit these regulations. All a super-aggressive taxpayer or tax shelter promoter needs to do is find an investment with a different name or character than the listed case and immediate expensing will be allowed. Perhaps the billion-dollar expenditure is obviously an investment and the transaction is pure abuse, but the prepublication rule will allow the promoter to flout U.S. law.

3. Let principle decide! The unidentified case needs to be decided according to the general principles of law: In an income tax, material expenditures in the nature of income-producing investments are not allowed as a deduction, but instead are capital expenditures that create basis when made. Expenses, by contrast, are expenditures that have expired and lost their value. A business expense is nothing but a capital expenditure that has ceased to be an income-producing investment. "Investment" and "expired expenditure" are not complicated or unfathomable concepts. We can trust judges to get the right result with respect to novel facts if they are given the proper standard.

4. The arrogance of it all! The genius of the common law, moreover, is that one can tell the right answer only after the facts have been developed. Civil law thinks it can settle all issues by fiat rules in advance, but a common-law-trained judge knows very well that unexpected cases come up all the time and that those cases can be settled only by the application of legal principles to developed facts. The regulations should not be so arrogant about what the unstated cases look like.

5. The law reaches past error! The rule that capitalization of unlisted expenditures will be applied only prospectively from the date of publication of guidance is also an error that will destroy precious tax base. Some cases are so clearly an abuse that the proper remedy is to put the taxpayer in jail retroactively and throw away the key. Planning cleverness in avoiding

[22]*Kuchman v. Commissioner,* 18 T.C. 154 (1952).

[23]*See* discussion, note 5 *supra.*

[24]Section 83 as enacted by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 588.

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listed categories should not be rewarded; planning cleverness should face the normal rules.

E. Build on Wise Capitalization Rulings

1. Ripping up the fabric of existing law. The Preamble at IIC states that revenue rulings that require capitalization of various expenses, inconsistent with the proposed regulations, will be withdrawn. The IRS should not withdraw rulings of venerable standing that require capitalization, but rather the regulations need to be built around those venerable rulings. Revenue rulings represent carefully considered legal positions of the Internal Revenue Service after many levels of review. A law written by conservatives respects tradition and continuity and so respects the carefully thought-out and venerable positions of the Service. For example, Rev. Rul. 80-70[25] held that advanced mineral royalties paid or incurred under minimum royalty provisions had to be capitalized if they had not expired by year-end, and amortized over the months to which the advance royalties related, although the prepayment was for less than 12 months. Rev. Rul. 67-379[26] held, noncontroversially, that the team's cost of a baseball player's multiyear contract under the standard major league contract form had to be capitalized and amortized over its useful life, and that rule would be overruled. Rev. Rul. 70-334[27] held that the purchase of a valuable contract right, that is, a seat on the New York Stock Exchange, was an investment. Such rulings are the rock of wisdom on which a regulation project must be built.

F. Default: Wait Until Impairment

1. The bad 15-year rule. Proposed regulation section 1.167(a)-3(b) sets 15 years as the default tax life for intangible expenditures. The correct backup default rule is that intangibles have an indefinite life until impairment, sale, or abandonment is shown.

2. They are all bank accounts. Financial economics measures all investments as if they were bank accounts. To make the effective tax rate on an investment (measured by the decline in "internal rate of return") equal to the statutory tax rate, the basis of an investment must equal the real income-producing value of the investment. Adjusted basis in theory is the balance on the bank account that is exactly like the investment under review. Some investments are like a constant bank account balance giving a constant amount of income, and for those investments, the basis should not be amortized, any more than bank account balances should be amortized.

3. Undercuts Congress's rates. Amortization of an intangible that in fact continues perpetually cuts the effective tax rate on the return from the investment to about half of what Congress intended. A taxpayer that purchases a newspaper's customer base, for example, does not lose its capital investment as its customer base turns over, from Jones to Smith, as long as the customer base as a whole remains constant or grows. Allowing amortization of a continuing customer base over 15 years means that the effective tax rate on the purchase of the customer base will be not 35 percent, but 17 percent.[28]

4. Why are you subsidizing intoxicating liquor? There is nothing wrong with an indefinite, nonamortizable tax life for intangible assets that are not impaired. Assume, for example, that a taxpayer buys a liquor license for $100,000. The license grows and grows in value because it gives a strategic position on a busy street among ladies and gentlemen who want their alcohol. Having that license is like having more than $100,000 in the bank. Requiring the $100,000 to be maintained as basis and not amortized is the only rule that properly describes the liquor store's wise investment. Amortizing the $100,000 over 15 years will subsidize liquor (for reasons that are beyond me) by cutting the effective tax rate on investments in liquor licenses in half.

5. Revenue-neutral means no depreciation. In 1993 Congress settled billions of dollars in litigation over whether costs of acquisition were nonamortizable goodwill or some other asset on a revenue-neutral basis by the enactment of section 197.[29] Fifteen years was the tax life chosen for section 197, amortization of acquired intangibles, because it was the revenue-neutral life. Section 197 extended the tax life on billions of dollars of intangibles that had claimed as having shorter than 15-year lives under prior law, but would be forced to use a longer (15-year) tax life once section 197 came into effect. The revenue-neutrality rationale was important because Congress was unwilling to subsidize any takeover as a matter of policy. Under the principle of revenue neutrality that guided section 197, the default life for the proposed Treas. reg. section 1.263-4 intangibles needs to be an infinite life: Because these proposed regulations do not extend the tax life or amortization period for any expenditure, it cannot under revenue neutrality shorten any tax life. The taxpayer will need to show the limited life, if there is one.

6. Good GAAP. On this issue, the regulations need to follow the wisdom of the science of accounting: After a long and serious review on the merits, the Financial Accounting Standards Board (FASB) has recently concluded that goodwill and other indefinite life intangibles are not amortized unless impairment is shown.[30] These regulations need to follow nontax generally accepted accounting principles, when as here FASB gets the issue right.

[25]1980-1 C.B. 104.

[26]1967-2 C.B. 127.

[27]1970-1 C.B. 56.

[28]*See* Calvin H. Johnson, "The Mass Asset Rule Reflects Income and Amortization Does Not," *Tax Notes*, Aug. 3, 1992, p. 629 at 633, for the calculations.

[29]Revenue Reconciliation Act of 1993, P.L. 103-66, section 13261(a), enacting section 197.

[30]Financial Accounting Standards Board, Statement No. 142, paragraphs 18, 16 (July 2001).

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G. Realization Event

1. Research query. The Preamble[31] requests research help on the tax treatment of use of appreciated property to make an expenditure. The Preamble asks whether a noncash inducement is properly valued at the taxpayer's cost to acquire or produce the inducement, or at the fair market value of the inducement, and whether any gain or loss is realized on the transfer of the noncash inducement.

The established rule is that payment of an expense with appreciated property is like a sale of the property for its fair market value in cash followed by use of the cash to pay the expense.[32] The rule is highly forced by the logic of tax, at least in those cases in which the taxpayer could have sold the property. It is just one of a number of cases in which we use cash transactions that are like the actual transaction to help us understand the necessary tax treatment of the noncash transactions.

H. Capitalize Salary!

1. Delete expensing of investments in paying for services. The Preamble[33] says that "amounts paid for personal services actually rendered are not required to be capitalized under this rule." Whatever that means, it needs to be deleted. Architects' fees are capitalized to the cost of the building, legal fees are capitalized to the costs of the reorganization, a hard hat's salary is capitalized to the cost of whatever the hard hat is building.[34] There is no principled basis for allowing expensing of costs of services, when the payment is an investment. It is common to have capital expenditures that are ordinary income for the recipient.

I. *De Minimis* Is 100 Times Too High

1. Worth keeping track of? Proposed Treasury regulation section 1.263-4(d)(6) allows deduction of *de minimis* amounts, defined as expenditures of under $5,000. We all agree that litigation should not go forward over *de minimis* amounts. Section 132(e)(1), for example, appropriately defines *de minimis* as an amount that is "so small as to make accounting for it unreasonable or administratively impracticable." With computer accounting programs, that standard sets the *de minimis* amount quite low, on the order of $50. And as computers and programs get cheaper in future years, the *de minimis* amount should get lower. Moore's law, which says that computer costs drop by half every 18 months, implies that *de minimis* should drop to half its prior level every 18 months. For 12-month prepayments, for example, it is as easy to debit the cost to an asset account, which will be picked up as an expense next year, as it is to debit the expenditure to an expense account deducted this year. The hard part is recording the expense for the accountants to see, and once the expenditure is recorded and in the pipeline it should be recorded right. There is nothing wrong, for example, with the elegantly simple rule that a prepayment worth recording at all is a capital expenditure and that is the end of controversy. The proposed *de minimis* rule at $5,000 is in fact 100 to 1,000 times too large for the rationale of worth not losing in the accounts. A *de minimis* level that is 100 to 1,000 times too high is unprincipled and is just bad faith destruction of precious tax base.

2. Good job on aggregating cost! The proposed regulations properly apply the *de minimis* test to transactions rather than items. Costs that are *de minimis* in isolation cease to be *de minimis* when they clot together. Thus, a single $5 expense may be *de minimis* — not worth even stopping to pick up on the street these days — but a large number of $5 expenses are well worth accounting for. Unless we view the transaction as a whole, the vicious tax planners a wise Treasury must worry about every day will break down their billion-dollar expenditures into $5 items just to avoid treating the $1 billion correctly as an investment.

3. Pools are basis. The regulations, however, need to capitalize items if the taxpayer maintains a pool for the items. Once the taxpayer maintains a pool to keep track of the items, the full accounting effort needed for capitalization has been undertaken and there is no justification for expensing the pooled items on the grounds that the accounting effort is too high to be worth it. One can look to the pool to determine what part of the costs has expired by year end. Since an expense is nothing but a capital investment that has expired, the unexpired costs are capital.

4. Take the GAAP confession. The Preamble at V.D.1 says that the Treasury and IRS anticipate that the book-tax conformity rule would not apply to *de minimis* costs. This is an error. The *de minimis* line for tax is appropriately far lower for tax than for book purposes. Thus, a taxpayer who identifies that an amount is not *de minimis* in GAAP reports to outsiders has told its government by its actions that the cost is not *de minimis* for tax. The Treasury needs to rely on these confessions in a world in which taxpayers try to avoid confessing tax. Immaterial expenses in nontax accounting are those that would not affect anyone's decision as to whether to invest in or buy the company. An expenditure which is a small percent of the worth of the whole company is not worth capitalizing. But for tax, the Treasury is not trying to buy the company, just collect tax from it. Thus, for tax, we are just comparing the cost of calculation with the tax involved, not with the value of the overall company. Most expenses that immaterial for financial accounting purposes are nonetheless not *de minimis* under stricter tax standards. Still, if a cost is material for financial purposes, it is necessarily far more than material for tax purposes.

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[31] 67 *Fed. Reg.* at 77704.

[32] Treas. reg. section 1.83-6(b) (1995); *International Freighting Corp. v. Commissioner,* 135 F.2d 310 (2d Cir. 1943).

[33] Preamble III.E, 67 *Fed. Reg.* 77704.

[34] *See, e.g.,* Treas. reg. section 1.263-2(d) (1958) (architect's fees are capital expenditures); *Mississippi Valley Tr. Co. v. United States,* 61 F. Supp. 451 (D.C. Mo. 1945), *rev'd on other issues* 155 F.2d 597 (8th Cir. 1946) (appraisal costs paid in connection with possession of premises are capital expenditures); *Acer Realty Co. v. Commissioner,* 132 F.2d 512 (8th Cir. 1943) (payments made to taxpayer's officers to supervise remodeling were in the nature of architects and general contractor's services and were capital expenditures).

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J. Investments via Another

1. Budweiser logo clocks. The proposed regulations improperly reverse *Alabama Coca-Cola Bottling Co. v. Commissioner,*[35] where the court required capitalization for the costs incurred by a wholesaler to provide signs, scoreboards, and clocks bearing its product logo to retail outlets. The expenditure created valuable benefits that would benefit the taxpayer beyond the tax year. The stated ground for expensing in the proposed regulations is that these *might* be costs "properly" expensed as advertising or business promotion costs. That premise is wrong:[36] The immediate expensing of advertising or business promotion costs is not a first-order rule that can trump any other sound rule of capitalization. We are not trying to subsidize advertising. Advertising is expensed only because there is no asset of definite duration the costs attach to, and if there is a logo clock or anything else with a continuing life, that is an asset sufficiently clear to allow capitalization. If the taxpayer prepays advertising costs for five years or pays for a sign on someone else's property that will last for five years, those are investments lasting for five years. Thus, when Samuel Adams Beer buys a clock, sign, and lighting for a neighborhood bar, the life of the clock, sign, and lighting is not shortened just because the bar, rather than the brewer, owns the sign. If there is an identifiable investment that has not expired at year-end, it does not matter that the cost is also advertising.

2. Shifty title. Moreover, the regulations go far beyond reversal of *Alabama Coca-Cola* and say that no personal property with title held technically by another can be the justification for capitalization, even when the issue is not advertising. Why? What scam or loophole is the proposed regulation trying to bless? We are going to see a blooming of tax planning under this rule in which the taxpayer shifts the technical title to personal property to another's friendly hands just to have its investments expensed immediately, in cases that would result in economically inappropriate descriptions of the taxpayer's investments. Tax administrators should leave to Congress changes in court holdings such as *Alabama Coca-Cola.* The proposed rule is unprincipled and just destroys precious tax base.

K. Land Is Nondepreciable

1. The amortization of land and easements. The Preamble invites comment on whether the Treasury should allow a 25-year safe harbor tax life for improvements to the real property held by another.[37] The 25-year safe harbor is inappropriate for land and buildings, and since the only case in which improvements are capitalized when title is held by another is for real property, the rule is always inappropriate. An improvement to land owned by the taxpayer is not an amortizable asset because it does not systematically expire over time. Land continues to be of value until Niagara Falls. There is no need for land to be amortized over 25 years — or at all. Many or most of the improvements to adjoining land are in the nature of an easement benefiting the taxpayer's property. Easements are not amortizable when the easement is perpetual and neither should the substitutes for easements be. The life of the improvement to land is not made any shorter, absent some proof in the facts and circumstances of the specific case, just because title is held by another.

2. Shifty title. The 25-year rule would create an incentive for planning in which taxpayers will avoid the accurate economic assessment of their costs by putting technical title into the hands of other, but distinctly friendly, hands. Sometimes the life of the improvement to the taxpayer is indeed shorter than the perpetual life of the land being improved, but the common law allows that. It is the life to the taxpayer of the asset and not the life of the asset in the abstract that will determine value. There need to be some special circumstances shown that cut off the perpetual life of the benefit. Accordingly, the proposed regulations should provide that contributions for the improvements of land owned by another will have a perpetual life, absent special circumstances.

L. *INDOPCO* Expenses Are Perpetual

1. Stick with the deal. The Preamble[38] invites comment as to whether section 197(e)(8) evinces a congressional intent to prohibit any amortization of transaction costs capitalized in a tax-free reorganization. Section 197(e)(8) exempts acquisitive reorganization costs from the 15-year amortization period of section 197. The first rationale for section 197(e)(8) was that costs of a tax-free reorganization are of primary benefit to shareholders or are poolings in which no gain is recognized at the corporate level because they are merely marriages of shareholders. In either case, the costs are dividends and not corporate costs. The second rationale was that the Supreme Court had held in *INDOPCO v. Commissioner* that the costs of a reorganization create a corporate asset — improved corporate structure — that had perpetual value until the corporate group ceased to exist. Section 197 was written to settle litigation on a revenue-neutral basis, and given *INDOPCO* there was no outstanding unsettled litigation to be settled.[39] The rule of indefinite duration should continue.

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[35]T.C. Memo. 1969-123.

[36]Indeed, in *Villarreal v. Commissioner*, T.C. Memo. 1998-420, *Doc 98-33895 (21 pages), 98 TNT 224-10,* the taxpayer's lawyer conceded that the cost of a big advertising sign was a capital expenditure.

[37]Preamble III.G, 67 *Fed. Reg.* 77705. Prop. Treas. reg. section 1.167(a)-3(b).

[38]Preamble VII.B.3.d, 67 *Fed. Reg.* 77705, 77711.

[39]Calvin H. Johnson, "Technical Memorandum Prepared for the Staff of the Joint Committee on Taxation: Costs of Tax-Free Reorganizations Are Not 14-Year Amortization Asset" (1992); Calvin H. Johnson, Letter to the Honorable Fred J. Goldberg, Assistant Secretary for Tax Policy, "Reorganization Expenses Under HR 3035" (July 8, 1992).

M. Pre-Investments Letter of Intent

1. Capital costs incurred before letter of intent. Prop. Treasury reg. section 1.263-4(e)(4) and the Preamble at V.B. (defining "facilitate") provide that costs of an acquisition performed before a letter of intent and before the date the taxpayer's Board of Directors approves the acquisition proposal will be expensed. The Supreme Court in *INDOPCO v. Commissioner* gave Treasury no authority for deducting the costs incurred before the Board of Directors gave approval.[40] Indeed, the rule is offered in contempt of the Supreme Court.

2. Outlaw and illegal. Exploratory and investigatory costs for an acquisition, including, for example, costs of gathering information to decide whether to go into some business or to learn about the health or value of a specific targeted firm are inherently future-directed, or they have no legitimate grounds for any deduction at all. There is no current income produced by the investigatory costs and the costs have not expired. There is no controversy in these cases that the costs are in the nature of future-directed investments. Allowing expensing of these costs is unprincipled and just destroys precious tax base.

3. Congress does not like takeovers of Mom and Pop. Congress has repeatedly told us, for better or worse, that it wants no tax subsidy for takeover expenses because it does not want large corporations gobbling up Mom and Pop enterprises, who vote in every congressional district.[41] Given Congress's antisubsidy intent, the regulations need to lean over backwards in favor of capitalizing exploratory and investigation expenses. The proposed letter of intent rule is also manipulatable by taxpayers because the letter of intent can be deferred to allow deduction of the bulk of the acquisition costs. The rule is unprincipled and will just destroy precious tax base.

N. Friendly Outcomes Count

1. Query for friendly vs. hostile. The Preamble at V.C. requests comments on rules that might be applied to determine the point at which a hostile acquisition attempt (generating target costs that can be expensed) becomes friendly (generating target costs that can be capitalized). The Preamble asks the wrong question because friendly acquisitions are always friendly and failed acquisitions are hostile because they did not pay enough.

2. You can't read corporate minds. The attempt to bifurcate a single acquisition so that some costs by the target are considered friendly (and capitalized) and some costs are consider hostile (and expensed) is a Sisyphean task doomed to failure. Corporate acquirers do not in fact have a mind, so that attempt to read their mind is doomed. One cannot rely on the supposed subjective intent of the agents of the target or of the acquirer to mark the difference between friendly and hostile mergers because subjective intent is too malleable and is counterfeited too easily to be relied on. Prop. Treasury reg. section 1.263-4(e)(4)(B)(iii) would determine the subjective hostility or friendliness of the corporate mind of the other party (the acquirer) according to "all the facts and circumstances," which is a useless and misleading standard because it does not give any hint about which facts count. Life is, alas, "a tale told by an idiot full of sound and fury and signifying nothing," so that directing the law toward all the facts directs an inquiry toward sound and fury that will signify only sound and fury.

3. Simple rule: How did it come out? The regulations need to make a bright-line rule according to the outcome. Takeovers that succeed are friendly in full from the start. But takeovers that fail generate expired expenses. In the cold, hard world of the marketplace, the only difference between a hostile and a friendly offer is price. If the price is too low, the offer is hostile. If the price is high enough, the offer is friendly enough. The shareholders, moreover, are the sovereign owners of the target and they (and not management) get to decide when the offer becomes friendly enough. By accepting the takeover, they declare that the price is sufficiently sweet. By rejecting the offer, in full and forever, they declare the offer to be hostile. One cannot try to parse a single process of haggling over price into a hostile segment, when the price is too low, and a friendly segment when the price is right because the entire process is one ongoing transaction. If a "hostility period" were artificially available for a successful takeover, one would expect the parties to act like TV wrestlers and grimace a bit longer for the camera before consummating their deal. Only the last two minutes of the show and one-half a percent of the costs would be considered capital expenditures. Even the adverse, hostile part of a negotiation contributes to the ultimately sweet enough price, even if the hostility were not manufactured, as long as the deal goes through.

4. Expensed costs in the big picture of things. If the acquisition fails to go through, however, the costs are expired costs and not investments made toward getting a better shareholder price. An expense is nothing but a capital investment that has expired by the end of the year. A rejected suitor has incurred nothing but lost costs, unless the suitor finds an alternative mate. In that case, the costs are part of the courtship in the big picture and not truly lost. On the target's side, if the target is ultimately picked up by another acquirer once it comes into play, then the target's costs need to be capitalized. Capitalization is judged by looking at the big picture and the larger transaction of which the successful takeover is a part.[42]

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[40] *INDOPCO v. Commissioner*, 503 U.S. 79 (1992).

[41] *See, e.g.*, sections 5881 (anti-"greenmail" provisions); sections 280G, 4999 (anti-golden parachute provisions); sections 172(b)(1)(E) and (h) (preventing interest incurred in a leveraged buyout from providing net operating loss carrybacks); section 279 (acquisition indebtedness).

[42] *See, e.g., Libson Shops, Inc. v Koehler*, 48 AFTR para. 1988, 1993 (D. Mo. 1955) (costs of rejected alternative ways to merge corporations to preserve net operating losses were not abandoned costs, because rejected and adopted alternatives were all done with one purpose in mind), *aff'd on another issue* 229 F.2d. 220 (8th Cir. 1956), *aff'd on the other issue* 353 U.S. 382, *rehearing den'd* 354 U.S. 943 (1957).

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5. The country needs simplification! The proposed bright-line rule — successful takeover costs are capitalized in full — will sometimes be a rough line necessary only because the law needs a bright line. But it will also generally be consistent with good theory. An expense is nothing but an expired cost and expired costs are properly deducted. But the adverse, even hostile, haggling-over price eventually leads to a takeover that may have material future benefits and the costs incurred during the haggling need to be kept in basis.

O. Depreciation Happens Later

1. Costs are not lost as they are paid, but only after. Proposed Treas. reg. section 1.167(a)-3(b)(3) would start amortization deductions on the first day of the month in which the property is eligible for amortization. Amortization should start on the first day of the month *following* the acquisition. Investments decline in value only *after* they are made, not simultaneous with their investment or even before their investment. If the investment lost value when it was purchased, no one would pay full price. The proposed rule is self-refuting. The regulations can make up for delaying amortization by allowing amortization for a full last month even if the asset is withdrawn from service before the end of the month.

P. Capitalized Employee Costs

1. Employees as per se expired. Why that howler? The Preamble at V.D.1 says that employee compensation and overhead costs of the acquisition of an intangible will never be capitalized, and prop. Treas. reg. section 1.263-4(c)(3) provides that compensation paid to an employee for an investment asset will never be treated as a capital expenditure. This rule rips up the fabric of established law for the benefit only of abuse. There are plenty of holdings to the effect that employee costs are capital expenditures. As your Supreme Court has said, "when *wages* are paid in connection with the construction or acquisition of a capital asset, they must be capitalized."[43] Your government won *INDOPCO*. *INDOPCO* gives this Treasury no authority to overrule current law to *decrease* capitalization. This is an unprincipled rule that will destroy precious tax base.

2. Cost means all of it. "Cost" is a broad concept that identifies what amounts need to be recovered to make a profit. Cost includes overhead costs, including the salary of top management.[44] The exclusion of overhead from the determination of cost does *not* constitute an acceptable accounting method, for either tax or nontax accounting.[45] The rationale for a broad concept of "cost" is simple: If your customers do not pay for your overhead costs, the tooth fairy will not do it.

3. Unfair to outside counsel! The proposed rule creates a subsidy for bringing service provisions in-house, even in the face of considerable waste. Outplacement of services or use of outside counsel is commonly very effective in this extraordinarily competitive economy. Use of outside lawyers, for example, allows a center in which expertise develops on the basis of a nationwide clientele; that expertise is lost by the balkanization of the lawyers, each restricted to the narrow confines of the firm he or she happens to work for. The lawyers inside the firm see the issues too rarely for an efficient division of labor to occur. Under the proposed rule, however, the federal government will give you a 35 percent subsidy for services related to your investments if the company will bring the service providers in-house. The intense subsidy at 35 percent is strong enough to force waste and inefficiency up to 34.9 percent of the cost. Lawyers working for the famous national accounting and law firms will have to drop their billing rates by 35 percent to compete. Tax law should not be the instrument of creating such a balkanized service system.

Q. Good Job! No 'Regular and Recurring!'

1. Kudos! The Preamble at V.D.3 properly rejects any "regular and recurring" justification for expensing. Within tax, "regular and recurring" is a badge of fraud and not a ground of legitimization. Under the Cary Brown thesis, the ability to deduct an investment is a bounty as good as exemption from tax of all of the income from the investment. That is a true bounty even if the investment occurs in every period. It is a fallacy, called the "steady state fallacy" by the economics profession, to say that regular and recurring helps justify expensing in any way.[46]

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[43] *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974). *See also, e.g., Madison Gas and Electric Co v. Commissioner,* 633 F.2d 512 (7th Cir. 1980); *Cleveland Electric Illuminating Co.*, 1985-1 USTC para. 9128 (Cl. Ct. 1985) (costs of training employees for a new power plant are capital expenditures and not expired, currently deductible costs).

[44] *Perlmuter v. Commissioner,* 44 T.C. 382, 391, 403-404 (1965), *aff'd* 373 F.2d 45 (10th Cir. 1967) (showing how overhead is allocated to investment); *Acer Realty Co v. Commissioner,* 132 F.2d 512 (8th Cir. 1943) (payments made to *officers* to supervise remodeling were in the nature of architects and general contractor's services and were capital expenditures); *Chevy Chase Motor Co., Inc. v. Commissioner,* T.C. Memo. 1977-

(Footnote 44 continued in next column.)

227 (salary paid for directing construction was capital expenditure); Treas. reg. section 1.266-1(e) (1958) (overhead taxes and carrying charges capitalized).

[45] Accounting Research Bulletin No. 43 (Restatement), ch. 4 paragraph 6 (1953) (exclusion of all overhead costs does not constitute an acceptable accounting procedure); Treas. reg. section 1.471-11 (1993) (requiring full absorption accounting).

[46] In a world without tax, after a transition period, annual income would be the same whether a company expenses or depreciates its capital investments. Assume, to illustrate, that a taxpayer, Expensing Inc., needs five widget makers each costing $1 million; each lasts five years. Expensing Inc. buys one machine and deducts $1 million each year. Assume Depreciating Inc., its identical crosstown rival, does the same thing but depreciates the machines, taking one-fifth of cost, or $200,000 a year. For the first four years, in transition, Depreciating Inc. will take deductions of $200,000, $400,000, $600,000, and $800,000 respectively, but in the fifth year and all years after that in which the $1 million purchase remains the same, Depreciating Inc. will also have deductions (from five different machines) of $1 million. In steady state and in absence of tax, a company that buys capital investments on

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V. Concluding Comments

The proposed regulations brush aside the Supreme Court cavalierly because the Supreme Court rule is not sufficiently generous to clients. *INDOPCO* was decided in favor of the government and was not an invitation to rerun the rules with taxpayer victories this time. The regulations make up a "separate and distinct asset" requirement for capitalization, although every judge who considered the Supreme Court's *INDOPCO* case rejected the requirement. In accounting, a "separate and distinct asset" test is illiterate since "asset" is a synonym for "basis." "Asset," like "basis," is an accounting conclusion and not even something about the outside world. The made-up "separate and distinct asset" requirement says that capitalized investments have to be enforced by property remedies and that contract remedies are insufficient to make an expenditure an investment. All receivables, under that rule, would be treated as worthless deductions by year-end, thereby ending accrual of income, because receivables are contracts, not property. Many investments are useful only internally; the requirement that "separate and distinct assets" must be saleable is an invitation only to abusive tax planning.

The worst of the proposed results is the rule that would allow unlimited deductions for next year's expenses, including accrued expenses set up just for shelters. On this watch, Treasury will see the first multibillion-dollar shelters used regularly and recurringly to destroy all the tax that a corporation owes. But there are other howlers, competing hard to be the worst outrage. For some, the worst howler of these regulations is the rule that employee salaries are free, never part of the cost of investment, and that overhead is also not part of the cost. This is terrible accounting for both tax and nontax purposes: Cost means what you have to get back before you make a profit. If you ignore the cost of overhead and employees, there is no way to get cost right — and the books become surreal.

The regulations give a short tax life to nondepreciating investments such as New York Stock Exchange seats, taxi medallions, and liquor licenses that are investments even better than blue-chip stocks. They give short tax lives to long-lived investments for investors who can shift mere title to some other taxpayer. They repeal venerable revenue rulings that held for capitalization for the government. They create *de minimis* rules for expenses that are well worth accounting for right. The regulations create subsidies for the octopuses in multibillion-dollar takeovers by giving the parties the motive to act like TV wrestlers and make hostile noises even in successful takeovers, purely to take advantage of the expensing of acquisition investments.

Procedurally, the proposed regulations try to make sure that the government never wins a case on the basis of sound principle by denying that the IRS can raise a principled argument on audit or for new cases. Somebody on the government's side has to unearth an abuse, other than by audit, and publish a condemnation before any IRS agent can raise the issue. The point, I take it, is to frustrate audits so that aggressive, even vicious, tax planners will always win on new issues.

These regulations have no North Star except perhaps that the government will always lose.

The regulations are also missing the guiding light of good theory. Given the way that we treat debt, we need to treat investments as income tax theory tells us to treat them. Otherwise, the tax system will be nothing but shelters giving not revenue to the Treasury but artificial tax losses. In an income tax, investments create not immediate expenses but basis. The basis is deducted as the costs expire and become worthless, but if the costs remain as investments, producing future income, the costs need to remain in basis.

There is a prime directive, a North Star, to help us judge accounting conventions. Keep basis equal to the income-producing balance of the bank account that best matches this expenditure. All costs, all investments are bank accounts, at the level of abstraction by which financial economics measures investments. To identify the interest-like income from the investment, one must also identify the balance of the bank account that is just like the investment. Allow the basis to slip below that bank account balance and you cease to have a nondiscriminating, fair tax base. High-bracket taxpayers outbid lower-bracket taxpayers even for assets that the lower-bracket taxpayers would use more efficiently. Shelters — defined as artificial accounting losses that wipe out real income — abound when the asset is debt-financed. These regulations have no North Star except perhaps that the government will always lose.

In the end, the most important task here may be to remind the Treasury of its duty. The duty of the Treasury is to protect a strong tax base for the benefit of our children. A healthy tax base allows the government to collect the same tax at lower rates. A loophole-ridden tax base is the worst of all worlds because it realizes no revenue, but causes economic damage as taxpayers plan around the tax. The real client of the Treasury is a healthy tax base.

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a regular and recurring basis will have the same result after the transition whether it depreciates or expenses its capital investments.

The argument is a fallacy when applied to tax, however. Under a 33.3 percent tax rate, Expensing Inc. will be able to buy not just $l million in machines but $1.5 million. The soft money privilege from expensing allows a bigger upfront investment, and that bigger upfront investment entails that expensing is ordinarily equal in value to exemption of the return from the investment. *See* note 5, *supra.* Depreciating Inc. gets its deductions only when its investment has been lost and getting an extra amount of a worthless investment is no advantage. The steady state fallacy arises because it compares apples and oranges, that is, Depreciating Inc. and Expensing Inc., whereas Expensing Inc. will be 1/1-T times bigger (e.g., 150 percent with a 33.3 percent T) because of the expensing privilege. Examples of and the fallaciousness of the regular and recurring argument are explained in greater depth in Calvin H. Johnson, "Soft Money Investing Under the Income Tax," 1989 *Ill. L. Rev.* 1019, 1072-1077.