Abstract

The Story of INDOPCO: What went wrong in the Capitalization v. Deduction Debate?

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INDOPCO v. Commissioner is the most recent decision discussed in this volume, and, in part for that reason, the decision that is most frequently discussed in the tax world. A case such as *Knetch v. United States* exerts its influence subtly, in forming the basis for today's economic substance doctrine. Lawyers can (and do) debate the merits of that doctrine, and in so doing comment upon the *Knetch* decision, but the decision itself has faded into the background. *INDOPCO*, by contrast, is still very much alive. Industry has lined up an (anti) "INDOPCO Coalition," headed by the (former) IRS Commissioner who pursued the case; the government has recently issued regulations *INDOPCO* regulations; the decision (and its aftermath) is discussed in today's tax and business journals. The case is important, then, for its practical significance. It is the most recent Supreme Court announcement on the deductibility of business expenses that do not produce or enhance tangible assets.

In time, of course, *INDOPCO* will lie under, and help give shape to, newer cases and regulations. The case will be worth studying less for its practical import than the light it sheds on the administration of an income tax, or, more speculatively, any tax or set of rules shaped by the political process. The judge, legislator or administrator must balance competing goals: uniformity, certainty, practicality and so on. In *INDOPCO*, that balancing act failed: the opinion in the case is widely seen as making a bad situation worse. What makes this failure particularly sobering is that the case fell into seemingly able hands. The opinion was written by one of the most knowledgeable tax jurists ever to sit on the Court. The opinion was solicited by an administration whose leadership opposed everything the opinion came to stand for.

The issue at stake in INDOPCO and like cases is a difficult one. Under a "pure" "Haig-Simons" income tax, the treatment of business expenditures is clear: outlays that produce benefit beyond a year comprise an investment that must be capitalized. The capitalized expense is amortized or depreciated as the asset declines in value; the remaining basis is deducted when the asset is sold or declared worthless. For tangible investments this regime works well enough, perhaps. For intangible investments, this regime is problematic. A primary difficulty is that there is no natural line of demarcation between expenses that produce lasting benefit and those that do not. A marketing campaign, for example, may yield sales in the current and future years. A secondary difficulty is that it is often difficult even to estimate as to

the proper amortization of capitalized expense. Cases involving corporate taxpayers sometimes raise yet another issue: whether an expense benefits the corporation or its shareholders.

No single rule or standard will give a satisfactory resolution to these issues. The best that can be hoped for, under an income tax, is to group issues within categories, and for each category to come up with a bright-line rule. Of course, the bright-line rules will be over or under-inclusive, and the categories will to some extent overlap. (A cash flow tax avoids the problem by replacing capitalization with deduction.).

As a circuit court judge, Blackmun had written a thoughtful though unremarkable opinion on the subject. After this elevation to the Court, Blackmun was presented with and wrote the opinion on, a spate of related cases, culminating in INDOPCO. The first case, *Lincoln Savings*, involved an outlay made by a financial institution to a regulatory agency. The facts of the case favored the government. On brief and in oral argument, the government made what might be referred to as the Haig-Simons, or purist, argument for capitalization: that capitalization was required for all expenditures with a useful life in excess of a year. The government might have felt this argument helped its cause in the case at bar, and might have seen the case at bar a good opportunity to sell the court on the purist argument. Blackmun gave the government the victory, but in his opinion stressed that the case involved "separate and distinct" assets. The emphasis on "separate and distinct" was clearly meant to be a negative response to the government's expansive argument for capitalization of all intangibles. That said, the test it was intended to establish was unclear. Was "separate and distinct" a necessary condition for capitalization, so that outlays connected to assets that lacked that quality were deductible? Or was it just that "separate and distinct" was a sufficient condition for capitalization? And what, for that matter, made an asset "separate and distinct?" Taxpayers, courts and the Treasury struggled with these questions for roughly twenty years.

That particular bit of uncertainty case to an end with Blackmun's opinion in INDOPCO. "Separate and distinct," wrote Blackmun, was sufficient to support capitalization, but not necessary. What was of central importance, wrote Blackmun, was the future benefit obtained by a given outlay. Unfortunately, Blackmun did not flesh out exactly what the test that revolved around future benefit might require. Was future benefit itself sufficient to uphold capitalization? Or (as suggested by precedent) was future benefit merely an important factor in the decision? And if the latter was true, what other factors might be considered, and to what extent?

Ironically, then, Blackmun proved a bit of a bumbler, as an opinion writer of tax opinions. His opinions would have been better had they been shorter and not

offered broad but ambiguous tests. His opinions would have been still better, perhaps, had they been longer, and stated with clarity the tests he meant to establish.

Blackmun was not the only party to have made a bad situation worse. In oral argument and brief, the government made broad arguments that (perhaps) made a victory more likely in the case at bar, but that made sensible development of the law less likely. The government would have done better had it behaved less like a litigator and more like a regulator. In this respect, one may question as to whether the transfer of Supreme Court cases to the Solicitor General's Office contributed to the role of government-as-litigator-rather-than-administrator, and, if so, whether it is wise policy.

The directional spin that INDOPCO gave the law has now been stopped (and perhaps been reversed) by administrative action taken by the George W. Bush administration. However, the central problem at issue in INDOPCO remains: it is difficult to apply the capitalization and amortization rules to outlays associated with intangible assets. In the near future, at least, outlays associated with human capital, intellectual property and service businesses are certain to increase – in absolute terms and as a proportion of total outlays. This will make the proper administration of the capitalization requirement even more difficult.