



2002

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Recommended Citation

Jaffke, Cheyanna L. (2002) "Sleeping with the Enemy? The IRS' Advanced Notice of Rulemaking Regarding Capitalization," *University of Baltimore Law Review*: Vol. 32: Iss. 1, Article 3.

Available at: <http://scholarworks.law.ubalt.edu/ublr/vol32/iss1/3>

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SLEEPING WITH THE ENEMY? THE IRS' ADVANCED NOTICE OF RULEMAKING REGARDING CAPITALIZATION

By Cheyaña L. Jaffke†

I. INTRODUCTION

Imagine being lost in a maze where the instructions to the exit are written in a way that is subject to many interpretations. Along the way, you stop and ask people for some direction in interpreting the instructions. You find that there are as many different interpretations as there are people to ask. You want to exit the maze but a wrong turn could be dangerous or costly. Once you reach what seems to be the exit, you feel a sense of relief. But, the next time you enter the maze, you find that it has changed. You have difficulty finding the exit again. Past experience in the maze does not help you. You find that you are once again lost, and so you start all over again.

This is the situation that many taxpayers face when determining if something is an expenditure that must be capitalized or an expense that is currently deductible. The tax code and regulations are vague at best. On this issue, the Internal Revenue Service (IRS) has issued inconsistent guidelines. The various courts have held that the same or similar expenditures between different taxpayers are subject to different treatment. Even tax practitioners do not agree on when something should be capitalized or expensed.

In an effort to provide guidance, the IRS announced in an advanced notice of proposed rule making that it would promulgate regulations regarding the capitalization or deduction of various expenditures.¹ The proposed regulations would address various issues, including a regulation that would permit taxpayers to immediately deduct “regular and recurring” expenses.² The impetus of the

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1. Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461 (proposed Jan. 24, 2002) (to be codified at 26 C.F.R. pt. 1).

2. *Id.* at 3462.

proposed regulations originates from *U.S. Freightways v. Commissioner*,³ where the seventh circuit chided the IRS for inconsistency regarding the application of the capitalization rules.⁴

The seminal case in the area of capitalization was *INDOPCO, Inc. v. Commissioner*,⁵ decided by the Supreme Court in 1992. The IRS, the courts, and taxpayers are still wrestling with the determination of when an item should be deducted or capitalized. Unfortunately, no bright line rule has emerged, and guidance is needed in this area of confusion. IRS regulations, however, are not the proper means to provide this guidance, especially in the area of a "regular and recurring rule." This rulemaking would be encroaching on the purview of Congress.

A glance at the proposed regulations and the resulting taxpayers' comments suggest that the proposal may be too taxpayer-friendly. This raises the question of whether the new kinder, gentler IRS is too kind and too gentle. Why is the IRS bowing to the influence of the business industry and creating rules that favor taxpayers?

Generally, regulations are seen as interpreting the intent of Congress in relationship to a particular code section. However, any proposed regulation that creates an exception for a "regular and recurring rule" would be creating new law, not interpreting the old law.⁶ The IRS lacks the authority to issue regulations that create new law. Therefore, the IRS and taxpayers should seek the necessary guidance from the body that is empowered to provide it, Congress.

Part II of this article provides a general background related to the issue of deducting and capitalizing expenditures and will describe the basic accounting principles that are necessary to fully comprehend the consequences of the IRS' ill-advised efforts to provide guidance. Part III illustrates why the IRS lacks the authority to issue these types of regulations, and discusses the reason why this authority is properly vested in Congress. Part IV explores the problems with a "regular and recurring" exception to the capitalization rules. Finally, Part V of this article concludes that Congress, and not the IRS, is the proper authority to offer desperately needed guidance in the area of capitalization and deduction of expenditures.

II. BACKGROUND

A. *Methods of Accounting*

The Internal Revenue Code permits taxpayers to report their income based upon the method of accounting that they use to keep

3. 270 F.3d 1137 (7th Cir. 2001).

4. *Id.* at 1141-42.

5. 503 U.S. 79 (1992).

6. *See infra* Part III.

their books.⁷ Additionally, the Code lists various methods of accounting that are acceptable.⁸ The vast majority of taxpayers are either cash method taxpayers or accrual method taxpayers.⁹

1. Cash Method of Accounting

The majority of individuals use the cash method of accounting.¹⁰ Under the cash method of accounting, a taxpayer is required to report income “for the year that amounts are actually or constructively received”¹¹ and takes deductions when expenses are paid.¹² Cash method taxpayers’ money flow is closely tied to their reporting of income and deduction.¹³ Income and expenses follow the money. Section 448(a)(1) prohibits C-corporations¹⁴ from using the cash method of accounting.¹⁵ Therefore, C-corporations tend to use the other most common method of accounting, the accrual method.¹⁶

2. Accrual Method of Accounting

Under the accrual method of accounting, taxpayers report income when the “all-events test” is met.¹⁷ This test is satisfied when all-events have occurred that fix the right to the income and the amount of the income can be determined with reasonable accuracy.¹⁸ Accrual taxpayers are permitted to take deductions when the “all-events test” is met and economic performance has occurred.¹⁹ The Supreme Court has emphasized that “a liability does not accrue as long as it remains contingent.”²⁰ Therefore, in order to comply with the “all-events test,”

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7. 26 U.S.C. § 446(a) (1984). All references to code sections are references to the Internal Revenue Code codified in Title 26 of the United States Code. How a taxpayer keeps his or her books refers to the method of financial accounting the taxpayer uses.
 8. 26 U.S.C. § 446(c) (1984).
 9. See 3 ALEXANDER LINDEY & MICHAEL LANDAU, LINDEY ON ENTERTAINMENT, PUBLISHING AND THE ARTS § 15.03 (2d ed. 2002).
 10. See 2 MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 12A:03 (2002).
 11. *Id.*; see 26 U.S.C. § 451(a) (1998); also BLACK’S LAW DICTIONARY 20 (7th ed. 1999).
 12. Treas. Reg. § 1.461-1(a)(1) (1999).
 13. See generally Treas. Reg. § 1.446-1(c)(1) (2002); MERTENS, *supra* note 10, § 12A:03.
 14. See generally BLACK’S LAW DICTIONARY 341 (7th ed. 1999) (defining C corporation as “[a] corporation whose income is taxed through it rather than through its shareholders”).
 15. 26 U.S.C.A. § 448(a)(1) (West 2002).
 16. See MERTENS, *supra* note 10, § 12A:04.
 17. Treas. Reg. § 1.446-1(c)(1)(ii)(A) (2001).
 18. *Id.*
 19. See *id.*
 20. *Brown v. Helvering*, 291 U.S. 193, 200 (1934); accord *Dixie Pine Prods. Co. v. Comm’r*, 320 U.S. 516, 519 (1944).

a liability must be "final and definite in amount,"²¹ "fixed and absolute,"²² and unconditional.²³

Economic performance²⁴ is a requirement that Congress created in order to prohibit taxpayers from taking advantage of the time value of money when taking deductions.²⁵ In essence, it was to prevent taxpayers from accelerating deductions by prepaying them. Generally, under the accrual method a taxpayer's income and deductions do not follow the money flow.²⁶

B. Deductions

Deductions are a matter of legislative grace.²⁷ Congress provided these deductions in Parts VI, VII, and VIII of the Internal Revenue Code, section 161 through section 249.²⁸ Section 161 states: "In computing taxable income . . . there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX."²⁹

Section 162 of the Internal Revenue Code is the trade or business deduction provision. It permits taxpayers to deduct from their gross income those expenses that are "ordinary and necessary" and "paid or incurred during the taxable year in carrying on any trade or business."³⁰

Therefore, in order for something to be currently deductible it must be an expense. Otherwise, it is an expenditure. If an item is an expenditure, it is covered by part IX, "Items Not Deductible," which includes section 263.³¹ Section 263 denies a deduction for those items that fall within its purview.³²

21. *Security Flour Mills Co. v. Comm'r*, 321 U.S. 281, 287 (1944).

22. *Brown*, 291 U.S. at 201.

23. *Lucas v. N. Texas Lumber Co.*, 281 U.S. 11, 13 (1930).

24. For a more detailed explanation of economic performance see Part IV.C.1.

25. H.R. REP. NO. 98-432 at 1254 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 917.

26. *See Baird v. Comm'r*, 256 F.2d 918, 924 (7th Cir. 1958) (stating "an 'accrual method' means that you report income when earned, even if not received, and deduct expenses when incurred, even if not paid, within the taxable period").

27. *See INDOPCO*, 503 U.S. at 84; *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

28. *See* 26 U.S.C.A. §§ 161-249 (West 2002).

29. 26 U.S.C.A. § 161.

30. 26 U.S.C.A. § 162(a).

31. *See* 26 U.S.C.A. §§ 261-80.

32. *See* 26 U.S.C.A. § 263.

1. Section 162

In order for a taxpayer to qualify for a deduction under section 162, the item must meet five requirements.³³ The 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.”³⁴ Each item must be met independently in order to qualify for a deduction.

An item is ordinary if it is the kind of expense that is common in the business community to which the taxpayer belongs.³⁵ An ordinary expense is not necessarily one that the taxpayer must pay on a regular basis.³⁶ Although, sometimes, of course, an ordinary item will be one that the taxpayer regularly incurs.

An item is necessary if it is helpful and appropriate to the particular business of the taxpayer.³⁷ Generally a court will not substitute its judgment for what is helpful and appropriate to the business, for that of the taxpayer.³⁸

The requirement that an item must be paid or incurred in the carrying on of a business³⁹ generally presupposes an existing business.⁴⁰ For example, expenses of investigating or creating a business would not be paid or incurred while carrying on business.⁴¹ Therefore, these expenses would not be deductible under section 162.⁴² A taxpayer would have to look to other code provisions to recover the cost of those expenditures, namely section 195.⁴³

The expense must be for a trade or business.⁴⁴ A trade or business depends upon how the taxpayer engages in the activity.⁴⁵ In order for the activity to qualify as a trade or business, the taxpayer’s activity must be regular and continuous with the primary purpose of the activity being profit or income.⁴⁶ Therefore, a taxpayer that holds herself out to others as selling goods or services would be engaged in a trade or business.⁴⁷

33. See *Comm’r v. Lincoln Sav. & Loan Ass’n*, 403 U.S. 345, 352 (1971).

34. *Id.* (quoting from I.R.C. § 162(a) (1954)).

35. *Welch v. Helvering*, 290 U.S. 111, 113-15 (1933).

36. See *id.* at 114.

37. See *id.* at 113.

38. See *id.* at 115.

39. *Frank v. Comm’r*, 20 T.C. 511, 513 (1953).

40. *Id.* at 513-14.

41. *Id.* at 513.

42. See *id.* at 514.

43. *Id.*

44. See *Comm’r v. Groetzinger*, 480 U.S. 23, 27 (1987).

45. *Id.* at 29.

46. *Id.* at 30.

47. See *id.* at 31.

By and large, the element often in question is whether or not the item is an expense or an expenditure. In order to analyze the issue one must seek guidance from section 263 and its regulations.

2. Section 263

Section 263 is the starting point for determining if something is an expenditure. The statute itself is of little assistance. It merely denies a deduction for items that are "new buildings or for permanent improvements or betterments."⁴⁸ Turning to the regulations, the key language describes an expenditure as "property having a useful life substantially beyond the taxable year."⁴⁹ If the taxpayer's payment creates or enhances an asset that has a useful life substantially beyond the tax year, then the taxpayer cannot currently deduct the payment.⁵⁰ The taxpayer must capitalize the payment, meaning that the taxpayer will recover the cost via depreciation, amortization, or upon sale.⁵¹

The language of the regulation created the confusion that led to the proposed regulations. Taxpayers, the IRS, and courts have been wrestling with whether and when something is substantially beyond the taxable year. The seminal case that attempted to answer these questions was *INDOPCO, Inc. v. Commissioner*.⁵²

C. *INDOPCO, Inc. v. Commissioner*

A taxpayer incurred investment banking, legal and other costs in the course of a friendly takeover.⁵³ The taxpayer sought to immediately deduct these costs under section 162.⁵⁴ The IRS argued that the taxpayer must capitalize the expense under section 263.⁵⁵ The taxpayer made its arguments based on the Supreme Court's holding in *Commissioner v. Lincoln Savings and Loan Ass'n*⁵⁶ that expenses that "create or enhance . . . a separate and distinct additional asset" must be capitalized.⁵⁷ The taxpayer argued that this created a test that limited when expenses must be capitalized.⁵⁸

48. 26 U.S.C.A. § 263(a)(1) (West 1997).

49. 26 C.F.R. § 1.263(a)-2(a) (2002).

50. *Comm'r v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 361 (1971).

51. 1 BORIS I. BITTKER, *FEDERAL TAXATION OF TAXATION OF INCOME, ESTATES AND GIFTS* § 20.4.1 (1981).

52. 503 U.S. 79 (1992).

53. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 82 (1992) (holding that investment banking, legal, and other expenses incurred in friendly takeover did not qualify for a deduction as "ordinary and necessary" business expenses).

54. *Id.*

55. *Id.* at 83 (quoting 26 U.S.C. § 263(a)(1) (1994)).

56. 403 U.S. 345 (1971).

57. *INDOPCO*, 503 U.S. at 83 (quoting *Lincoln*, 403 U.S. at 354).

58. *Id.* at 86.

However, the Court noted that “deductions are exceptions to the norm of capitalization.”⁵⁹ Therefore, deductions should be “strictly construed,” meaning that deductions would only be allowed if “there is a clear provision therefore.”⁶⁰ The Court in *INDOPCO* limited *Lincoln Savings* to the proposition that “the creation of a separate and distinct asset may well be a sufficient, but not a necessary condition to classification as a capital expenditure.”⁶¹ The Court proceeded to state that the indicia of capitalization includes “a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred [and that it] is undeniably important in determining whether the appropriate tax treatment is [an] immediate deduction or capitalization.”⁶² *INDOPCO*’s guidance falls far short of a bright line rule on when an asset should be capitalized; rather, it suggested an examination of the potential incidental future benefit of the asset and the “amorphous” nature of the asset itself.⁶³ The Court stated that “an incidental future benefit—’some future aspect’—may not warrant capitalization.”⁶⁴ Courts, the IRS and taxpayers have been unable to reach a consensus on what is meant by “an incidental future benefit.”

D. U.S. Freightways v. Commissioner

This lack of consensus culminated in *U.S. Freightways v. Commissioner*.⁶⁵ The taxpayer, an accrual method calendar year C- corporation, incurred over \$5 million for fees, licenses, insurance and permits (FLIP expenses) in order to operate its fleet of trucks.⁶⁶ These expenses were for exactly one year, but because of various due dates, some of the expenses carried over into the following calendar year.⁶⁷ According to the taxpayer’s financial records, fifty-five percent of the expenses were allocable to the following calendar year.⁶⁸

The taxpayer argued that it should be able to deduct the expenses all in the year paid, rather than allocating the expenses among the two years covered by the expenses.⁶⁹ The IRS argued that, because the benefit of the expenses extended substantially beyond the close of the tax year the taxpayer was required to capitalize the expenses.⁷⁰

59. *Id.* at 84.

60. *Id.* (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)); see also *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940).

61. *INDOPCO*, 543 U.S. at 87.

62. *Id.*

63. *Id.* at 87, n.6.

64. *Id.* at 87 (emphasis in original).

65. 113 T.C. 329 (1999), *rev’d* 270 F.3d 1137 (7th Cir. 2001).

66. See *id.* at 330-31.

67. *Id.*

68. *U.S. Freightways Corp. v. Comm’r*, 270 F.3d 1137, 1139 (7th Cir. 2001).

69. See *Freightways*, 113 T.C. at 330-31.

70. *Id.* at 331.

Because the taxpayer was an accrual method taxpayer, it could only deduct the expenses if the "all-events test" was met and if economic performance had occurred.⁷¹ The "all-events test" requires that all events have occurred, which establish liability and that the amount can be determined with reasonable accuracy.⁷² There was no question in this case that the "all-events test" was met as to the FLIP expenses.⁷³

Additionally, an accrual method taxpayer may not deduct the expense until economic performance has occurred.⁷⁴ According to the regulations, economic performance for the FLIP expenses occurred as the taxpayer paid the expenses.⁷⁵ Under a strict application of the accrual method of accounting, the taxpayer would have been able to deduct the FLIP expenses if the benefit of the payments was limited to the tax year of the payment.⁷⁶

The IRS used section 446(b) to argue that the taxpayer's method of accounting did not clearly reflect income for the FLIP expenses.⁷⁷ The IRS further argued that the proper method of accounting for these expenses was to prorate the expenses between the two tax years that were covered by the FLIP expenses.⁷⁸ The taxpayer already prorated the expenses in this way for financial accounting purposes.⁷⁹

In the tax court, the taxpayer argued that the "one-year rule" that applies to cash method taxpayers should apply to accrual method taxpayers.⁸⁰ The judicially created "one-year rule" permits cash method taxpayers to deduct a prepayment of expenses in the year paid, so long as the prepayment did not extend more than 12 months from the end of the tax year of the payment.⁸¹

The tax court recognized the distinction between cash method taxpayers and accrual method taxpayers, explaining that the application of some rules would hinge on the method employed by individual taxpayers.⁸² In accord with precedent, the tax court limited the applica-

71. See Treas. Reg. § 1.446-1(c)(1)(ii)(A) (2001).

72. See *id.*

73. See *Freightways*, 113 T.C. at 330 (stating that the company paid for licenses necessary to conduct business).

74. Treas. Reg. § 1.446-1(c)(1)(ii)(A) (2002).

75. Treas. Reg. § 1.461-4(g)(5) & (6) (2002).

76. See *Freightways*, 270 F.3d at 1143 (discussing that the problem with the FLIP expenses is not that they last longer than 365 days, but that they fall over two tax years).

77. See *Freightways*, 113 T.C. at 337.

78. *Id.* at 331.

79. *Id.* at 330-31.

80. See *id.* at 335.

81. *Zaninovich v. Comm'r*, 616 F.2d 429, 432 n.6 (9th Cir. 1980), *rev'g*, 69 T.C. 605 (1978).

82. *Freightways*, 113 T.C. at 336.

tion of the “one-year rule” to cash method taxpayers, negating the possibility of applying the rule to accrual method taxpayers.⁸³

On appeal, the seventh circuit reversed the holding of the tax court.⁸⁴ First, the court of appeals examined the level of deference afforded the Commissioner’s interpretation of the term “substantially” within the regulations.⁸⁵ The court of appeals decided that the Commissioner’s interpretation warranted less deference than granted in *Chevron v. Natural Resources Defense Council*⁸⁶ because of the informality of the Commissioner’s interpretation.⁸⁷

Second, the court then examined the regulation that requires capitalization for benefits that extend substantially beyond the tax year,⁸⁸ but only after noting that the language of the regulation was identical for cash method taxpayers and accrual method taxpayers.⁸⁹ The court opined that because of the identical language, the Commissioner’s interpretation must be consistent between cash and accrual method taxpayers.⁹⁰ The court also noted that the Commissioner’s interpretation lacked consistency between accrual method taxpayers; therefore, the court afforded the Commissioner’s interpretation little deference.⁹¹

After turning its attention to the recurring nature of the FLIP expenses,⁹² the court held that the “one-year rule” also applies to accrual method taxpayers.⁹³ It is unclear from the court’s opinion, whether the “one-year rule” would apply to accrual method taxpayers that do not have recurring expenses.

E. Advanced Notice Of Rulemaking

On January 24, 2002, the IRS issued an advanced notice of proposed rulemaking regarding the promulgation of regulations for section 263(a).⁹⁴ The notice for the proposed section recognized that the “fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expenditures re-

83. *Id.* at 337.

84. 270 F.3d 1137 (7th Cir. 2001).

85. *Id.* at 1141-42.

86. 467 U.S. 837 (1984) (holding that courts afford agency administrators deference when interpreting regulations where congressional intent is unclear).

87. *Freightways*, 270 F.3d at 1142.

88. *Id.* at 1143-45.

89. *Id.* at 1143.

90. *Id.*

91. *Id.* at 1145.

92. *Freightways*, 270 F.3d at 1145-47.

93. *Id.* at 1147.

94. Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (proposed Jan. 24, 2002)(to be codified at 26 C.F.R. pt. 1).

lating to the production of income in future taxable years."⁹⁵ The purpose of this proposed section is "[t]o reduce the administrative and compliance costs associated with section 263(a)."⁹⁶

The proposed regulations give certain havens to taxpayers including the "one-year rule" and "de minimis rules."⁹⁷ Under the "one-year rule," expenditures that relate "to intangible assets or benefits whose lives are of a relatively short duration are not required to be capitalized."⁹⁸ The "de minimis rules" would permit specific expenditures to be deducted when they fall below a certain dollar amount.⁹⁹

The proposal also stated that the IRS would consider a "regular and recurring rule," which would permit "costs incurred in transactions that occur on a regular and recurring basis in the routine operation of a taxpayer's trade or business" to be immediately deductible.¹⁰⁰

Part III focuses on the "regular and recurring rule," and takes the position that the IRS lacks the authority to issue regulations on this topic.¹⁰¹ It further argues that even if the IRS has the authority, Congress is in the best position to offer taxpayers guidance concerning the "regular and recurring rule."¹⁰² Finally, Part IV argues that any proposed regulation that offers a "regular and recurring rule" would be inappropriate, because it conflicts with Congress' rule regarding recurring items in section 461(h)(3).

III. THE IRS LACKS THE AUTHORITY TO ISSUE REGULATIONS

Under the administrative law policies, agencies can promulgate two types of regulations: legislative and interpretative.¹⁰³ The basic difference between these two regulations is how the regulations are promulgated.¹⁰⁴ Generally, legislative regulations comply with the Administrative Procedures Act and are subject to public notice and comment.¹⁰⁵ Interpretive regulations, on the contrary, are not re-

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (proposed Jan. 24, 2002) (to be codified at 26 C.F.R. pt. 1).

100. *Id.*

101. *See infra* Part III.C.

102. *See infra* Part III.C.

103. William G. Andreozzi, *Prohibiting the Deduction for Non-Corporate Tax Deficiency Interest: When Treasury Goes Too Far*, 34 J. MARSHALL L. REV. 557, 576 (2001); *see also* Elizabeth Williams, *What Constitutes "Interpretative Rule" of Agency so as to Exempt Such Action From Notice Requirements of Administrative Procedure Act* (5 U.S.C.S. § 553(b)(3)(A)), 126 A.L.R. FED. 347 (1995).

104. Naftali Z. Dembitzer, *Beyond the IRS Restructuring and Reform Act of 1998: Perceived Abuses of the Treasury Department's Rulemaking Authority*, 52 TAX LAW. 501, 503 (Spring 1999).

105. *See* 5 U.S.C.A. § 553(b)-(c) (West 1996); *see also* CHARLES H. KOCH, JR., *ADMINISTRATIVE LAW AND PRACTICE* § 4.11[2] (2d ed. 1997).

quired under the Administrative Procedures Act to be subject to public notice and comment.¹⁰⁶ Because legislative and interpretive regulations have different authorization requirements, the procedural steps needed to promulgate the regulations vary.¹⁰⁷

A. Tax Regulations

However, in the tax arena, the two different regulations are not based upon how they are promulgated.¹⁰⁸ Almost all of the treasury regulations that address a tax issue have been subject to public notice and comment in compliance with the Administrative Procedures Act.¹⁰⁹ The difference between the two types of regulations is generally the authority under which the Secretary promulgates the regulations.¹¹⁰

1. Legislative

Legislative regulations are those regulations in which Congress has expressly granted the Secretary authority to promulgate regulations for a particular code section.¹¹¹ It is generally viewed that legislative regulations are the result of an incomplete code section in which Congress envisions the Secretary and his agent, the Commissioner, completing the code section with regulations.¹¹² For example, in section 1(g)(7)(C), Congress grants the Secretary specific authority to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph.”¹¹³ Therefore, any regulations issued by the Secretary that deal with the election to claim certain unearned income of a child on the parent’s return would be legislative regulations.¹¹⁴

2. Interpretive

Interpretive regulations are those regulations that the Secretary issues pursuant to the authority granted to him under section 7805.¹¹⁵

106. 5 U.S.C.A. § 553(b)(3)(A) (West 1996).

107. See KOCH, *supra* note 105, at § 4.11[3].

108. Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 56 (1996).

109. *Id.* at 57.

110. *Id.* at 56-57.

111. *Id.* at 56.

112. See *Chevron v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984); see also John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 GEO. WASH. L. REV. 35, 69-70 (1995); Jason T. Bell, Comment, *Bankers Life & Casualty Co. v. United States: Using a Balanced Approach to Review a Treasury Regulation Issued Pursuant to the Commissioner’s General Authority*, 34 NEW ENG. L. REV. 449, 454 (2000).

113. 26 U.S.C.A. § 1(g)(7)(C) (West 2001).

114. See *id.*; see also Aprill, *supra* note 108, at 56-57.

115. 26 U.S.C.A. § 7805(a) (West 1989) (stating “the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all

When Congress does not grant specific authority to enact regulations to enforce a particular code section, then the code section is viewed as complete.¹¹⁶ Any regulations would serve only to interpret the law as given by Congress.¹¹⁷ Most tax regulations are interpretive regulations.

B. *The Proposed Regulations*

In its advanced notice of proposed rulemaking, the IRS cites section 263 as the code section for which the proposed regulations will be issued.¹¹⁸ An examination of section 263 reveals no specific authority within the section for the Secretary to issue regulations to enforce the code section.¹¹⁹ Therefore, the regulations would have to be promulgated under the authority of section 7805 and will be interpretive regulations.

Because the regular and recurring rule will permit the immediate expensing of trade or business expenses, an examination of section 162 is unwarranted. Section 162(h)(3) grants the Secretary authority to prescribe regulations relating to the time and manner of an election that state legislatures can make regarding their expenses as state legislatures.¹²⁰ Section 162 contains no other grants of specific authority.

Because neither section 162 nor section 263 grants the Secretary specific authority to prescribe these regulations, the proposed regulations would be interpretive regulations. However, the regulations will be subject to the same public notice and comment as legislative regulations.

C. *Why The IRS Lacks Authority*

Section 7805 grants authority for necessary rules.¹²¹ That is not to say that rules and regulations are not needed in section 263 and the determination of when an expenditure should be capitalized. However, that authority should be interpreted narrowly so that not any regulation can be promulgated under the auspices of a particular code section, when that regulation greatly exceeds or contradicts the intent of Congress.

rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue"); see also Aprill, *supra* note 108, at 56.

116. Coverdale, *supra* note 112, at 70; see also Bell, *supra* note 112, at 454.

117. See Coverdale, *supra* note 112, at 69-70.

118. Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (proposed Jan. 24, 2002) (to be codified at 26 C.F.R. pt. 1).

119. 26 U.S.C.A. § 263 (West 1997).

120. 26 U.S.C.A. § 162(h)(3) (West 2000).

121. 26 U.S.C.A. § 7805(a) (West 1998).

The Supreme Court has stated that the Secretary cannot use his rulemaking authority to create new law.¹²² A “regular and recurring” rule would be just that, a new law. It would fit under the auspices of an exception to the norm of capitalization. In other words, something that should be capitalized absent the rule will now be deductible if it is a regular and recurring item in the taxpayer’s business. It has been repeatedly recognized that capitalization is the norm and that deductions need to be narrowly construed.¹²³ In effect, although the regulation would appear to be an exception to the capitalization norm, it would, in fact, act as a deduction.

Section 263(a) disallows deductions for capital expenditures.¹²⁴ Therefore, a taxpayer needs another code section allowing the deduction.¹²⁵ The taxpayer will turn to section 162. However, the regulation seems to add an additional intermittent aspect to the expense element of section 162.¹²⁶ It would create a new test for the expense element of section 162. The taxpayer would ask first, is the item regular and recurring? If yes, then the expense element is met. The taxpayer would never get to section 263.

This contradicts Congress’ intent of capitalization being the norm.¹²⁷ Under section 162, Congress indicated, and the courts have recognized, that an expense is a required element for deduction, which requires an analysis of, and comparison with, section 263.¹²⁸ Congress enacted section 263 so that taxpayers would be forced to analyze their expenses to properly match income with expenses.¹²⁹ However, a regular and recurring rule would permit taxpayers to side step this necessary, but difficult examination. The result would be a lack of matching of income and expenses, and the opportunity for abuse. Taxpayers could pre-pay regular and recurring expenses that would otherwise have to be capitalized in order to accelerate the tax benefits.

122. *Morrill v. Jones*, 106 U.S. 466, 467 (1883).

123. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1991); *see supra* Part II.C.

124. 26 U.S.C.A. § 263(a) (West 2002).

125. *See* 26 U.S.C.A. § 161 (West 2002).

126. *See* 26 U.S.C.A. § 162(a) (2000).

127. *INDOPCO*, 503 U.S. at 84; *see* Alan Gunn, *The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COMMERCIAL L. REV. 443 (1974); John W. Lee & Nina R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473 (1981).

128. *Comm’r v. Lincoln Sav. & Loan Ass’n*, 403 U.S. 345, 352 (1971) (quoting I.R.C. § 162(a)); *see also* John Lee et al., *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations (Part One)*, 23 OHIO N.U. L. REV. 631, 633 (1997).

129. *See* *Comm’r v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *see also* Peter L. Faber, *INDOPCO: The Still Unsolved Riddle*, 47 TAX LAW. 607, 612 (1994).

Because the proposed regulations would conflict with the intent of Congress in enacting sections 263 and 162, the regulations would be improper under section 7805.¹³⁰

D. Congress Is the Proper Actor

Although the IRS consists of experts on tax law, the agency's purpose is to interpret and administer the tax laws, not make them.¹³¹ Enacting the proposed regulation, or a similar one, would be creating a new law.¹³² The IRS is attempting to make sense of the widespread confusion that has followed *INDOPCO* by enacting this regulation. However, the various and often conflicting judicial, as well as, IRS interpretations demand that Congress intervene and resolve the issue of capitalization versus deduction.

One of the IRS' charges is to protect the interest of the public treasury.¹³³ Another is to represent the best interest of the government.¹³⁴ In compliance with the Administrative Procedures Act, the IRS will submit the proposed regulation for public notice and comment.¹³⁵ Various taxpayers and taxpayer entities will make comments regarding the regulations. However, because of widespread support for the regulation, as seen by the comments sought by the proposed regulation,¹³⁶ the regulation may not necessarily result in the best law, which is in the best interest of the government.

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130. See *Idaho Power Co.*, 418 U.S. at 16; Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3462 (proposed Jan. 24, 2002) (to be codified at 26 C.F.R. pt. 1); see also I.R.C. §§ 7805, 263 (2002).
131. See David A. Brennen, *Treasury Regulations and Judicial Deference in the Post-Chevron Era*, 13 GA. ST. U. L. REV. 387, 388 (1997).
132. See George Hertz, *IRS Agent Criticizes Proposed Guidance on Rules on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Mar. 29, 2002), available at LEXIS, Taxation, Legal News, 2002 TNT 61-22; see also Samuel E. Whitley, *Writer Criticizes Proposed Guidance on Capitalizing Cost of Intangibles*, TAX NOTES TODAY (Mar. 29, 2002), available at LEXIS, Taxation, Legal News, 2002 TNT 61-24.
133. *U.S. v. Hughes Properties, Inc.* 476 U.S. 593, 603 (1986); *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542 (1979).
134. Coverdale, *supra* note 112, at 71.
135. Administrative Procedure Act § 6, 5 U.S.C. § 553 (West 1994).
136. Deborah Aiken, *ABA Tax Section Meeting: Accounting Guidance Gets Thumbs Up*, TAX NOTES TODAY (May 13, 2002), available at LEXIS, Taxation, Legal News, 2002 TNT 92-9; Mark R. Baran, *Bankers Association Offers Suggestions For Rules on Capitalizing Costs of Intangibles*, TAX NOTES TODAY (Apr. 5, 2002), available at LEXIS, Taxation, Legal News, 2002 TNT 66-26; Catherine Barre & Keith Lawson, *Investment Institute Suggests Changes to Capitalization Rules for Intangible Assets*, TAX NOTES TODAY (Apr. 2, 2002), available at LEXIS, Taxation, Legal News, TNT 63-15; Pamela J. Pecarich, *AICPA Suggests Changes to Proposed Regs on Capitalizing Expenditures*, TAX NOTES TODAY (May 17, 2002), available at LEXIS, Taxation, Legal News, 2002 TNT 66-26; Frederick H. Robinson, *Attorney Expresses Support for Capitalization Rules for Intangible Assets*, TAX NOTES TODAY (Apr. 2, 2002), available at LEXIS, Taxation, Legal News, 2002 TNT 63-14.

Very few of the comments regarding the proposed regulations are negative.¹³⁷ The fear is that the IRS will attempt to draft the regulation in a manner that is too favorable to the taxpayer and unfavorable to the government.¹³⁸ In proposing such a regulation, the IRS is abandoning its responsibilities in favor of appeasing taxpayers.

Once the regulation has survived the notice and comment procedure and is enacted, courts will generally grant the regulation *Chevron* deference.¹³⁹ With this level of deference, the government's interest becomes harder to protect.¹⁴⁰ If the IRS fails to protect the government's interest at the first level, the promulgation stage, then Congress cannot assume that the IRS will act in the government's best interest when carrying out the regulations.¹⁴¹ This failure requires the courts to intercede. However, because of *Chevron*, most courts will feel uncomfortable assuming this role.¹⁴² With the IRS abandoning its responsibilities and the courts unlikely to act, Congress will be forced to enact legislation to correct the problem. Because it is likely that Congress will have to respond to the issue at some time, it is better to have Congress respond sooner than later.

The IRS has been inconsistent in the interpretation of when something should be capitalized.¹⁴³ Will the proposed regulations resolve the tendency to be inconsistent regarding capitalization? The regulations would only serve as guidelines for the IRS. Those guidelines will still be subject to interpretation by IRS agents, attorneys and other employees, because someone will have to determine if the item is regular and recurring. Unless a taxpayer's particular expenditure falls within a stated exception to the norm of capitalization, the IRS and the taxpayer may still disagree on whether or not the expenditure should be capitalized. Outside the stated exceptions there still exists the opportunity for taxpayers to face inconsistent interpretations. It would be impossible for the IRS to draft regulations that would cover every possible expenditure and determine if it should be deducted or capitalized.

137. Hertz, *supra* note 132; *see also* Whitley, *supra* note 132.

138. Hertz, *supra* note 132; *see also* Whitley, *supra* note 132.

139. Bankers Life and Cas. Co. v. U.S., 142 F.3d 973, 980 (7th Cir. 1998); *see* Aprill, *supra* note 108, at 63-64 and Coverdale, *supra* note 112, at 69-70 for a discussion of *Chevron* deference.

140. With *Chevron* deference, the first step a court examining a regulation takes is to determine if Congress has spoken on the issue on point. *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 842-44 (1984). If not, then the court determines if the agency's interpretation is reasonable. *See id.*

141. Aprill, *supra* note 108, at 64.

142. *See* U.S. v. Correll, 389 U.S. 299, 306-07 (1967) (stating that the judiciary's role is to make sure that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner).

143. U.S. Freightways, Corp. v. Comm'r, 270 F.3d 1137, 1139 (7th Cir. 2001).

IV. PROBLEMS WITH A REGULAR AND RECURRING RULE

A. *The "One-Year Rule"*

Part of the confusion surrounding the capitalization versus deduction issue involves a misunderstanding of what is commonly referred to as the "one-year rule."¹⁴⁴ The proposed regulations suggest a twelve-month rule,¹⁴⁵ which must be read in conjunction with the regular and recurring rule. Failure to do so, would suggest that a taxpayer could deduct a regular and recurring item even if the expenditure created an asset that had a useful life of more than one year. Such a reading would avoid section 263 and the norm of capitalization.¹⁴⁶

The "one-year rule" arose out of the ninth circuit in *Zaninovich v. Commissioner*.¹⁴⁷ In *Zaninovich*, a cash basis taxpayer prepaid 12 months of rent for farm property as required by the lease,¹⁴⁸ which was also the custom in the area farming industry.¹⁴⁹ The taxpayer sought to deduct the entire amount in the year paid, even though the rent was mostly allocable to the next tax year.¹⁵⁰ The tax court declined to permit the deduction.¹⁵¹ However, the ninth circuit permitted the deduction, stating: "[u]nder the 'one-year rule' an expenditure is treated as a capital expenditure if it creates an asset, or secures a like advantage to the taxpayer, having a useful life in excess of one year."¹⁵²

The court distinguished between accrual method and cash method taxpayers.¹⁵³ The court noted that a difference in deductions for the two methods is that the accrual method requires deductions to be matched to income, whereas the cash method does not have the same requirement.¹⁵⁴ It emphasized that pro-ration is necessary for proper matching of income to expenses.¹⁵⁵

The court then goes on to note that "the 'one-year rule' is strictly applied to allow a full deduction in the year of payment."¹⁵⁶ *Zaninovich* suggests that the court understood that the "one-year rule" did

144. Compare *U.S. Freightways, Corp. v. Comm'r*, 113 T.C. 329, 337 (1999) (holding that the "one-year rule" does not apply to accrual method taxpayers), with *U.S. Freightways, Corp. v. Comm'r*, 270 F.3d 1137, 1141 (7th Cir. 2001) (extending the "one-year rule" to accrual method taxpayers).

145. Guidance Regarding Deduction and Capitalization of Expenditures 67 Fed. Reg. 3461, 3462 (proposed Jan. 24, 2002) (to be codified at 26 C.F.R. pt. 1).

146. See *id.*

147. 616 F.2d 429 (9th Cir. 1980).

148. *Id.* at 430.

149. *Id.* at 430 n.2.

150. *Id.* at 430.

151. *Zaninovich v. Comm'r*, 69 T.C. 605, 608 (1978).

152. *Zaninovich*, 616 F.2d at 432.

153. *Id.* at 431 n.5.

154. *Id.*

155. *Id.*

156. *Id.* at 432 n.6.

not apply to accrual method taxpayers, because as a general rule, their deductions are not tied to payment, like those of a cash method taxpayer.¹⁵⁷

In addition to mistakenly applying the “one-year rule” to an accrual method taxpayer, the seventh circuit in *U.S. Freightways* failed to acknowledge the additional requirements of the “one-year rule” that were created by the tax court in *Grynberg v. Commissioner*.¹⁵⁸ The cash method taxpayer in *Grynberg* attempted to deduct the prepayment of expenses that would have been deductible under section 162 as trade or business expenses.¹⁵⁹ The tax court stated that when a deduction for a prepayment by a cash method taxpayer is considered under this section, then three requirements must be met.¹⁶⁰

The first requirement is that the taxpayer must actually pay the expense.¹⁶¹ The next requirement is that the taxpayer must have a “substantial business reason” for prepayment of the expense and that the purpose for prepayment must be one other than to accelerate a deduction.¹⁶² Finally, the last requirement mandates that the prepayment cannot cause a material distortion in the taxable income of the taxpayer.¹⁶³

Arguably, these requirements are for cash method taxpayers, and the court did not consider what requirements might apply to accrual method taxpayers. This court’s lack of consideration of the accrual method taxpayers might suggest that the tax court did not contemplate application of the “one-year rule” to these taxpayers. Despite the limitation of these requirements to cash method taxpayers, the seventh circuit, when considering extending the “one-year rule” to accrual method taxpayers, should have examined the purpose and intent behind the additional requirements to ensure that taxpayers are treated consistently. By ignoring these additional requirements, the court created a loophole that accrual method taxpayers can use to avoid matching income to expenses.

The proposed regulations also appear to disregard these additional requirements. It is unclear from the regulations if cash method taxpayers would now be excused from meeting these requirements.

157. *Zaninovich*, 616 F.2d at 431-32 nn.5-6.

158. *U.S. Freightways Corp. v. Comm’r*, 270 F.3d 1137, 1142-43 (7th Cir. 2001) (citing *Grynberg v. Comm’r*, 83 T.C. 255 (1984)).

159. *Grynberg*, 83 T.C. at 265 n.10.

160. *Id.* at 265.

161. *Id.*

162. *Id.* at 266.

163. *Id.*

B. Where Would the One-Year Rule Fit into the Internal Revenue Code?

Because regulations modify and interpret existing code sections,¹⁶⁴ the regular and recurring regulation must fall under a particular code section. The regulation will not be able to stand on its own. This requirement necessitates that the authors of the regulation carefully consider the tax scheme of the code and properly fit in the regulation. The regulation's author has two options for placement of the regulation.

1. Would This Regulation Modify Section 263?

The regulation could fall under the auspices of section 263, the code section known as the capitalization section. In essence, the regulation would operate as an exception to the norm of capitalization. However, section 263 is not a deduction statute. In fact, it is just the opposite. Section 263 states: "[n]o deduction shall be allowed" and then lists capital expenditures in which deductions are not allowed.¹⁶⁵ Consequently, section 263 cannot operate as authority for expressly allowing a deduction; whereas in section 161, Congress specifically enumerated deductions allowed by the Code.¹⁶⁶

Logic suggests that the IRS cannot use a non-deduction statute to create a deduction. Therefore, despite coming under the auspices of section 263, the regulation would need to be read together with another code section in order to create a deduction. The obvious choice is section 162 -the trade or business expense section.

2. Would This Regulation Modify Section 162?

Another way to interpret the regulation is that it substitutes a recurring element for the expense element. Under this interpretation, a taxpayer who is determining whether an expenditure is deductible under section 162 or must be capitalized under section 263, would be able to deduct the amount in full if the expenditure is regular and recurring in nature. It is unclear if a taxpayer would be required to determine if the deduction resulted in better matching or caused a material distortion in income. If this were the case, then there would no longer be a need for different methods of accounting.

By adding this substitution to section 162, the IRS would be creating an exception that is in direct conflict with the spoken intent of Congress.¹⁶⁷ Congress has spoken on the issue of recurring expenses with section 461(h)(3), the recurring item exception.¹⁶⁸

164. See generally Brennen, *supra* note 131, at 388-89.

165. 26 U.S.C.A. § 263(a) (West 2002).

166. See *id.*; see also 26 U.S.C.A. § 161 (West 2002).

167. See 26 U.S.C.A. § 461(h)(3) (West 2002).

168. *Id.*

C. *How Would The One-Year Rule Interact with Other Code Requirements?*

1. How Would This New Rule Interact with and Impact the Congressionally Created Recurring Item Exception of Section 461(h)(3)?

In 1984, Congress added an economic performance requirement to the deduction of expenses for accrual method taxpayers.¹⁶⁹ This requirement was to take into account the time value of money and to prevent accrual method taxpayers from accelerating deductions by prepaying them.¹⁷⁰ In general, economic performance requires that all the obligations tied to the expense be fulfilled.¹⁷¹ For example, if the taxpayer hires an employee, economic performance would occur as that the employee provides services to the employer.¹⁷²

Congress recognized that the economic performance requirement might hinder the normal operations of a business, so it created the recurring item exception to economic performance.¹⁷³ This exception would allow a taxpayer to deduct an expense prior to economic performance if economic performance would occur within a reasonable period after the close of the tax year, or eight and one-half months after the close of the tax year.¹⁷⁴ Congress also created three other requirements.¹⁷⁵

Additionally, the item must be recurring in nature.¹⁷⁶ It needs to be an expense that the taxpayer regularly incurs in business.¹⁷⁷ Furthermore, the taxpayer must have consistently treated it as deductible in the year that the all-events test is met.¹⁷⁸ This requires that the taxpayer's treatment of the item for financial accounting as well as tax accounting should correspond. Finally, the item needed to be immaterial or that immediate deduction would result in a better matching of the expense to the income it generated.¹⁷⁹

Was this what the seventh circuit had in mind when it held in *U.S. Freightways* that "ordinary, necessary, and recurring expenses for the business" would be deductible?¹⁸⁰ *Freightways* qualified for a recurring

169. 26 U.S.C.A. § 461(h) was added by Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 1984 U.S.C.C.A.N. (98 Stat.) 494, 598-601.

170. H.R. REP. NO. 98-432 at 1254 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 917.

171. For a detailed explanation of economic performance and the history of its enactment, see Erik M. Jensen, *The Deduction Of Future Liabilities By Accrual-Basis Taxpayers: Premature Accruals, The All Events Test, And Economic Performance*, 37 U. FLA. L. REV. 443 (1985).

172. 26 U.S.C.A. § 461(h)(2)(A)(i) (West 2002).

173. See H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 873, *reprinted in* 1984 U.S.C.C.A.N. 1445, 1561.

174. 26 U.S.C.A. § 461(h)(3)(A)(ii) (West 2002).

175. *Id.* § 461(h)(3)(A)(iii) & (iv).

176. *Id.* § 461(h)(3)(A)(iii).

177. *U.S. Freightways, Corp. v. Comm'r*, 270 F.3d 1137, 1147 (7th Cir. 2001).

178. 26 U.S.C.A. § 461(h)(3)(A)(iii) (West 2002).

179. *Id.* § 461(h)(3)(A)(iv).

180. *U.S. Freightways*, 270 F.3d at 1147.

item exception because the expenses at issue were fixed yearly expenses.¹⁸¹ That being the case, it would suggest that the recurring nature the court was referring to was outside the scope of section 461(h)(3). Additionally, tying the recurring nature with ordinary and necessary it would appear that the court was adding a requirement to section 162.

What is the effect of having a regular and recurring rule on the recurring item exception that Congress created? Would the regulation replace the exception Congress created? If an item was recurring under the regulation would it be presumed to be recurring for purposes of section 461(h)(3)? Would a taxpayer no longer have to be concerned with the materiality or the matching of expenses to income if the item is recurring?

A regular and recurring regulation that grants a deduction is not necessary, because Congress has already provided for it with section 461(h)(3).¹⁸² Any regulation that runs counter to section 461(h)(3) would violate Congressional intent. Any regulation that replaces or usurps the recurring item exception will be overreaching its bounds. The regular and recurring regulation must take into account the intent of Congress in requiring a lack of materiality or better matching for immediate deduction of recurring items.

2. At What Point of Analysis Would a Taxpayer Input the New Regular and Recurring Rule?

Another issue that needs to be clarified regarding the regular and recurring regulation is where it would fit in the analysis a taxpayer completes for each expenditure in determining if that expenditure is immediately deductible. Would the taxpayer first determine if section 162 applies, then determine if the item is recurring? If that is the case, then the method of accounting the taxpayer uses would be immaterial. An accrual method taxpayer will be able to avoid the economic performance requirement by characterizing the item as recurring.

If the regular and recurring regulation is taken into account under the taxpayers' method of accounting, it will only be useful to accrual method taxpayers. Cash method taxpayers do not need a regular and recurring exception, because these taxpayers have the judicially created "one-year rule."¹⁸³

So, would this regulation be used to treat accrual and cash method taxpayers equally? Doing so would ignore the diverse purposes and goals of the two different methods of accounting. The purpose of the

181. *Id.*

182. 26 U.S.C.A. § 461(h)(3)(A)(iv) (West 2002).

183. *See U.S. Freightways*, 270 F.3d at 1140.

cash method of accounting is simplicity.¹⁸⁴ The purpose of the accrual method of accounting is to match the expenses of a business with the income that it produces.¹⁸⁵ There will be times when these various purposes create inconsistencies for different taxpayers.

The placement of section 461(h)(3) suggests that Congress recognizes the recurring item exception as a timing element and only relevant to accrual taxpayers. Therefore, Congress uses it as a substitute for economic performance, but still requires a clear reflection of income or matching. Whereas a regular and recurring rule would do away with this clear reflection of income requirement, which is inconsistent with Congress' spoken intent.

V. CONCLUSION

It is without question that taxpayers need guidance in determining whether to capitalize or currently deduct an expenditure. However, both the courts and the IRS have demonstrated a lack of consistency and a misunderstanding of the issues. Therefore, it is necessary for Congress to act to clarify the issues. It is only with a strong general rule that both the courts and the IRS will be able to provide guidance to taxpayers.

The current state of the law is in such a shamble that neither the court nor the IRS can be expected to make cohesive, coherent guidelines. The IRS' efforts to provide the needed guidance, while laudable, are ill advised. This issue is one that requires the voice of Congress.

184. Frank J. Slagle, *Accounting for Interest: An Analysis of Original Issue Discount in the Sale of Property*, 32 S.D. L. REV. 1, 13 (1987).

185. Joseph W. Blackburn, *Fragmenting Cost Of Goods Sold For Accounting Accuracy And Tax Profits*, 31 ST. LOUIS U. L.J. 295 (1987).