Nebraska Law Review

Volume 38 | Issue 4 Article 11

1959

Income Tax—Capital Expenditure v. Business Expenditure

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The tax treatment of company funds expended in the solicitation of business supply sources arose in the case of *Van Iderstine Co. v. Commissioner of Internal Revenue.*[1] Petitioner company rendered lard, tallow, and other by-products from fat and bones which it collected from butcher shops, restaurants, hotels, slaughter houses, and chain stores. Petitioner during the year 1950 paid $25,000 to Food Fair Stores chain in consideration for agreements giving petitioner the right for an indeterminate period to purchase all raw materials becoming available at their stores at the current market price to be determined from time to time. The agreements were subject to being discontinued at any time by either party; no express promise existed on the part of either party. Petitioner in filing its 1950 tax return treated the expenditure as a deductible business expense, but the Tax Court held it to be a capital expenditure.[2] On appeal, the Tax Court decision was reversed by the Court of Appeals for the Second Circuit.

Four alternative methods appear for accounting for the expenditure:

1) deducted as an "ordinary and necessary" business expense of the current tax year,

2) capitalized and amortized over the expected life of the right,

3) capitalized and carried on the company books as an intangible asset until the agreement is terminated by either party, then deducted as a capital loss,

4) capitalized and retained on the company books as an intangible asset until the sale of the company, then treated as a capital gain or loss.

The Commissioner contended that the expenditure was a "capital expenditure" in that a contract right which extends past the end of 1950 has been raised, but the Court of Appeals readily disposed of the argument, stating that a contract must fail for want of "mutuality of obligation."[3] The Court then summarily

[1] 261 F.2d 211 (2nd Cir. 1958).

[2] ¶ 57,177 P-H Tax Tc. Rep. & Mem. Dec. (1957).

[3] 1 CORBIN, CONTRACTS § 152 (1950).

dismissed the Commissioner's second contention that petitioner purchased "goodwill" which also constitutes a capital expenditure, by stating that goodwill "always involves the relations of the seller with third persons, relations that exist prior to purchase-sale."

Although it is apparent that no contract existed between the parties, it is submitted that a contract is not necessary in order to constitute a capital expenditure; for example, the premium cost of obtaining a liquor license may be capitalized, even though it is renewable each year, and there is no *right* to renewal, but mere *custom* to renew.[4] Although a contract of fixed duration would form a basis for the amortization of the expenditure, such amortization is not a necessary prerequisite for the expenditure to be treated as a capital one, because an intangible asset may be carried for the life of the company. Where an expenditure brings about the acquisition of an asset having a period of useful life in excess of one year, or if it secures to the taxpayer a like advantage which has life of more than one year, it should be treated as a capital outlay.[5] Although it is recognized that Food Fair is not bound by this agreement, it is also recognized that business is conducted daily upon the word of the reputable businessman, so that even though the agreement could not be enforced by petitioner in a court of law, there still exists the moral obligation of Food Fair, including their reputation, which may be considered an asset to the petitioner's business. At the time of the action in the Tax Court, seven years after the payment of the money to Food Fair, the "right" of petitioner to collect scrap from Food Fair still existed.

Expenditures made to increase supply sources may be analogized to those made by publishing houses to increase their circulation. Expenses incurred in carrying on campaigns, drives, or contests for the express purpose of increasing the circulation of magazines have been held to constitute capital expenditures.[6] The court in the *Meredith* case distinguished between expenditures made to increase circulation, which are capital, and those made

[4] Morris Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951).

[5] United States v. Akin, 248 F.2d 742 (10th Cir. 1957).

[6] Meredith Publishing Co. v. Commissioner, 64 F.2d 890 (8th Cir. 1933). 26 U.S.C. § 23 (1939) was revised in 1954 to allow the cost of increasing circulation to be deducted as a business expense at the option of the taxpayer. Cost of building up and establishing a clientel for a national advertising directory held to be a capital expenditure. Reuben H. Donnelly Corp. v. Commissioner, 26 BTA 107 (1932).

to maintain the present volume, which are ordinary and necessary, and thus deductible business expenses of the year in which incurred. It is submitted that the expenditures made by petitioner in the instant case were for the express purpose of expanding its source of supply, or "circulation", considering that the basis for payment was $2,500 for each new store opened, and that payments were not made in order to maintain any existing volume of supply.

Because of the nature of petitioner's business, there is a constant market for its product, so that no problem of goodwill arises in the normal relationship of vendor-vendee. Peculiar, however, to the business is the requirement for goodwill between the buyer petitioner and his seller supplier; a constant source of raw materials is necessary for petitioner to remain in business. Expenditures to gain new customers and to maintain the goodwill of the old constitute capital outlay.[7] In order to insure the existence of its business, and to facilitate expansion, it is as necessary for petitioner to cultivate goodwill among its suppliers as it is for another businessman to maintain goodwill with his customers. How better can this relationship be acquired than by the payment of money for the goodwill of one of the largest suppliers in the area, an expanding food market chain.

It can be argued that there is possibly poor business taste in calling the expenditure one for "goodwill", for it may appear to constitute commercial bribery, in that the Court of Appeals stated that goodwill of A cannot be obtained by paying money to A; it will be noted that petitioner does not wish to call it goodwill. But whether the expenditure is entitled "goodwill" or not, it appears to the writer that it results in the acquisition of some intangible asset which, in keeping with good accounting principles,[8] should be carried on the balance sheet of petitioner and not deducted during any one tax year.[9]

It is therefore submitted that the Court of Appeals has correctly answered the questions which it poses: 1) there is no contract, and 2) the expenditure does not constitute goodwill, but that the Court has asked the wrong questions. The query should

[7] Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir. 1937).

[8] HILLS LAW OF ACCOUNTING AND FINANCIAL STATEMENTS 102 (1957). JOHNSON, FEDERAL INCOME, GIFT, AND ESTATE TAXATION § 3.10 (7) (1954).

[9] A distortion of yearly income results from a write-off in one year. Commissioner v. Boylston Market Assn., 131 F.2d 966 (1st Cir. 1942).

rather be directed toward examining the nature, basis, and purpose of the expenditure, and in view of the expansion characteristics of the expenditure, and the acquired intangible "right" existing past the end of the taxable year, it is submitted that the decision of the Tax Court should have been affirmed.

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