The Deductibility of Bank Branching Expenditures: Central Texas Savings & Loan Association v. United States: A Weak Rebuttal to NCNB Corp. v. United States

David Fields Webb
University of Richmond

Follow this and additional works at: http://scholarship.richmond.edu/lawreview
Part of the Banking and Finance Law Commons, and the Tax Law Commons

Recommended Citation
Available at: http://scholarship.richmond.edu/lawreview/vol19/iss1/8
THE DEDUCTIBILITY OF BANK BRANCHING EXPENDITURES:
CENTRAL TEXAS SAVINGS & LOAN ASSOCIATION v. UNITED STATES: A WEAK REBUTTAL TO NCNB CORP. v. UNITED STATES

In *North Carolina National Bank Corp. v. United States,* the Court of Appeals for the Fourth Circuit held that certain expenditures incurred by a national bank in connection with, yet prior to, the opening of branch offices were deductible under I.R.C. section 162 as ordinary business expenses. In *Central Texas Savings & Loan Association v. United States,* the Court of Appeals for the Fifth Circuit held that similar costs incurred by a savings and loan institution in its branching activities were capital rather than ordinary in nature, and could not be deducted under section 162.

In both cases, the controverted expenditures included expenses for procuring branch licenses and for studying the economic feasibility of each new location. There were some minor factual differences between the two cases in that NCNB, a much larger company, also expended funds for a

---

1. 684 F.2d 285 (4th Cir. 1982).
2. The expenditures at issue do not include those relating to tangible assets such as land, building, and equipment costs. These are readily conceded as capital. *Id.* at 293. For a description of the costs at issue, see *infra* notes 8-12 and accompanying text.
3. I.R.C. § 162 (1976) (allows for certain business expenses to be deducted in full in the year in which they are incurred). Section 162 expenses are often referred to as "ordinary" expenses because the ordinary requirement is considered the essence of a business expense. *See infra* note 33 and accompanying text.
4. 731 F.2d 1181 (5th Cir. 1984).
5. The Central Texas Corp. did not expend any funds for the general market studies, while NCNB did. Otherwise, the expenditures in the two cases were basically the same. *See infra* note 11.
6. "Branching" will be used to refer to the general practice of existing banks opening new branches. *See* NCNB Corp. v. United States, 651 F.2d 942, 946 (4th Cir. 1981), *rev'd on other grounds en banc,* 684 F.2d 285 (4th Cir. 1982).
7. I.R.C. § 263 (1976). Items which are deemed to be capital in nature must be amortized over the life of the resulting benefit, if that life is determinable. If the life is not determinable, the cost may not be recovered until liquidation or sale of the asset created. *See Note, Start-up Cost Treatment Under § 195: Tax Disparity in Disguise,* 36 Okla. L. Rev. 449, 450 (1983).
8. In order to open a branch one must obtain approval from the Comptroller of the Currency (for a national bank) or the Savings and Loan Commissioner (for a savings and loan) which involves attorney's fees, sometimes very substantial. For the purposes of the issues discussed in this article, the many differences between banks and savings and loans do not appear important. The tax laws are identical for both types of lending institutions.
9. Location feasibility studies assess potential profitability. *See* NCNB, 684 F.2d at 289.
10. NCNB opened 57 new branches between the years 1970-1973. *Id.* at 286. Central Texas, on the other hand, only opened four branches from its inception to the date of its
second “metro” study, and that Central Texas, a state-regulated savings and loan, was subject to different licensing procedures. Yet the conflicting results reached in NCNB and Central Texas stem not from any distinguishing factual differences but from disparate views concerning the proper test for determining what is an “ordinary business expense.”

For an expenditure to be deductible as a business expense, it must meet the three basic requirements of section 162 of the Internal Revenue Code: (1) it must be incurred or paid in the taxable year; (2) it must be incurred while carrying on a trade or business; and (3) it must be a necessary and ordinary expense. The first requirement is an easily determined one and is rarely the subject of litigation. This note examines the remaining two requirements as they relate to the NCNB decision, concentrating primarily on the meaning of the “ordinary” requirement. It then analyzes the Central Texas decision as a rebuttal to NCNB, and offers some insight as to the probable resolution of the conflict between the two cases.

I. THE REQUIREMENTS OF SECTION 162(a)

The major issue in both NCNB and Central Texas is whether the contested expenditures are “ordinary.” This issue is closely related to the “carrying on a trade or business” requirement of section 162(a). Therefore, an understanding of the “carrying on” requirement is essential to a full comprehension of the NCNB rationale.

11. The metro studies were of an entire metropolitan area—not just a potential branch location. See NCNB, 684 F.2d at 289.

12. The only significant difference noted by the court was that the Central Texas license gave it the right to challenge the entry of competitors into the local market. See supra note 8. See also infra note 118 and accompanying text.


14. The requirement that expenditures be paid or incurred during the taxable year was conceded by the government in both NCNB and Central Texas. Disputes in this area usually arise only when a taxpayer on a cash accounting basis relies on the “incurred” requirement, or when a taxpayer on an accrual accounting basis relies on the “paid” requirement. See, e.g., Burrows v. Commissioner, 38 B.T.A. 236 (1938).

15. See Central Tex., 731 F.2d at 1183; NCNB, 684 F.2d at 287.

16. The relationship is based on the idea that if an expense is eligible under section 195 for amortization, then it must, by nature, be ordinary. As an “ordinary” expense, it is deductible if incurred by an existing business. See infra notes 21-27 and accompanying text.

17. While the Central Texas opinion ignores the relationship of the “carrying on” and “ordinary” requirements under section 195, according to Pat Beard, the attorney for Central Texas Savings and Loan Association, the argument was raised by Central Texas, and is a viable point. Telephone interview with Pat Beard, Beard & Kultgen (Oct. 3, 1984).
BANK BRANCHING EXPENDITURES

149

A. In Carrying on a Trade or Business

Frequently a business seeking to deduct an item as a section 162 expense will be denied the deduction because the taxpayer has no currently operating business to which the expenditures could be attributed—that is, the taxpayer is not "carrying on" an existing trade or business. This "existing business" requirement often arises when a new business incurs substantial "start-up" expenses before its actual operations begin. The requirement also applies, however, in the somewhat less obvious situation where an existing business incurs substantial costs in developing or acquiring a new, additional business, prior to the commencement of that new business. In both of these situations, there is no "existing business" and so the "carrying on" requirement of section 162 is not satisfied. Any deduction of such expenses would be disallowed by the I.R.S.

Prior to adoption of section 195 of the Code, expenditures which failed to pass the existing business (or new business/old business) test for deductibility had to be capitalized. In an effort to ease the burden of these "start up" costs, Congress enacted section 195, which allows a taxpayer to amortize such pre-opening expenditures over a period of no less than sixty months. It is important to note that the expenditures

18. In this situation, the issue is usually whether the taxpayer's activities have risen to the level of a trade or business. See, e.g., Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965); Petersburg Television Corp. v. Commissioner, 20 T.C.M. (CCH) 271 (1961); Ward v. Commissioner, 20 T.C. 332 (1953).

19. In this second situation, the issue is usually whether or not the new business is of a significantly different type from the existing business. See, e.g., Malmstead v. Commissioner, 578 F.2d 520 (4th Cir. 1978) (hotel venture sufficiently related to existing residential real estate business—deduction allowed); Radio Station WBIR, Inc. v. Commissioner, 31 T.C. 803 (1959) (expenditures incurred by a radio station relating to its development of a television station were not sufficiently related to the radio business to meet the existing business requirement).


21. See Note, Costs of Expanding an Existing Business: Current Deductions Versus Capital Expenditures—North Carolina National Bank Corp. v. United States, 18 WAKE FOREST L. REV. 1127, 1132 (1982). (The new business/old business test, as it is often referred to, simply restates the existing business requirement: if the cost relates to the old business, it is deductible, but if it relates to a new business it is a capital item.).

22. Frequently, with capitalization, these costs could not be amortized or depreciated because they gave rise to benefits with indeterminate lives. Hence the costs could only be recovered upon sale or liquidation of the asset. [1984] 3 STAND. FED. TAX REP. (CCH) ¶ 1999YF.01.

23. Section 195 refers to the costs as start-up expenditures, which are meant to include amounts incurred in connection with (i) investigating the creation or acquisition of an active business, or (ii) creating an active business, or which, if incurred in connection with the operation of an existing business, would be allowable as a deduction for the taxable year. I.R.C. § 195(b) (1981).

24. Id. § 195(a).
which may be amortized under section 195 are those which would have been deductible under section 162, but for the fact that they failed to satisfy the existing business requirement.\textsuperscript{25}

While the tax years at issue in both the \textit{NCNB} and \textit{Central Texas} decisions preceded the passage of section 195,\textsuperscript{26} the close relationship between sections 195 and 162 had important implications in both cases. Thus, an understanding of the relationship between the two sections is necessary in analyzing the divergent results reached by the \textit{NCNB} and \textit{Central Texas} courts. The relationship between sections 195 and 162 was essential to the \textit{NCNB} court's determination that branch development costs were "ordinary" and thus deductible under section 162,\textsuperscript{27} while the \textit{Central Texas} court disregarded the relationship between the two sections in reaching the opposite result.

B. \textit{Necessary} and \textit{Ordinary Expenses}

In addition to the "carrying on" requirement, section 162 also requires that an expenditure be both necessary and ordinary in order to be deductible.\textsuperscript{28} The "necessary" provision has been held to constitute only a minimal requirement—it requires only that the expense be appropriate and helpful for the development of a business.\textsuperscript{29} The "ordinary" requirement, however, is often the benchmark for distinguishing between what is by nature a business expense, and what is by nature a capital expenditure.\textsuperscript{30} Consequently, what is "ordinary" is frequently the major issue between the government and the taxpayer.\textsuperscript{31}

1. The Future Benefit Test

Courts have relied on various tests and definitions to interpret the "ordinary expense" language of section 162(a).\textsuperscript{32} One such test, which

\textsuperscript{25} Eligible expenses are those "which, if paid or incurred in connection with the expansion of an existing trade or business . . . would be allowable as a deduction . . . ." \textit{Id.} § 195(b). In other words, only those expenses which are deductible in nature (i.e., ordinary expenses) are eligible for section 195 amortization. \textit{See NCNB}, 684 F.2d at 295 (Murnaghan, J., dissenting).

\textsuperscript{26} Section 195 was not retroactive. The question of whether or not the expenditures were eligible under section 195 was not yet ripe for adjudication. \textit{See, e.g., Central Texas}, 731 F.2d at 1186.

\textsuperscript{27} \textit{NCNB}, 684 F.2d at 291.

\textsuperscript{28} I.R.C. § 162(a) (1976).


\textsuperscript{30} \textit{Id.} at 690; Southland Royalty Co. v. United States, 582 F.2d 604, 610 (1978), \textit{cert. denied}, 441 U.S. 905 (1979).

\textsuperscript{31} \textit{See, e.g., NCNB}, 684 F.2d at 287.

\textsuperscript{32} \textit{See, e.g., Deputy v. DuPont}, 308 U.S. 488 (1940) (expense is ordinary if transaction which gives rise to the expense commonly occurs in the particular type of business involved); \textit{Welch v. Helvering}, 290 U.S. 111, 114 (1933) (ordinary does not mean payments
originated in the Tenth Circuit\textsuperscript{33} and gained wide acceptance\textsuperscript{34} for many years, was the future benefit test. Under the future benefit test, an expenditure would not be considered ordinary if it resulted in the "acquisition of an asset having a period of useful life in excess of one year or if it secure[d] a like advantage to the taxpayer which [had] a life of more than one year."\textsuperscript{35}

2. The Separate and Distinct Asset Test

The future benefit test was the primary tool used by courts in determining whether an expense was ordinary until it was rejected in \textit{Commissioner v. Lincoln Savings & Loan Association}.\textsuperscript{36} The new test adopted by the \textit{Lincoln} court for identifying a capital (as opposed to an ordinary) expenditure was whether the expenditure "serves to create or enhance . . . what is essentially a separate and distinct additional asset . . . ."\textsuperscript{37} Applying this test, the Court held that payments made by Lincoln Savings and Loan into an FSLIC secondary reserve fund were not ordinary, but capital in nature.\textsuperscript{38}

It is important to note that the Court in the \textit{Lincoln} decision could easily have reached the same holding using the future benefit test.\textsuperscript{39} In

\begin{itemize}
\item \textsuperscript{33} See \textit{Hotel Kingkade v. Commissioner}, 180 F.2d 310, 312 (10th Cir. 1950).
\item \textsuperscript{34} See, e.g., \textit{Zaninovich v. Commissioner}, 616 F.2d 429, 432 (9th Cir. 1980); \textit{Cagle v. Commissioner}, 539 F.2d 409, 415 (5th Cir. 1976); \textit{Bilar Tool \& Die Corp. v. Commissioner}, 530 F.2d 708, 713 (6th Cir. 1976); \textit{Paxman v. Commissioner}, 414 F.2d 265, 267 (10th Cir. 1969); \textit{American Dispenser Co. v. Commissioner}, 396 F.2d 137, 138 (2d Cir. 1968); \textit{Richmond Television Corp. v. United States}, 345 F.2d 901, 907 (4th Cir. 1965) (while primary basis for disallowing a section 162 deduction was failure to meet the existing business requirement, an alternative rationale was that the costs were not "ordinary" under the future benefit test); \textit{United States v. Akin}, 248 F.2d 742, 744 (10th Cir. 1957) (though \textit{Hotel Kingkade preceded Akin}, \textit{Akin} is usually cited as the source of the test's origin); \textit{Frankford Quaker Grocery Co. v United States}, 353 F. Supp. 93, 98 (E.D. Pa. 1972); \textit{Clark Oil \& Refining Corp. v. United States}, 326 F. Supp. 145, 149 (E.D. Wis. 1971).
\item \textsuperscript{35} \textit{Hotel Kingkade}, 180 F.2d at 312. For courts which relied on the future benefit (or one year) test, the issue usually became one of accounting. Revenues necessarily had to be matched, as well as possible, against costs in the appropriate period. If the revenues extended longer than a year, the cost was considered capital. For a good example of such an application of the future benefit test, see \textit{North Carolina Nat'l Bank v. United States}, 651 F.2d 942 (4th Cir. 1981), \textit{rev'd en banc}, 684 F.2d 285 (4th Cir. 1982).
\item \textsuperscript{36} 403 U.S. 345 (1971).
\item \textsuperscript{37} Id. at 354.
\item \textsuperscript{38} Id. at 364.
\item \textsuperscript{39} The Supreme Court could simply have held, as did the Tax Court whose ruling the Court affirmed, that because the payments resulted in a benefit (in the form of insurance coverage) with "a useful life which extends substantially beyond the close of the taxable year . . . .," the payments represented capital expenditures. \textit{Lincoln Savings \& Loan Assoc.}
adopting the “separate and distinct asset” test, however, the court elected to reject the “conceptual simplicity”46 of the future benefit test, noting that there are “many expenses concededly deductible [under section 162 which] have prospective effect beyond the taxable year.”41

The NCNB majority, in accepting the Lincoln “separate and distinct asset” test as controlling,42 ruled that the new branch offices,43 though enhanced by the expenditures at issue,44 were not separate and distinct additional assets. In so ruling, the Court of Appeals for the Fourth Circuit compared the branching activities of the bank to the efforts of a candy company in Briarcliff Candy Corp. v. Commissioner45 to develop new sales territory. The court held that the branch offices constituted no more separate and distinct assets than did the franchise arrangements Briarcliff established in order to gain new markets.46

The NCNB court also compared the situation before it to several credit card cases which held that a bank, in establishing a new credit card service for customers, did not create a separate and distinct asset.47 The court reasoned that NCNB’s efforts to expand into new markets were similar to the credit card expenditures in that they only “introduced a

v. Commissioner, 51 T.C. 82, 98 (1968).
40. NCNB, 684 F.2d at 288-89.
41. Lincoln, 403 U.S. at 354. The future benefit test was never mandated by the Supreme Court as the primary consideration for “capital” versus “ordinary” issues.

There is one difficulty in interpreting the Lincoln case as an absolute rejection of the future benefit test. The problem stems from the Court’s post-Lincoln ruling in United States v. Mississippi Chem. Corp., 405 U.S. 298 (1972). In that case the Supreme Court held that cooperative bank stock purchased by the taxpayer was a capital asset due to its future benefit beyond the tax year. That application of the future benefit rule, however, appears to be confined to the facts of Mississippi Chemical because, as the Court noted, Congress had specifically and intentionally created the long-term characteristics of cooperative bank stock in order to provide both a stable membership and permanent capital for the regional bank. Id. at 304. See also Farm Credit Act, 69 Stat. 656, 12 U.S.C. § 1134d(a)(3) (1955). Mississippi Chemical thus appears to be treated by the Court as a congressionally mandated exception to the Lincoln rule.

42. Acceptance of the Lincoln test was the major issue in the en banc reversal of the NCNB panel decision, which had relied heavily on the future benefit rule. North Carolina Nat’l Bank Corp. v. United States, 651 F.2d 942 (4th Cir. 1981), rev’d en banc, 684 F.2d 285 (4th Cir. 1982). This was not even an issue in Central Texas, nor, in all probability, would it be a major issue before the Supreme Court today. See infra note 124.
43. The court emphasized that the costs relating to tangible property such as land, buildings and equipment, were concededly capital under section 263. NCNB, 684 F.2d at 293.
44. The notion that the costs enhanced the branch offices was not contested. See NCNB v. United States, 651 F.2d 942, 960 (4th Cir. 1981), vacated, 684 F.2d 285 (4th Cir. 1982). But that enhancement is irrelevant under the Lincoln rationale if what is enhanced is ruled not to be a separate and distinct asset.
45. 475 F.2d 775 (2d Cir. 1973).
46. NCNB, 684 F.2d at 290, 291.
more efficient method of conducting an old business."  

In addition to dismissing the notion that the branch offices were separate and distinct assets, the Fourth Circuit also rejected the claim that the branch licenses were separate and distinct assets. The decisions which held licenses to be capital assets were not persuasive to the NCNB court because these decisions either resulted from an application of the future benefit rule or involved the establishment of a new business. Moreover, the court noted that unlike most of the license cases cited by the government, the NCNB branch license was neither transferable nor an exclusive franchise—thus, there was very little support for the notion that the license was a separate and distinct asset.

3. Senate Report on Section 195

The NCNB court did not rely solely on the Lincoln test to show that the disputed expenditures were ordinary. The court also relied on the Senate Report accompanying section 195 to justify its position.

The Senate Report states that "eligible expenses [under section 195] consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business. These costs include expenses incurred in the analysis or survey of potential markets . . . ."

This is where the relationship between sections 162 and 195 becomes vital. As noted earlier, expenses eligible under section 195 are, by nature, "ordinary business expenses." The primary reason such expenses are not deductible under section 162 is simply that they fail to meet the "existing business" requirement. Since Congress cited "investigatory costs"
as expenses eligible under section 195, the NCNB court considered this a congressional determination that "investigatory costs" would be deductible under section 162(a) but for the existing business requirement.

NCNB was undisputedly an existing business. Because it was already in the banking business, NCNB's branching activities could not be considered forays into a "new" business; therefore, the "existing business" requirement was clearly met. The court then ruled that the expenses incurred by NCNB for metro studies and location feasibility studies were "investigatory expenses." Consequently, the expenses were deductible under section 162.

4. Accounting Considerations

A final factor in considering whether an expenditure is an ordinary expense or capital expenditure is the relevant accounting method of the taxpayer. When a taxpayer is subject to a compulsory accounting method by a governmental agency, the Supreme Court has held that that method will control federal income tax consequences, provided the method clearly reflects income.

The accounting method required by the Comptroller of the Currency (to which NCNB was subject) charged to current operations "all expenditures relating to the development and expansion of banking services

---

56. See supra note 53 and accompanying text.
57. NCNB, 684 F.2d at 291.
58. Id. at 287.
59. Id. The dissenting opinion held that the expenses could not be deducted. NCNB, 684 F.2d at 295-96. (Murnaghan, J., dissenting) Judge Murnaghan's dissent is based on an imprecise reading of the Report. The relevant portion of the Report reads as follows:

Eligible Expenditures

In general, expenditures eligible for amortization must satisfy two requirements. First, the expenditure must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer. Second, the expenditure involved must be one which would be allowable as a deduction for the taxable year in which it is paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

Under the provision, eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets . . . .


Judge Murnaghan claims that the investigatory costs mentioned are not all includible—only those which satisfy the first two general requirements or which are ordinary in nature. NCNB, 684 F.2d at 295. This interpretation, however, ignores the structure of the Report, which implies that the investigatory costs specifically mentioned as eligible expenses are presumed to have met the two preceding, general requirements.

The only issue for the NCNB court was whether the required accounting method clearly reflected income. Because the Comptroller was in a "unique position of expertise to determine what accurately reflects a bank's income," the court reasoned that the Comptroller's method should dictate the tax consequences and held that the controverted costs were current, ordinary expenses.

II. Central Texas Savings & Loan Association v. United States: Case and Analysis

In Central Texas Savings & Loan Association v. United States, the Court of Appeals for the Fifth Circuit also examined the issue of whether expenditures incurred by a bank prior to the opening of branch offices were deductible as section 162 business expenses. While agreeing with the NCNB court that the Lincoln test was the proper tool for determining if the contested expenditures were ordinary expenses, the Central Texas court differed in its application of that test. The Fifth Circuit held that the new branch offices of Central Texas Savings & Loan were separate and distinct additional assets; thus, the expenditures enhancing the value of these assets were capital in nature and therefore not deductible under section 162. In addition, the court addressed what it perceived as two other ways in which the expenditures fell short of the section 162 requirements: (1) they did not meet the existing business requirement; and (2) they did not meet a "benefit exhausted" requirement.

A. The Existing Business Requirement

The Central Texas court first discussed what it viewed as the failure of the contested expenditures to meet the "carrying on a trade or business" requirement of section 162(a). Citing Ellis Banking Corp. v. Commissioner, the court claimed it would be anomalous to say that one savings and loan acquiring another must capitalize the investigative costs, while a

---

62. NCNB, 684 F.2d at 293.
63. Id.
64. Id.
65. 731 F.2d 1181 (5th Cir. 1984).
66. Id.
67. Factual differences between Central Texas and NCNB are discussed supra notes 12-18 and accompanying text.
68. Central Tex., 731 F.2d at 1185.
69. Id. at 1183. The alleged "benefit exhausted" requirement is not, in fact, a requirement of section 162. See infra notes 75-80 and accompanying text.
70. I.R.C. § 162(a) (1976). See discussion supra notes 18-20 and accompanying text.
71. 688 F.2d 1376 (11th Cir.), cert. denied, 103 S. Ct. 3537 (1983).
savings and loan establishing a new office may deduct them. In Ellis Banking, a section 162(a) deduction of investigatory costs incurred by Ellis prior to its acquisition of another operational bank was disallowed by the I.R.S. In that case, however, the Ellis court readily conceded that the bank was "in the course of its business of promoting banks"—clearly satisfying the existing business requirement of section 162. The only issue was whether the expenditures were ordinary. Thus, the Fifth Circuit's allegation that Central Texas did not meet the existing business requirement of section 162 is not only unsupported by the Ellis decision, but appears contrary to the language in that case.

B. The Alleged Benefit Exhausted Requirement

The Central Texas court also addressed what was described as a second requirement of section 162(a), that the "item be paid or incurred and the benefit exhausted during the taxable year to be deductible." While there is, in fact, a "paid or incurred" requirement in section 162(a), no such "benefit exhausted" requirement exists.

The Fifth Circuit apparently derived the "benefit exhausted" requirement from a misinterpretation of the purpose of the future benefit rule. That rule, which does require that an expenditure's benefit be exhausted during the taxable year to be deductible, was intended only as a tool for determining which expenses were ordinary under section 162(a), and not as a separate requirement.

Not only was the Central Texas court incorrect in referring to a separate "benefit exhausted" requirement of section 162(a), but its discussion of that requirement is inconsistent with the court's subsequent endorsement of the Lincoln test as the predominant consideration for the "ordinary" requirement of section 162(a). The "benefit exhausted" test is merely a rewording of the "future benefit rule," and the future benefit rule was clearly rejected in the Lincoln decision in favor of the "separate and distinct asset" test.

72. Central Tex., 731 F.2d at 1183.
73. Ellis Banking, 688 F.2d at 1378.
74. Even as to the "ordinary" requirement, Ellis Banking provides a poor analogy. The acquisition in Ellis Banking was of a fully operational and independent bank, with 35,000 shares of existing stock worth $10 per share. 41 Tax Ct. Mem. Dec. (P-H) ¶ 37,759 (1983). That acquisition is hardly comparable to developing a branch bank, which is totally dependent on its parent at the outset.
75. Central Tex., 731 F.2d at 1183 (emphasis added).
77. United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957).
78. Id.
79. Central Tex., 731 F.2d at 1183.
80. Id. at 1184.
81. See supra notes 36-41 and accompanying text.
C. The Necessary and Ordinary Requirement

The third and central issue addressed by the Central Texas court was the "necessary and ordinary expense" requirement of section 162(a). Conceding that the costs in dispute were necessary, the court concentrated on the application of the Lincoln test to the "ordinary" issue. According to the Lincoln test, if the expenditures created or enhanced a separate and distinct additional asset, then they were capital in nature. Disagreeing with the result in NCNB, the Central Texas court held that the branch offices did constitute separate and distinct additional assets, and that the related expenditures incurred prior to the opening of the branches were capital in nature.

In so holding, the Central Texas court attempted to distinguish the decision in Briarcliff Candy Corp. v. Commissioner, which the NCNB court relied upon heavily to support its holding that the bank branches did not constitute separate and distinct additional assets. The Central Texas court noted that the Briarcliff decision "distinguishes creation of a branch office from mere expansion of existing services to new markets." The Central Texas court interpreted this distinction to mean that if a business merely expands existing services to new markets, no separate and distinct additional asset is created; but, if the expansion involves the creation of branch offices, it does create separate and distinct additional assets.

A close reading of the Briarcliff case indicates that this interpretation is misguided. While Briarcliff does draw a distinction between the "mere expansion of existing services to new markets" and the "creation of branch offices," a branch office is considered a separate and distinct additional asset only if the "new . . . branch or division [is acquired] to make and sell a new and different product." If the branch is not acquired for the purpose of making or selling a new or different product, then it is not a separate and distinct additional asset.

Applying this holding to the NCNB and Central Texas cases, the banking services extended through the branch offices were no different from the existing services offered; they certainly were not in the nature of a "new and different product." Thus, the Fifth Circuit failed to ade-

82. I.R.C. § 162(a) (1976).
83. Central Tex., 731 F.2d at 1183. See supra note 29 and accompanying text.
84. Central Tex., 731 F.2d at 1185.
85. 475 F.2d 775 (2d Cir. 1973).
86. See supra note 45 and accompanying text.
87. Central Tex., 731 F.2d at 1185.
88. Id.
89. Briarcliff, 475 F.2d at 782.
90. Id.
quately distinguish *Briarcliff* from the facts of *Central Texas*. 91

The court also attempted to distinguish the *Central Texas* facts from those of the credit card cases upon which the *NCNB* court relied. 92 Noting that in the credit card cases there were no intangible property rights created with new credit services, the *Central Texas* court claimed there were intangible property rights created with the new savings and loan branches. 93 Yet the court failed to provide any authority affirmatively supporting that claim. 94

Instead, the court emphasized what it perceived to be a "property right" inherent in the branch's right to do business and challenge new competitors. 96 Noting that the Central Texas branches acquired this new property right upon being licensed, the *Central Texas* court concluded that the branch offices constituted separate and distinct assets, and the expenditures relating to them were capital in nature. 98

Finally, the *Central Texas* court justified its finding that the expenditures were capital rather than ordinary by rejecting the *NCNB* rationale that the compulsory accounting methods of the Comptroller were an accurate reflection of income. 97 The court reasoned that a proper accounting method should reflect the longevity of the benefits related to the expenditures at issue. 98 Thus, while it ostensibly rejected the "future benefit" test, the *Central Texas* court concluded that the most accurate accounting method would be one which supported capitalization of the expendi-

91. Of course, the Fifth Circuit in *Central Texas* was not obliged to distinguish *Briarcliff*; that case was only persuasive authority.
92. See supra notes 47-48 and accompanying text.
93. *Central Tex.*, 731 F.2d at 1185.
94. The court does mention Skilken v. Commissioner, 420 F.2d 266 (6th Cir. 1969) (holding that goodwill of a company must be capitalized). That case, however, involved purchased goodwill rather than self-developed goodwill.

Purchased goodwill is almost always treated as a capital item. See Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Good Will*, 81 Harv. L. Rev. 859 (1968). Self-developed goodwill, on the other hand, is rarely capitalized. See Gunn, *The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C.L. Rev. 443, 489 (1974). Central Texas did not purchase a branch. If an analogy is to be made, it should be to self-developed goodwill rather than purchased goodwill.

95. *Central Tex.*, 731 F.2d at 1185. The court discusses the right to do business, to receive new accounts for new customers in a new market, and to challenge new competitors. These rights are all derived from the branch license, yet the court does not mention the license itself as being a property right.

Concluding that the license is a separate capital asset only implies that costs related to the license are capital expenditures; whereas concluding that the branch is a separate capital asset implies that all the contested expenditures are capital. Therefore, the *Central Texas* court's failure to adequately distinguish between the two concepts adds confusion to an imprecise opinion.
96. *Id.*
97. *Id.*
98. *Id.*
III. SEARCHING FOR A RATIONALE IN SUPPORT OF THE Central Texas DECISION

After an analysis of Central Texas, one is left with very little basis for a rebuttal to the NCNB decision. The Central Texas court seemed to stress the separate, tangible characteristics of a branch, noting that it was separately staffed in an exclusive territory. Yet a branch office may use funds of its parent or another branch to meet its own loan demands. Undoubtedly, a new branch will use those funds before it builds up its own local deposit accounts. Thus, while physically and structurally separate, a branch office actually is quite dependent on, and interrelated with, its parent bank.

The Central Texas court’s failure to find authority in support of its position is not surprising. Houston Natural Gas Corp. v. Commissioner is one of the few cases to be found supporting the Central Texas view on expansion costs. In Houston Natural Gas, expenditures incurred for solicitation of new customers were held to be capital and, therefore, not deductible. While dicta in that case supported the Central Texas result, the facts were easily distinguishable in that Houston Natural Gas involved a very intense campaign to gain new customers and create a monopoly, while Central Texas was merely expanding through branches.

There is other limited support for the Central Texas result aside from the dicta in Houston. Natural Gas. Despite rather persuasive evidence to the contrary, it has been argued that the Central Texas court was, in fact, correct in distinguishing its case from the holding in Briarcliff Candy Corp. v. Commissioner. The basis for distinguishing Briarcliff is that it, unlike Central Texas and NCNB, fell within the accepted rule that expenditures for the protection of an investment are not capital in nature. However, the argument that the NCNB and Central Texas

99. Id. For a more detailed discussion on why the Comptroller’s method of accounting is arguably not the most accurate method, see NCNB, 651 F.2d at 954-55 (Murnaghan, J., dissenting).
100. Central Tex., 741 F.2d at 1185.
103. Although it was the case primarily relied on by the Commissioner in Briarcliff, Houston was not mentioned in the Central Texas decision.
104. Houston Natural Gas, 90 F.2d at 817.
105. "[A]n intensive campaign to get new customers at anytime gives rise to capital expenditures." Id.
106. Id. at 816-17.
107. See supra notes 85-91 and accompanying text.
108. 475 F.2d 775 (2d Cir. 1973).
109. See NCNB, 651 F.2d at 968-59.
branching efforts were necessary to protect their respective market shares of business is no less tenuous than the Fourth Circuit's argument that Briarcliff's contested expenditures were for the protection of its business.\textsuperscript{112} On the contrary, Briarcliff, the credit card cases,\textsuperscript{113} and several recent letter rulings\textsuperscript{114} provide a much more updated and analogous comparison to the deductibility issue than does the Houston Natural Gas decision.\textsuperscript{115}

With very little authority to support the conclusion that the branch offices are separate, distinct assets, the contention that the branch license itself is a separate asset remains the only alternative for the capitalization argument. Yet, the authority supporting the concept of a license as an "asset" is easily distinguished from the facts of Central Texas and NCNB.\textsuperscript{116} The right to challenge new competitors, allowed by a Texas savings and loan branch license emphasized in Central Texas, is a right granted to any interested party, with or without a license.\textsuperscript{117} In order for a license to be considered capital, it should be transferable\textsuperscript{118} to some extent and somewhat limited in number.\textsuperscript{119} Essentially, the only right obtained with the branch office licenses in NCNB and Central Texas was

\textsuperscript{110} 684 F.2d at 290.
\textsuperscript{111} Central Texas did assert that it was attempting to maintain its relative position with respect to the rest of the banking industry. Telephone Interview, supra note 17.
\textsuperscript{112} Briarcliff, 475 F.2d at 787.
\textsuperscript{113} Discussed supra notes 47-48 and accompanying text. Most notably, these cases illustrate the application of the separate and distinct asset test, not in existence at the time of Houston Natural Gas.
\textsuperscript{114} See, e.g., Ltr. Rul. 8423005, 84 Fed. Taxes (P-H) \$ 2366, at 941 (A restaurant expanding its business by opening restaurants in new geographical locations did not create separate intangible assets.); Ltr. Rul. 8303012, 83 Fed. Taxes (P-H) \$ 635 (Expenses incurred in developing operating procedures, testing new equipment and recruiting and training work force in connection with establishment of new manufacturing facility are deductible under section 162. Taxpayer has similar existing operational plants in other locations.); Ltr. Rul. 8141033, 81 Fed. Taxes (P-H) \$ 797 (Mutual savings bank expenditures for preliminary costs to obtain approval and feasibility studies deductible since they were not start-up costs.); Ltr. Rul. 8135031, 81 Fed. Taxes (P-H) \$ 796 (advertising, pre-opening rental and merchandise premiums offered to new depositors are all to protect and expand bank's existing business—section 162 deduction allowed.). Despite the clear stand these letter rulings take on deductibility of expansion costs, letter rulings carry little weight in court.
\textsuperscript{115} This is especially true since Houston Natural Gas was decided nearly 50 years ago. See supra note 102.
\textsuperscript{116} In most of the license cases, the capitalization result emanated from the use of the future benefit rule or the failure of the business to meet the existing business requirement. See supra notes 49-52 and accompanying text.
\textsuperscript{118} The thrust of the Lincoln discussion on transferability was not that it was a non-essential characteristic, but that some minimal degree of transferability is important to the capitalization of an asset. See Lincoln, 403 U.S. at 155. Contra Central Tex., 731 F.2d at 1185.
\textsuperscript{119} For a discussion of these characteristics, see Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951).
the non-transferable right to operate the branch, a right which alone is not recognized as a capital item. Thus, expenditures relating to a savings and loan branch license would not be capital, unless a particular state's laws created additional "capital" characteristics in the license not present in Central Texas and NCNB.

IV. CONCLUSION

In view of the recent flourishing of branching activities throughout the United States, and the directly conflicting results in NCNB and Central Texas, there is a great likelihood that the issue of the deductibility of the expenditures contested in those cases will reach the Supreme Court. Despite a significant lack of authority on that issue, certain aspects could be easily resolved.

The Senate language pertaining to section 195, while not controlling because of its indirect relation to the issue, should favor the deductibility of the controverted expenditures. The conflicting views on the most accurate accounting method, however, appear to be more a result of, rather than a determining factor in, the resolution of the "ordinary" issue.

The primary task before the Supreme Court would be the application of its own "separate and distinct asset" test. In view of the authority favoring the deductibility of business expansion costs, the intangible value of a branch office would probably not be viewed as a separate and distinct asset. Thus, the Court should adopt the position of the NCNB court that the costs relating to that value are deductible as section 162 business expenses. To hold otherwise would not only go against the weight of authority on that issue, "but would be contrary to the objectives of our expanding national economy."

David Fields Webb

120. There was also no apparent limit on the number of licenses which could be granted in either case.
121. See, e.g., Nachman, 191 F.2d 934 (the official cost of the license relating to right to operate liquor store was ordinary expense; only the excess of that cost upon resale, which related to other rights and privileges, was a capital expense).
122. Central Texas did not appeal because of temporary financial difficulties. Its primary attorney was out of the country at the time of the decision and he returned too late to persuade the savings and loan to appeal. Many Texas attorneys were reportedly "incensed" at the outcome and the subsequent failure to appeal. Telephone Interview, supra note 17.
123. Acceptance of the Lincoln test has been widespread. See, e.g., Central Tex., 731 F.2d at 184 (5th Cir. 1984); NCNB, 684 F.2d at 289-91 (4th Cir. 1982); First Security Bank of Idaho v. Comm'r, 592 F.2d 1050, 1055 (9th Cir. 1979); Iowa Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433, 436 (8th Cir. 1979); Colorado Springs Nat'l Bank v. Commissioner, 505 F.2d 1185, 1191 (10th Cir. 1974); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 786 (2d Cir. 1973). There does not appear to be any reason for the court to draw an exception to its own rule with the branching scenario.