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TAXATION

Franchise Costs Considered "Ordinary and Necessary" Business Expenses

Briarcliff Candy Corp. v. Commissioner

Business expenses which are ordinary and necessary are deductible in the year incurred.[1] Conversely, investments which are capital may not be deducted but must be amortized where possible.[2] In *Briarcliff Candy Corp. v. Commissioner*[3] the Second Circuit held that the net expenses incurred by the taxpayer in promoting and establishing franchises were deductible as ordinary and necessary business expenses.

The Briarcliff Candy Corporation, formerly Loft Candy Corporation, was a major manufacturer and seller of confectionery products. Briarcliff's own retail stores accounted for eighty per cent of its sales while the remainder was derived from sales to wholesalers.[4] These retail stores were located primarily in the urban centers of the northeast United States. However, in the 1950's, a major demographic phenomenon occurred as a large scale exodus from the urban centers began. This trend toward suburbanization had a detrimental effect on Briarcliff because great numbers of its customers relocated. The most disturbing barometer of this trend was a decline in operating profits from $886,614 in 1958 to $257,390 in 1951.[5]

The petitioner reacted to this situation in late 1961 by soliciting

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1 Int. Rev. Code of 1954, § 162(a) [hereinafter cited as the Code] reads:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

The Supreme Court recently enunciated the requirements for a deductible business expense:

> To qualify as an allowable deduction under § 162(a) of the 1954 Code, an 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.

Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 352 (1971).

2 Code § 263(a)(1) provides:

> No deduction shall be allowed for —
> (1) Any amount paid out for new buildings or for improvements or betterments made to increase the value of any property. . . .

Such expenditures are considered the cost of acquiring capital assets. Moreover, if these assets have an ascertainable useful life, a depreciation deduction is allowable under Code § 167.

However, there are no generally applicable criteria for distinguishing between business expenses and capital expenditures. Fall River Gas Appliance Co. v. Commissioner, 349 F.2d 515, 516 (1st Cir. 1965); Mountain Paper Prod. Corp. v. United States, 287 F.2d 957, 958 (2d Cir. 1961); United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958). *See* cases cited note 10 *infra*.

3 475 F.2d 775 (2d Cir. 1973).

4 31 CCH Tax Ct. Mem. 171 (1972).

5 475 F.2d at 777.

independent retail outlets, such as drugstores and card shops, in an effort to follow its dwindling market into the suburbs.[6] Toward this end, a separate division within the petitioner's organization was established and staffed with personnel from the sales department and directed by a vice-president. The "franchise" division entered into contracts with the independent retailers whereby in return for merchandise and service the retailer agreed to display and use his best efforts to sell the petitioner's candy. The net operating cost of the "franchise" division was $212,028.[7] The amount of $212,028 was deducted by Briarcliff as an ordinary and necessary business expense for the 1962 fiscal year. This deduction was disallowed by the Commissioner who concluded that the solicitation campaign resulted in the development of capital assets "consisting of 159 valuable franchise contracts."[8] This decision was sustained by the Tax Court.[9]

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6 Prior to the initiation of the franchise program, Briarcliff attempted to stimulate sales by opening its own retail sales outlets in the suburbs. This proved unsuccessful in that no appreciable increase in sales resulted while operating expenses rose. Thus, a lower profit margin resulted. *Id.*

7 For the taxable year ending June 30, 1962, petitioner's net operating expense applicable to its franchise division was $332,869. Of this sum, the Commissioner delineated expenditures for such items as clerical salaries, displays and boxes as "recurring operational expenses" and permitted them to be deducted. However, those sums expended for, among other items, sales, salaries and promotion, amounting to $212,028 were deemed "Promotional Expenses" and disallowed. 31 CCH TAX CT. MEM. at 173, 175.

8 475 F.2d at 780. The contracts entered into between Briarcliff and the various franchised dealers were for terms varying between one and five years. However, after the agreed upon term expired the contracts were to continue unless one of the parties exercised an option to cancel.

Furthermore, the Commissioner refused to allow the expenditures to be amortized under CODE § 167 because these assets had an indefinite life. 31 CCH TAX CT. MEM. at 177-78. It has generally been held that an intangible capital asset whose useful life is indefinite may not be amortized under § 167. Commissioner v. Indiana Broadcasting Corp., 350 F.2d 580 (7th Cir. 1965), *cert. denied*, 382 U.S. 1027 (1966) (two-year, indefinitely renewable network affiliation contract not depreciable); Thrifticheck Service Corp. v. Commissioner, 287 F.2d 1 (2d Cir. 1961), *aff'g* 33 T.C. 1038 (1960) (purchase price of five-year service contracts which were automatically renewable, but cancellable upon notice, not depreciable); Meredith Pub. Co. v. Commissioner, 64 F.2d 890 (8th Cir.), *cert. denied*, 290 U.S. 646 (1933) (cost of creating circulation of magazine or newspaper may not be amortized); Toledo TV Cable Co., 55 T.C. 1107 (1971) (10-25 year CATV municipal franchises held to have no determinable useful life). Once an intangible capital asset exists, the key is to prove an ascertainable useful life. Super Food Services, Inc. v. United States, 416 F.2d 1236 (7th Cir. 1969) (franchise contracts terminable on 30 days notice held depreciable when workable formula for determining average useful life claimed); Meredith Broadcasting Co. v. United States, 405 F.2d 1214 (Ct. Cl. 1968) (network affiliation contracts obtained with less than a year to run on each held to be deductible business expense. But, one year broadcast licenses renewable almost indefinitely not depreciable); Hampton Pontiac, Inc. v. United States, 294 F. Supp. 1073 (D.S.C. 1969) (automobile dealer franchise, renewable indefinitely, held to be depreciable, and useful life determined with mortality tables). *But see* Van Iderstine Co. v. Commissioner, 261 F.2d 211 (2d Cir. 1958) (payment of money for good will which created no contractual obligation, although undoubtedly influenced recipient, held to be deductible as a business expense).

9 31 CCH TAX CT. MEM. at 177-78. A deficiency based on 1962 losses was claimed in

While there are no cases precisely in point, existing precedent had classified similar expenses as capital rather than "ordinary and necessary." The holdings of these cases had been predicated on a finding that 1) the benefits flowing out of such assets extend beyond one year[10] and/or 2) the expenditures were incurred in developing a new market or channel of distribution.[11] The Tax Court utilized both of these rationales in *Briarcliff* and concluded that the advertising and promotional expenses would prove beneficial beyond the year in which they were made[12] and that the expenses were not aimed at advertising and promoting its product[13] but rather the franchise campaign was "directed

the taxpayer's income tax return for the fiscal year 1959. The question to be determined was whether a carryback from 1962 could include an ordinary and necessary deduction for developing franchises in computing its net operating loss deductions for 1959. *Id.* at 171.

10 *See* United States v. Wehrli, 400 F.2d 686, 688 (10th Cir. 1968) ("One-year" rule of thumb used to classify expenses incurred in repairing rented property as a capital expenditure); American Dispenser Co. v. Commissioner, 396 F.2d 136 (2d Cir. 1968) (payment for agreement held to be a capital expense since rights purchased were not confined to one year, but enjoyed for an indefinite period); Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494, 496 (4th Cir.), *cert. denied*, 393 U.S. 962 (1968) (Fourth Circuit held that a capital expenditure can be distinguished from an ordinary and necessary business expense by "its intendment to produce a positive business benefit whose effects will be reaped in seasons beyond a single year"); Connecticut Light & Power Co. v. United States, 368 F.2d 233, 241 (Ct. Cl. 1966) (cost of damages incurred in construction of a dam held to be a capital expenditure); United States v. Akin, 248 F.2d 742 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958) (expenditure which results in the acquisition of an asset with a useful life of more than one year said to be a capital outlay); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir.), *cert. denied*, 302 U.S. 722 (1937) (a drive to obtain new customers by installation of free service lines said to result in benefits extending beyond one year since this almost insured continued patronage); Gould-Mersereau Co., 21 B.T.A. 1316 (1931) (commissions paid to secure a five year lease classified as capital expenditures due to their duration); Rev. Rul. 331, 1969-1 CUM. BULL. 87 (expenses incurred in acquiring five-year leases for hot water heaters deemed capital expenditures which can be amortized over five years).

11 *See* Mountain Fuel Supply Co. v. United States, 449 F.2d 816 (10th Cir. 1971), *cert. denied*, 405 U.S. 989 (1972) (rehabilitation of pipeline); Fall River Gas Co. v. Commissioner, 349 F.2d 515 (1st Cir. 1965) (installation of leased gas appliances); Hardesty v. Commissioner, 127 F.2d 843 (5th Cir. 1942) (wells drilled in return for transfer of interest in lease); Willcuts v. Minnesota Tribune Co., 103 F.2d 947 (8th Cir.), *cert. denied*, 308 U.S. 577 (1939); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir.), *cert. denied*, 302 U.S. 722 (1937) (intensive campaign to obtain new customers); Public Opinion Pub. Co. v. Jensen, 76 F.2d 494 (8th Cir. 1935) (contest to increase newspaper circulation); Meredith Pub. Co. v. Commissioner, 64 F.2d 890 (8th Cir.), *cert. denied*, 290 U.S. 646 (1933) (new magazine subscriptions); Fire Companies Bldg. Corp. v. Burnet, 57 F.2d 943 (D.C. Cir. 1932) (replacement of iron piping with brass piping); Manhattan Co. of Va., Inc., 50 T.C. 78 (1968) (purchase of potential customer lists); Herbert Shainberg, 33 T.C. 241 (1959) (building shopping center); Red Star Yeast & Prod. Co., 25 T.C. 241 (1959) (technical assistance and know-how to help develop new manufacturing process); Hart-Bartlett-Sturtevant Grain Co., 12 T.C. 760 (1949), *aff'd*, 182 F.2d 153 (8th Cir. 1950) (two year research project by non-profit group); Goodell-Pratt Co., 3 B.T.A. 30 (1925) (development of patents, secret processes, special processes, special machinery, new markets, etc.).

12 31 CCH TAX. CT. MEM. at 176.

13 Almost all of the Briarcliff advertising campaign was directed at the proprietors of retail outlets in the suburbs which it hoped would set up franchises. For example, the petitioner placed advertisements in drugstore trade journals, sent circulars to druggists and set

at establishing new channels of distribution for that product. Therefore [the expenditures] would not be 'ordinary' within the meaning of section 162(a)."[14]

Both the Internal Revenue Service (IRS) and the Tax Court relied heavily on *Houston Gas Corp. v. Commissioner*[15] for the proposition that "an intensive campaign to get new customers at any time gives rise to capital expenditures."[16] In *Houston Gas* the expenditures involved the free installation of service lines to customers and was followed by the acquisition of a competitor's business. Good will, new customers and the elimination of a competitor were held to be necessarily capital.[17]

The petitioner contended that the franchise contracts were not capital assets because they were intended to *recapture* its customers who had moved to the suburbs.[18] The adverse decision of the Tax Court was appealed to the Second Circuit[19] and was reversed in a unanimous decision.[20] Circuit Judge Anderson, writing the opinion, acknowledged the limited extent of the court's power to review: "[T]he line between capital and current expenses is often a difficult one to draw, and Courts of Appeals should not overturn decisions of the Tax Court on this question unless they are *manifestly wrong*."[21] Nonetheless, the court held that manifest error had been committed by the Tax Court in the application of the 'benefits beyond one year test.'[22]

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up information booths at conventions. By mid-1962 Briarcliff had contacted some 50,000 independent drugstores.

14 31 CCH TAX CT. MEM. at 176.

15 90 F.2d 814 (4th Cir.), *cert. denied*, 302 U.S. 722 (1937).

16 *Id.* at 817.

17 *Id.* at 816.

18 475 F.2d at 780.

19 CODE § 7482 provides:

> The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury. . . .

20 The *Briarcliff* panel was composed of Kaufman, J., Anderson, J., and Oakes, J.

21 475 F.2d at 782 (emphasis added), *quoting* Seas Shipping Co. v. Commissioner, 371 F.2d 528, 532 (2d Cir. 1967). FED. R. CIV. P. 52(a) states that "[f]inding of fact shall not be set aside unless clearly erroneous." Thus, to overturn a Tax Court ruling, the court must find an error as to the legal principle involved, Commissioner v. Tower, 327 U.S. 280, 287 (1945); Commissioner v. Heininger, 320 U.S. 467 (1943), or a clearly erroneous factual error. Commissioner v. Court Holding Co., 324 U.S. 331, 333 (1945); Commissioner v. Scottish Am. Inv. Co., 323 U.S. 119 (1944); Allen v. Commissioner, 283 F.2d 785 (7th Cir. 1960). However there is no real definition of "manifest error" or "clearly erroneous," and the courts, therefore, have some leeway. Frequently, a Tax Court decision will be upheld notwithstanding that it is based on unsound legal principles. Helvering v. Rankin, 295 U.S. 123, 133 (1934); Boe v. Commissioner, 307 F.2d 339, 342 (9th Cir. 1962); Collins v. Commissioner, 216 F.2d 519, 522 (1st Cir. 1954); Maytag v. Commissioner, 187 F.2d 962, 964 (10th Cir. 1951); Clinton Cotton Mills, Inc. v. Commissioner, 78 F.2d 292, 295 (4th Cir. 1935). Also, the rulings of the Commissioner are presumptively correct. Commissioner v. Heininger, 320 U.S. 467, 475 (1943); Public Opinion Pub. Co. v. Jansen, 64 F.2d 890 (8th Cir.), *cert. denied*, 290 U.S. 646 (1933). The taxpayer has the burden of showing he fits within an exclusion. *See, e.g.*,

The court emphasized that this standard had been rejected as a decisive measure of capital assets by the Supreme Court in *Commissioner v. Lincoln Savings & Loan Association.*[23] Rather "what is important and controlling . . . is that the . . . payment serves to create or enhance for . . . [the taxpayer] what is essentially a separate and distinct additional asset. . . ."[24]

The next point the court considered was: When is "an intensive campaign to get new customers" deductible under section 162? Because such a campaign constitutes an intangible asset, it is unclear whether intangible contributions thereto produce the requisite permanence to be a capital asset. The Tax Court applied the *Houston Gas* rule and held that since the advertising expenditures were an effort to develop new channels of distribution, they are capital because a valuable asset was to be created.

The Second Circuit disagreed with the Tax Court's focus on *Houston Gas.* Judge Anderson stated that while the proposition stated in *Houston Gas* "may be valid enough if confined to the facts of that case, it is not acceptable as an unqualified general rule. In fact, expenditures by an already established and going concern in developing a new sales territory are deductible under § 162."[25] Judge Anderson reasoned that the effect of the Tax Court's rule would mean that retailers who sell their products to the consumer could deduct advertising costs, while wholesalers, because their customers are retailers, would be denied such a deduction. He further felt that such an interpretation was erroneous because "[e]very business entity, to remain viable, must continue to promote the sale of its product."[26]

Having dispensed with the approach of the Tax Court, Judge Anderson attempted to resolve this question. He noted that the Legislature had failed to establish clear standards.[27] Moreover, the court ex-

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American Dispenser Co. v. Commissioner, 396 F.2d 136 (2d Cir. 1968); P. Dougherty Co., v. Commissioner, 159 F.2d 269 (4th Cir. 1946), *cert. denied,* 331 U.S. 838 (1947); Harden Mortgage Loan Co. v. Commissioner, 137 F.2d 282, 284 (10th Cir.), *cert. denied,* 320 U.S. 791 (1943).

22 475 F.2d at 785.

23 403 U.S. 345 (1971).

24 *Id.* at 354.

25 475 F.2d at 782.

26 *Id.* at 783.

27 *Id.* The court illustrates the absence of legislative guidelines for use in determining which expenditures on intangibles are deductible expenses as opposed to capital outlays by reference to rulings of the IRS.

In one instance, a public utility initiated a campaign to increase gas consumption. As a result, expenses were incurred which included salaries of taxpayer's representatives as well as advertising costs. The Commissioner ruled that such expenditures were ordinary and necessary business expenses and therefore deductible under CODE § 162. The logic behind plained that the 'new channel of distribution' cases[28] relied upon by the Tax Court involved intangible contributions to tangible assets which were clearly capital in nature. Where, however, the questioned deduction involves an intangible contribution to intangible assets, as in the instant case, "the rulings and decisions are in a hopeless state of confusion. . . ."[29]

Unable to discern any consistent guideline, Judge Anderson concluded that the determination of whether there is an intensive campaign for new customers or merely the promotion of a product is a matter of degree.[30] The court added that the gravamen of this question is whether an asset with a distinct value in money results. It then examined Briarcliff's franchise campaign and found no acquisition of a capital asset because the results did not have a value ascertainable in money. The court rejected the idea that the petitioner had created a new additional branch, and held that it "was doing no more than stimulating its sales department to stem the downward course of sales"[31] by merely recapturing customers who had moved to the suburbs.

In *Briarcliff*, the Second Circuit has attempted to elucidate the

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the ruling rested on the fact that the expenditures were "less directly and significantly productive of intangible assets having a value extending beyond the taxable years in which they were paid or incurred." Rev. Rul. 561, 1968-2 CUM. BULL. 117, 119.

However, in Rev. Rul. 331, 1969-1 CUM. BULL. 87, a contrary conclusion was reached. There, to increase revenue, the taxpayer offered bonuses and commissions to its salesmen and dealers for acquiring customers interested in renting the company's hot water heaters. These expenditures, as well as those for advertising were deemed to have a more direct and significant effect on the production of the intangible assets than was present in the prior situation. Thus, they were considered as capital items.

Such determinations appear of limited practical value since no guidance is given as to when the effect of the expenditure is sufficiently direct and significant to warrant capitalization. As a result, the court notes that further elucidation on the subject "would certainly be welcome." 475 F.2d at 783.

[28] *See* note 11 *supra*.

[29] 475 F.2d at 785.

Where there is an attempt to acquire intangible assets, including new customers, there is a divergence of opinion as to whether the expenditures incurred in such ventures are capital or ordinary expense items. *See* note 27 *supra*. In Meredith Pub. Co. v. Commissioner, 64 F.2d 890, 891 (8th Cir.), *cert. denied*, 290 U.S. 646 (1933), the court noted in regard to a magazine publisher that "money expended in building up . . . circulation structure is a capital expenditure, and not the ordinary and necessary expense in carrying on a trade or business." However, there are instances where sums expended to protect and promote a business, although not directly related to the acquisition of new customers, have been deemed deductible expenses. *See* Van Iderstine Co. v. Commissioner, 261 F.2d 211 (2d Cir. 1958); A. Harris & Co. v. Lucas, 48 F.2d 187 (5th Cir. 1931).

[30] 475 F.2d at 783.

[31] *Id.* at 782-83. It is interesting to note that the Second Circuit chose to treat the franchise campaign as an effort to recapture old customers while the thrust of the Commissioner's argument was that Briarcliff was attempting to attract *new* customers. *Id.* at 782.

The court also rejected the argument that the deduction was prohibited by CODE § 263(a). It held that CODE § 263(a) applies to intangible assets only when they have an ascertainable value in money. *Id.* at 785.

deductibility of intangible contributions to intangible assets. The ultimate rule appears to be that such contributions are deductible expenses unless the intangible assets take on a present, ascertainable value so as to transform them into a distinct property interest, *i.e.*, capital asset. Furthermore, the *Briarcliff* decision rejects as a general rule the *Houston Gas* test which characterized an advertising campaign as an "intensive campaign to get new customers," which is a non-deductible capital investment. At first blush, this holding may appear generally advantageous for taxpayers seeking to expand their markets. However, in reaching its decision, the court noted that its decision was a matter of degree which depended on the finding that the petitioner was recapturing old customers and not nurturing new ones. Moreover, the decision emphasized the unique demographic circumstances involved. In view of these factors, the precedential effect of *Briarcliff* may be severely limited in the future.[32]

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[32] In a case grappling with the concept of ordinary and necessary business expenses Mr. Justice Cardozo observed:

> Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations, at times with borderline conclusions.

Welch v. Helvering, 290 U.S. 111, 116 (1933).