DEDUCTION OF PROMOTIONAL CAMPAIGN COSTS AS "ORDINARY AND NECESSARY" EXPENSES

Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973)

Taxpayer conducted an advertising and promotional campaign to regain lost customers for its line of Loft candies.[1] The campaign attempted to secure franchise agreements with drugstore owners, pursuant to which the owners would retail Loft candy, while Briarcliff would assist the store owner in installing a refrigerating display unit and provide the candy at a discount price.[2] Briarcliff deducted the costs of the campaign as ordinary and necessary business expenses for the taxable year[3] pursuant to section 162(a) of the Internal Revenue Code of 1954.[4] The Commissioner disallowed two-thirds of the campaign costs[5] on the ground that the franchise agreements were capital assets, and hence the campaign costs were nondeductible capital expenditures.[6] The Tax Court upheld the disallowance.[7] On appeal,

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1. Briarcliff Candy Corp., P-H Tax Ct. Mem. ¶ 72,043 (1972). Due to a shift in population from urban centers to the suburbs, the taxpayer's urban stores were rapidly losing business. In addition, retail stores that the taxpayer established in the suburbs failed to attract a profitable volume business. Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 777 (2d Cir. 1973).

2. P-H Tax Ct. Mem. ¶ 72,043, at 180 (1972). More specifically, the drugstore owner agreed to install a refrigerating unit and display area for Loft candy and promised to use his best efforts to sell the candy. As consideration, the taxpayer agreed not to enfranchise another store in the area, to aid the retailer in installing and operating the display, and to furnish the product at a discount price. The contracts varied from one to five years in duration and were renewable. *Id.*

3. These expenses were recurring since they were incurred in every taxable year from 1962 to 1970. Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 780 (2d Cir. 1973).

4. INT. REV. CODE OF 1954, § 162(a):

> Trade or Business Expenses: (a) In General—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 . . . .

Every revenue act has contained a provision allowing the ordinary and necessary business expense deduction.

5. The Commissioner permitted § 162(a) deductions totalling $332,869, which were attributable to the cost of supplies, commissions, and bad debts. Briarcliff Candy Corp., P-H Tax Ct. Mem. ¶ 72,043, at 181 (1972).

6. INT. REV. CODE OF 1954, § 263 provides:

> Capital Expenditures:
> (a) General Rule—No deduction shall be allowed for—

the Second Circuit Court of Appeals reversed and *held*: All of the advertising and promotional costs were deductible as ordinary and necessary business expenses pursuant to section 162(a) of the Code.[8]

Section 162(a) allows the deduction of ordinary and necessary business expenses incurred during the taxable year.[9] While an ordinary and necessary expenditure need not be an habitual or normal expense to the particular taxpayer, it must be considered normal according to the type of business in which the taxpayer is involved.[10] In addition, the expenditure must be so closely related to the economic needs of the taxpayer as to be considered an integral part of his business.[11] Even if an expenditure is "normal" and directly related to the taxpayer's business, however, the deduction will be disallowed if the benefits resulting from the expenditure are determined to be capital assets.[12] Expenditures for capital assets are nondeductible under section 263(a).[13] Relying on the "greater than one year" rule,[14] the Commissioner often argues that the benefits derived from a taxpayer's expenditures have a "life" of greater than one year's duration

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(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

. . . .

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

7. Briarcliff Candy Corp., P-H Tax Ct. Mem. ¶ 72,043 (1972).

8. Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973).

9. *See* INT. REV. CODE OF 1954, § 162(a). The statute sets forth five elements necessary to establish deductibility. The expenditure must be: (1) an expense; (2) paid or incurred in the taxable year; (3) for carrying on any trade or business; (4) ordinary; and (5) necessary. *Id. See generally* 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.01 (J. Malone ed. 1972).

10. Courts recognize that although an expense may occur only once to any individual taxpayer, it nevertheless must be classified as ordinary and necessary if the expense is so common that failure to incur it would be considered unusual. *See* Deputy v. DuPont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933); Bing v. Helvering, 76 F.2d 941 (2d Cir. 1935).

11. The concept of integrality is necessary to prevent deduction of expenses which only indirectly aid the business, but which may directly further a personal interest of a manager or director. *See* Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46 (1955); Allen v. Commissioner, 283 F.2d 785 (7th Cir. 1960); Commissioner v. Doyle, 231 F.2d 635 (7th Cir. 1956); Rev. Rul. 67-1, 1967-1 CUM. BULL. 28.

12. *See* INT. REV. CODE OF 1954, § 263.

13. *Id.*

14. The "greater than one year" rule is the basic rule used by the Commissioner to determine if a capital asset has been created. *See* Treas. Reg. §§ 1.173-1(c), 1.461-1(a)(1) (1973).

and therefore the payments for such benefits are nondeductible capital expenditures.[15]

The "greater than one year" rule does not apply, however, if the resulting benefit is a repair of an existing asset[16] or if the purpose of the expenditure was to protect an existing investment or business.[17] Thus, even where the benefit resulting from an expenditure lasts for more than one year, a court must examine the nature of the benefit and the purpose for which the benefit was acquired in order to determine if the "greater than one year" rule is inapplicable, in which case the expenditure may be properly deductible if found to be an ordinary and necessary expense.

Advertising and promotional expenditures intended to increase current sales or use of services do not create future benefits and hence ordinarily are deductible,[18] since they are recognized as a normal and essential element of modern business.[19] Advertising and promotional expenditures intended to promote future sales or use of ser-

15. The theory underlying the Commissioner's argument is that a benefit which lasts more than one year adds to the value of the business and hence should be considered a capital asset. A benefit which has a life of less than one year, on the other hand, normally will have to be continually repurchased in order to maintain the value of the business. *See* Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 361 (1971) (Douglas, J., dissenting); Manhattan Co., 50 T.C. 78, 86 (1968); Liberty Ins. Bank, 14 B.T.A. 1428, 1435 (1929), *rev'd on other grounds sub nom.* Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320 (6th Cir. 1932).

16. *See* New Pittsburgh Coal Co. v. United States, 200 F.2d 146 (6th Cir. 1952) (storage track for railroad cars necessary for maintenance of normal coal output since car shortage was impending); Perkins Bros. v. Commissioner, 78 F.2d 152 (8th Cir. 1935) (advertising expenditures necessary to get newspaper circulation up to normal level were deductible); J.H. Collingwood, 20 T.C. 937 (1953) (cost of terracing acreage to prevent loss of topsoil deductible as expense in nature of repair).

17. *See* Commissioner v. Heininger, 320 U.S. 467 (1943) (legal fees incurred in defense of "fraud order" by Postmaster in connection with mail order business held deductible as expenditure to protect going business); United States v. E.L. Bruce Co., 180 F.2d 846 (6th Cir. 1950); Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935); Scruggs-Vandervoort-Barney, Inc., 7 T.C. 779 (1946).

Note that the deduction allowed for the repair of an existing asset, *see* note 16 *supra*, results from an examination of the benefit itself, whereas the "purpose" exception leads to a deduction whether or not the expenditure results in effective benefit.

18. *See* Rodgers Dairy Co., 14 T.C. 66 (1950); *cf.* French Broad Ice Cream Co., 57-2 U.S. TAX. CAS. ¶ 9972 (E.D. Tenn. 1957); Rev. Rul. 69-510, 1969-2 CUM. BULL. 23. *See also* Peterson, *Treatment of Unusual Deductions of a Business*, N.Y.U. 7TH. INST. ON FED. TAX. 1, 2 (1949).

Such expenditures are subject only to a test of reasonableness. INT. REV. CODE OF 1954, § 162(c). *See generally* 4A J. MERTENS, *supra* note 9, § 25.38, at 191.

19. *Cf.* notes 10-11 *supra* and accompanying text.

vices, however, may create benefits with a life of greater than one year.[20] The nature and purpose of such benefits therefore must be examined in order to determine whether the "greater than one year" rule applies. Although the ultimate benefit of advertising expenditures is "customers,"[21] the court will treat the customer-acquiring device as the benefit to be examined for purposes of determining the deductibility of the expenditure.[22]

In *Briarcliff* the Second Circuit held that the taxpayer's expenditures for the franchise agreements were deductible pursuant to section 162 (a), despite the Commissioner's argument that the agreements had a life of greater than one year and hence were capital assets.[23] The court's decision did not rest, however, on the taxpayer's having established an exception to the "greater than one year" rule.[24] Rather, the

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20. *See* Van Iderstine Co. v. Commissioner, 261 F.2d 211 (2d Cir. 1958); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir.), *cert. denied*, 302 U.S. 722 (1937); French Broad Ice Cream Co., 57-2 U.S. TAX CAS. ¶ 9972 (E.D. Tenn. 1957), 4A J. MERTENS, *supra* note 9, § 25.38, at 193.

21. The courts have been inconsistent in deciding whether the customers themselves constitute capital assets. *Compare* Perkins Bros. v. Commissioner, 78 F.2d 152 (8th Cir. 1935), *with* Meridith Pub. Co. v. Commissioner, 64 F.2d 890 (6th Cir. 1933), *cert. denied*, 290 U.S. 646 (1937).

This issue as it relates to publications was settled by statute. INT. REV. CODE OF 1954, § 173 provides that all expenditures by newspapers and magazines to maintain or increase circulation can either be deducted in the taxable year or amortized. The taxpayer has the option to choose the tax treatment he desires.

22. The court will decide whether a capital asset has been purchased in the taxpayer's attempt to gain customers. In *Briarcliff*, for example, the customer-acquiring devices were the franchise agreements. *See generally* Rodgers Dairy Co., 14 T.C. 66 (1950) (showdogs); Liberty Ins. Bank v. Commissioner, 14 B.T.A. 1428 (1929), *rev'd on other grounds sub nom.* Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320 (6th Cir. 1932) (novelty banks); Northwestern Yeast Co., 5 B.T.A. 232 (1926) (sample products).

In the publication cases, courts examined the customers themselves to determine this issue. *See* note 21 *supra*.

23. 475 F.2d 775 (2d Cir. 1973). The Commissioner relied heavily on Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814, *cert. denied*, 302 U.S. 722 (1937), which involved an advertising and promotional campaign to establish the taxpayer in a new geographical area. The campaign resulted in the acquisition of a large number of new customers and the elimination of all competition in that area. The expenditures were held to be nondeductible under § 162(a). Thus, the Commissioner asserted in *Briarcliff* that *Houston* established the principle that any intensive campaign to get new customers creates capital expenditures and reaffirmed the "greater than one year" rule. The court in *Briarcliff* distinguished *Houston* by noting that the expenditures in *Briarcliff* were intended only to regain lost customers from the taxpayer's established customer base, and not, as in *Houston*, to acquire new customers in a new geographical area.

24. 475 F.2d at 782-83. Although the court recognized that its decision was con-

court determined that the Supreme Court's decision in *Commissioner v. Lincoln Savings & Loan Association*[25] had shifted emphasis away from that rule to a test permitting a section 162(a) deduction unless the resulting benefit constitutes a "separate and distinct additional asset."[26] Following this approach, the Second Circuit reasoned that since store owners were only retail agents for the taxpayer's established products[27] and since the agreements gave the taxpayer no property interest in the refrigerating display,[28] Briarcliff had not obtained an "additional asset," and hence the campaign costs were deductible as ordinary and necessary business expenses.[29]

Although this approach apparently eliminates examination of the taxpayer's purpose in making the expenditure,[30] since by its terms it looks only to the nature of the resulting benefit, it would appear that deductions allowed under the purpose exception to the "greater than one year" rule[31] would remain deductible under the "additional asset" test.[32]

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sistent with a long line of cases allowing deduction of expenditures for the protection of an existing business, *see* note 17 *supra* and accompanying text, it did not analyze the case or base its decision in terms of the purpose exception to the "greater than one year" rule.

25. 403 U.S. 345 (1971).

26. *Id. Lincoln* involved the deductibility pursuant to § 162(a) of an additional payment to the Federal Savings and Loan Insurance Corporation which the taxpayer was required to pay by statute. The Court mentioned the "greater than one year" rule, stated that it was not controlling, and then articulated the new test. 403 U.S. at 354. The Court found the payment in *Lincoln* to be a nondeductible additional asset since the taxpayer had a continuing interest in the money because of the possibility that a portion of the payment might be refunded in the future. *Id.* at 355.

27. The court implied that the "greater than one year" rule would still be relevant in a case in which the taxpayer had established a new product. 475 F.2d at 782-87.

28. *Id.* From this the court implied that the agreements were of no cash value to Briarcliff, and therefore could not be considered capital assets. *But see* United States v. Mississippi Chem. Corp., 405 U.S. 298 (1972).

29. 475 F.2d at 786.

30. The issue under the new test is whether an additional asset has been created. Under the exceptions to the former rule the taxpayer could establish his deduction by showing that his purpose was to protect an existing business. The new test appears to eliminate this factor from consideration.

31. *See* note 17 *supra* and accompanying text.

32. The "additional asset" test did not revoke the "greater than one year" rule, but simply added another test.

The result in *Briarcliff* probably would have been the same under the former test. The franchise agreements were intended to rebuild the taxpayer's business. Since Briarcliff (Loft) had an established but depleted customer base, the expenditures for the

Far more significant is the fact that a taxpayer now may be able, pursuant to the "additional asset" test, currently to deduct expenditures that were previously nondeductible. Formerly, the taxpayer could acquire the section 162(a) deduction only by proving either that the resulting benefits lasted less than one year or that the expenditure was excepted from the "greater than one year" rule.[33] Now, however, it appears that the taxpayer can obtain the current deduction simply by proving that the benefit, regardless of its "life," does not constitute an "additional asset."[34]

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agreements were expenditures made to protect an existing business. *See* notes 17 & 26 *supra.*

33. *See* notes 14-17 *supra* and accompanying text.

34. *See* note 33 *supra.* The courts in both *Lincoln* and *Briarcliff* treated the question whether an "additional asset" had been created as a question of law. Therefore, after a taxpayer has proven what benefit was created, he must argue that it does not qualify as an "additional asset." *See* notes 29 & 30 *supra.*