Tax Accounting

BY JAMES E. SALLES

In this month's column:

- In *Wells Fargo & Co. v. Commissioner*,[1] the Eighth Circuit overturns a Tax Court holding that required the taxpayer to capitalize a portion of executives' salaries in a corporate acquisition.
- The Tax Court holds in *Chrysler Corporation v. Commissioner*[2] that estimated warranty costs cannot be deducted when a car is sold.

TAX COURT REVERSED IN ANOTHER CAPITALIZATION CASE

In *Norwest Corporation v. Commissioner*,[3] discussed in this column in *CBTM's* inaugural issue,[4] the Tax Court held

- that the taxpayer had to capitalize "preparatory expenditures" in anticipation of a corporate acquisition, even if incurred before a formal commitment to enter into the transaction and
- that the costs to be taken into account included a portion of officers' regular salaries representing time devoted to the deal.

The Eighth Circuit has now affirmed the Tax Court as to part of the expenses involved in the first issue, but reversed as to the second, adding another chapter to the saga that began with the Supreme Court's 1992 decision in *INDOPCO v. United States*.[5]

BACKGROUND

INDOPCO established that you could have a capitalizable asset without its necessarily being associated with some sort of property interest—a "separate and distinct asset," in the parlance of the Supreme Court's earlier holding in *Commissioner v. Lincoln Savings & Loan Association*.[6] *Wells Fargo*, while in a large sense an "*INDOPCO* case," is really about the next inquiry: once you have an intangible asset, what kinds of expenditures are includable in its basis? Any self-constructed asset, of course, presents the potential issue of how to determine its cost. In contrast to the situation as to real and tangible personal property, however, there is little guidance as to how to determine the "cost" of intangible assets, particularly the somewhat amorphous intangibles frequently involved in post-*INDOPCO* capitalization cases.

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The Facts of Wells Fargo

The expenditures at issue in *Wells Fargo* were incurred by a target bank that was eventually absorbed into Norwest. The parties agreed that *INDOPCO* required the target to capitalize expenditures attributable to the acquisition, but disagreed as to which those were.

The first controversy concerned fees paid lawyers and investment bankers during the run-up to the transaction. The taxpayer argued these were generic "investigatory costs" and hence currently deductible, but the Tax Court held they were "sufficiently related" to the particular transaction at hand to require capitalization.[7] The second controversy concerned a portion of the salaries of the target's officers during the acquisition period that represented the time spent on the deal. The taxpayer contended these salaries were deductible as "ordinary and necessary expenses" but again, the Tax Court held that they were attributable to the deal and had to be capitalized.

The appellate court framed the issue as whether the expenditures were "directly attributable" to the transaction. In the case of the fees, the parties had refined their positions on appeal, with the government conceding that most of the expenditures that had been at issue before the Tax Court were currently deductible. As to the remainder, the parties agreed that true investigatory expenses incurred in deciding *whether* to acquire a business, and *which* business to acquire, were deductible, while expenditures incurred after a "final decision" to participate in the particular transaction were not. The issue was when that "final decision" had been taken.

While declining to adopt all aspects of the IRS' reasoning in Revenue Ruling 99-23,[8] the court agreed with that ruling to the extent that it held that there was no

"bright-line" test for determining when expenditures ceased to be deductible. On the facts, the court held that the taxpayer had made a "final decision" before incurring the small amount of expenditures remaining in dispute, which therefore had to be capitalized.

As to the salaries, however, the appellate court sided with the taxpayer, dismissing the Commissioner's reliance upon *INDOPCO* and several of its progeny as misplaced. The costs involved in those cases were incremental costs that would clearly not have been incurred "but for" the deal, and the issue was whether or not the taxpayers had to capitalize anything at all. In *Wells Fargo*, by contrast, the parties agreed that the deal provided a "future benefit," and the point in dispute was what expenditures were attributable to it. The salaries, the court held, were deductible because they were "directly related to (and [arose] out of the employment relationship, and . . . only indirectly related to the acquisition." [9]

Shades of PNC and Johnson

Wells Fargo is somewhat reminiscent of the recent decision of another Eighth Circuit panel in *Johnson v. Commissioner*,[10] which allowed the taxpayer a current deduction for otherwise capitalizable costs that were directly associated with advance receipts, again overruling the Tax Court. Both cases rejected what the panels evidently believed to be a hypertechnical reading of the tax accounting rules in general and the capitalization requirement in particular. Instead, the courts adopted a broader—though perhaps less rigorously logical—approach favoring the deduction of commonly incurred costs if it does not distort income.

A more direct parallel to *Wells Fargo* is *PNC v. Commissioner*,[11] another recent case in which a Tax Court holding requiring capitalization of labor costs into the bases of intangible assets was reversed on appeal, this time by the Third Circuit. The expenditures involved in *PNC* were the salaries of personnel involved in loan processing—the so-called loan origination costs—but the case presented essentially the same question as *Wells Fargo*. "Ordinary" expenses of a recurring nature—such as the salaries of the corporate officers in *Wells Fargo* or of the loan processing gremlins in *PNC*—are generally deductible. The issue in both cases was, when does the presence of a concededly capitalizable intangible asset—the benefit from the bank acquisition in *Wells Fargo*, or the bank loans in *PNC*—change the result?

The IRS' position, and evidently the Tax Court's, is that taxpayers must include in the cost of an intangible asset what in the context of tangible assets would be referred to as "direct labor costs." (It is hard to incur direct materials costs for an intangible asset.) In contrast, the appellate courts in *Wells Fargo* and *PNC* appear to have concluded that only "extraordinary costs" that are outside of the taxpayer's ordinary operations base need be capitalized. Under this reasoning, the salaries in *Wells Fargo* did not have to be capitalized because the courts and the IRS "have traditionally permitted a current deduction for expenses attributable to employee compensation." [12]

The Tax Court's approach in the two cases is closer to the Supreme Court's treatment of self-constructed property in *Commissioner v. Idaho Power*,[13] but the appellate decisions more closely reflect the traditional approach to intangible assets. Practitioners were not slow to applaud the appellate holding in *Wells Fargo* as a signal that *INDOPCO* was not to be taken to extremes.[14] While the IRS and the Tax Court appear to be groping toward a common "unified field theory" of capitalization in the aftermath of *INDOPCO*, at least some appellate courts are exhibiting reluctance to fall into line. And the saga continues.

VEHICLE WARRANTY LIABILITY NOT "FIXED"

In *Chrysler Corp. v. Commissioner*,[15] the Tax Court held that the automobile manufacturer could not accrue a deduction for its warranty liabilities because they did not represent "fixed liabilities" under the "all events" test.

Background

Accrual basis taxpayers normally become entitled to deductions when "all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability." [16] This "all events" test does not permit deductions for unpaid contingent liabilities.[17] Courts respect the hazy line between a "condition precedent" that renders a liability contingent, and a "condition subsequent that does not prevent its accrual." [18]

The tension between conditions precedent and subsequent is illustrated by a brace of Supreme Court cases from the mid-1980s that illuminated, without radically changing, the surrounding legal landscape. *United States v. General Dynamics Corp.*[19] involved a self-insured employer's medical plan. The Court held that the employer's liability did not become "fixed"—even if employees had incurred covered expenses—until the employees submitted claims under the plan.

On the other hand, *United States v. Hughes Properties*[20] permitted a casino to accrue a deduction for "progressive jackpots" accrued on its slot machines. The casino was legally required to pay these amounts to eventual winners. The Court disregarded the possibility that the casino might go out of business beforehand as a "condition subsequent." [21]

Chrysler Corporation

Chrysler Corporation obligated itself to pay its dealers to make repairs under ordinary and "extended" warranty contracts. It also was liable, in certain circumstances, under implied warranties found in certain federal and state laws, such as "lemon laws." Chrysler sought to deduct an estimate of its warranty liability on each car as the sale was made. As the years at issue (1983–85) antedated the extension of the "economic performance" rules to such liabilities,[22] battle was joined on the issue of whether there was a "fixed liability."

The IRS cited *General Dynamics* in support of its position that the liability could not be accrued except as customers brought their cars to dealerships for servicing. Chrysler, on the other hand, argued that it was obligated to make repairs by contract and under law, and that *Hughes Properties* established that an obligation to perform imposed by statute could qualify as a "fixed liability." The Tax Court upheld the IRS' analogy to *General Dynamics* while rejecting the taxpayer's attempted reliance upon *Hughes*.

The state gambling regulations at issue in *Hughes Properties* imposed a liability in a known amount—and required the taxpayer to retain a cash reserve to cover it.[23] By contrast, the various laws discussed in *Chrysler* merely imposed a general duty to perform under particular circumstances, albeit circumstances likely to be met sooner or later with respect to at least some vehicles. Courts have consistently rejected taxpayers' attempts to justify deductions for multiple contingent liabilities on the grounds that, in the aggregate, claims are statistically certain to be incurred, thus attempting to make up in quantity what each individual claim lacks in fixed "quality." [24]

The critical issue was not that the liabilities in *Hughes* and those in *Chrysler* were both imposed by public law—which, arguably, is ultimately true of any legal liability anyway, voluntarily assumed or otherwise—but that the liabilities in *Hughes* were fixed while those in *Chrysler* were not. The Tax Court relied upon its earlier decision in *World Airways v. Commissioner*,[25] in which it refused to allow a taxpayer to ratably accrue the cost of periodic overhauls of its aircraft under an FAA-imposed schedule. The court in *World Airways* reasoned that the taxpayer might never become obligated to repair a particular aircraft if, for example, it crashed, was permanently grounded, or more likely, was sold.[26]

Similarly, in *Chrysler*, what expense might have to be incurred as to any particular warranty would ordinarily remain uncertain until, at least, a customer brought in a car. The court noted that it did not have to reach the issue of exactly when Chrysler's liability became "fixed." The fact that the liability was *not* fixed when Chrysler initially sold the car was sufficient to disallow the claimed deduction.

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1. 224 F.3d 874, 2000 WL 1219430 (8th Cir. Aug. 29, 2000), *aff'g and rev'g Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999), discussed in 1(1) Corp. Bus. Tax'n Monthly 26 (October, 1999).
2. 80 T.C.M. (CCH) 334 (2000).
3. 112 T.C. 89 (1999), *aff'd and rev'd sub nom. Wells Fargo v. Commissioner*, 224 F.3d 874, 2000 WL 1219430 (8th Cir. Aug. 29, 2000).
4. 1(1) Corp. Bus. Tax'n Monthly 26 (Oct. 1999).
5. 503 U.S. 79 (1992).
6. 403 U.S. 345 (1971).
7. 112 T.C. at 100.
8. 1999-1 C.B. 998.
9. 2000 WL 1219430 at 12.
10. 184 F.3d 786 (8th Cir. 1999), *aff'g and rev'g* 108 T.C. 448 (1997), discussed at 1(2) Corp. Bus. Tax'n Monthly 28 (November, 1999).
11. 110 T.C. 349 (1990), *rev'd*, 212 F.3d 822 (3d Cir. 2000), discussed at 1(11) Corp. Bus. Tax'n Monthly 26 (August, 2000).
12. 2000 WL 1219430 at 13.
13. 418 U.S. 1 (1975).
14. D. Lupi-Sher, "Tax Bar Applauds Eighth Circuit's Decision in *Wells Fargo*," 88 Tax Notes 1303 (Sept. 11, 2000).
15. 80 T.C.M. (CCH) 334 (2000).
16. Treas. Reg. § 1.461-1(a)(2).
17. *See generally* Treas. Reg. § 1.461-2.
18. *Helvering v. Russian Finance & Construction Corp.*, 77 F.2d 324, 327 (2d Cir. 1935).
19. 481 U.S. 239 (1987).
20. 476 U.S. 593 (1986).
21. Id. at 605–06, citing Russian Finance, supra at n. 19.
22. See Treas. Reg. §§ 1.461-4(g)(5), (k)(3), generally requiring payment as a prerequisite to deduction for taxable years after 1991.
23. See 476 U.S. at 596 and authorities cited.
24. Cf. *Milwaukee & Suburban Transport Corp. v. Commissioner*, 367 U.S. 906 (1961) (per curiam), vacating and remanding 283 F.2d 279 (7th Cir. 1960) in light of *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961); see also, e.g., *Supermarkets General Corp. v. United States*, 537 F. Supp. 759 (D. N.J. 1982).
25. 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).
26. 62 T.C. at 804.