

Tax Accounting

By James E. Salles

This month's column continues the discussion of the treatment of taxpayers' internal costs (employee compensation and "overhead") in the proposed "INDOPCO regulations." The May issue described the "incremental costing" approach that prevailed before the advent of detailed rules governing manufacturing and construction. The following discussion begins with a summary of the authorities addressing intangible property, and then turns to the proposed regulations.

Basic Principles

Background: Tangible Property

Before detailed regulations were adopted in the 1970s, the courts and the IRS had largely followed an "incremental cost" approach to capitalizing manufacturing and construction outlays. This method was sometimes referred to as "direct costing," but that did not mean that only direct materials and direct labor had to be capitalized. The courts consistently required capitalizing at least some indirect ("overhead") costs. This was equally the case as to inventory,¹ where the regulations expressly so required;² long-term contracts,³ where they did not;⁴ and self-constructed property, which was not specifically addressed in regulations at all.⁵ The Supreme Court held in *Commissioner v. Idaho Power Co.*⁶ that all types of costs are subject to capitalization unless some specific exception applies.

There was more uncertainty about *which* indirect costs had to be capitalized. The IRS favored a "full absorption" or "full costing"

approach under which most indirect costs that had some relation to productive activity had to be capitalized. Several cases approved the IRS's imposing this treatment when the taxpayer had capitalized no overhead at all,⁷ but these seem to have reflected the principle that the IRS gets to choose among acceptable methods if the taxpayer's method is wrong.⁸ The courts suggested that only costs that varied with production ("variable costs") had to be capitalized, while the treatment of "invariable" costs, such as rent and real estate taxes, was optional.⁹ Similarly, employees' compensation was allocated when they spent substantial time on manufacturing and construction activities,¹⁰ but not when their involvement was sporadic or "incidental."¹¹ Something close to "full absorption" costing was eventually imposed by regulation and, eventually, in the uniform capitalization ("UNICAP") and contract costing rules enacted in the Tax Reform Act of 1986.¹² None of these rules apply to intangible property except in very limited situations, however, so the early cases remain the starting point for analysis.

The "Directly Related" Standard

Intangibles costing questions generally arise in one of two settings. The first type of situation involves intangibles acquired, created, or entered into in the course of ordinary business operations. The question is whether recurring outlays like salaries and different types of overhead are part of the cost of that *class* of intangibles. The second type of situation involves an isolated, more or less one-of-a-kind transaction like a business acquisition. The first issue in such cases is identifying the outlays that would not have been incurred "but for" the transaction and are closely enough related to it to justify capitalization. The second ques-

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tion that arises is whether recurring costs should be attributed to the transaction even if they would have been incurred anyway.

The relatively sparse early authorities carried over principles familiar from the manufacturing and construction cases. Revenue Ruling 68-561¹³ required a utility to capitalize subsidies of new customers' gas appliances but allowed deductions for salaries and advertising because these were less "directly and significantly productive of intangible assets." The National Office concluded that requiring capitalizing these costs would conflict with the traditional deductibility of marketing expenses, and it was hard to properly amortize them.¹⁴ Presumably, the promotional program did not involve substantial incremental costs apart from the subsidies. Revenue Ruling 69-331,¹⁵ by contrast, concluded that bonuses and commissions (both in-house and external) were "directly related" to another utility's leases of equipment to its customers and had to be amortized over the lease terms. Revenue Ruling 73-580¹⁶ held employee compensation attributable to corporate mergers and acquisitions must be capitalized, emphasizing that "internal" expenses should be on the same footing as comparable outlays to outsiders.¹⁷ The ruling did not discuss how the salaries were to be attributed, but both cases that it relied upon were consistent with incremental costing. One involved a specially designated executive bonus,¹⁸ and in the other, essentially all of the officers' services related to a past capital transaction.¹⁹

Over time, the IRS came to focus on "recurring" capital transactions involving assets regularly created or acquired in ordinary business operations. The taxpayer in Revenue Ruling 74-104²⁰ regularly renovated real property for resale. The ruling concluded that both payments to agents involved in acquiring the properties and "salaries, travel, and other related costs subsequently incurred by the taxpayer in evaluating the agent's report" were capital. The ruling did not, however, specify how the "salaries, travel, and other related costs" were to be identified.

A 1974 general counsel memorandum considered a proposed revenue ruling addressing financial institutions' loan costs, destined to become a recurring and troublesome issue. The National Office required that "directly related" expenditures—the example given was employee commissions—be capitalized, again emphasizing that "in-house" costs and external costs should be treated the same. However, deductions were allowed for "salaries, rents, office overhead, and other similar expenses," even though the taxpayer maintained a dedicated staff "for the primary purpose of soliciting mortgage loans." This position was arguably more liberal than the construction and manufacturing cases, which capitalized compensation of employees predominantly engaged in "capital" activities.

The IRS revisited the issue two years later,²¹ when it considered another proposed ruling, this one involving a mutual life insurance company that invested in mortgage loans and real property. The taxpayer maintained an "investment department," including loan specialists, lawyers, appraisers, and actuaries, working exclusively on acquisition-related matters. Again emphasizing that in-house costs were subject to capitalization, this time the National Office concluded that the salaries and "other expenditures" attributable to those employees were "directly related" to the investments.

Other Pre-INDOPCO Authority

Taken together, the rulings and internal documents suggest that the IRS thought costs should be assigned to intangible property much as they were to real and tangible personal property before the "full absorption" regulations. The cost of assets derived from ordinary operations would include labor and possibly variable overhead (likely small) attributable to the overall "capital activity," even these could not be identified to any individual asset produced. "One of a kind" transactions would require capitalizing only outlays that would otherwise not have been incurred, which would exclude most internal costs, except

specifically identifiable items like bonuses and commissions and perhaps travel costs, telephone calls, and the like.

This costing approach would be generally consistent with the few pre-*INDOPCO* cases involving intangible property. In *Dunlap v. Commissioner*,²² a bank capitalized the costs that it deemed “directly attributable” to its various acquisitions, including minor salary expense. The IRS, however, argued for capitalizing more compensation, along with an allocation of rent, depreciation, and other overhead. Relying upon *Fort Howard Paper Co. v. Commissioner*,²³ in which the court refused to attribute overhead to “incidental” plant improvements, the Tax Court held that none of the bank’s overhead was capital because its acquisitions were “incidental to its business of holding and managing banks.” The court apportioned compensation of an officer who was directly involved with the transactions, but not that of employees whose services were “*de minimis* and incidental to the[ir] regular tasks.” In *Encyclopedia Britannica, Inc. v. Commissioner*,²⁴ the taxpayer paid another publisher an advance against expected royalties to research, prepare, edit, and arrange a manuscript. The Seventh Circuit held the payments capital, distinguishing the taxpayer’s one-time payment for an essentially complete manuscript from ordinary business expenses incurred over time in producing a publication in-house.

This reading is supported by implication in the UNICAP “reseller rules,”²⁵ which can apply to intangible property in limited circumstances.²⁶ The regulations²⁷ distinguish between property’s “acquisition cost,” including “necessary charges incurred in acquiring possession of the goods,”²⁸ which is always capital, and additional “indirect costs” that may be capitalized under section 263A. Among the latter is “indirect labor,” defined to include “all labor costs . . . that cannot be identified with particular units or groups of units of specific property produced or . . . acquired for resale.”²⁹ The implication is that labor costs that can be “identified with particular units or

groups of units”—presumably meaning much the same as “directly related”—are “direct labor” and part of the “acquisition cost.”

Post-*INDOPCO* Cases

The IRS Refines Its Position

There was some suggestion after the Supreme Court’s watershed decision in *INDOPCO*³⁰ that the IRS might be drifting away from strict incremental costing. IRS position papers on leases hewed fairly closely to Revenue Rulings 68-561 and 69-331 with their distinction between “directly related” expenditures and others.³¹ However, another paper required capitalizing a long list of costs in connection with obtaining a cable television franchise, their number and nature suggesting some allocation.³²

The same period saw the IRS getting serious about its position requiring capitalizing internal costs connected with routine business assets. IRS documents had addressed loan costs in the 1970s,³³ but the issue became prominent after financial reporting practices changed in the late 1980s. Assuming they are really fees for services,³⁴ loan fees are taxable income upon receipt.³⁵ Traditionally, banks had also recognized fee income for book purposes when the loan was made, and any associated costs were simply deducted along with other current expenses. The new rules generally required the fee income net of related costs, including both “direct costs” of labor and third-party outlays, be amortized into book income.³⁶ Identifying the expenditures associated with the loans made proposing adjustments easy—although the IRS warned agents that book costing practices were not controlling³⁷—and it is hard for taxpayers to argue against their own books.³⁸ The issue surfaced in technical advice as early as 1990.³⁹ After *INDOPCO*, the IRS suspended consideration of accounting method changes⁴⁰ and began routinely capitalizing loan costs on audit.⁴¹ It also pressed similar adjustments in connection with other types of routine business assets, for example, requir-

ing capitalization of employee compensation and travel costs incurred in "soliciting, evaluating, and negotiating" long-term service contracts.⁴²

Internal costing issues are difficult because two basic capitalization principles come into conflict. Deductions are traditionally allowed for routine business expenses, even though they yield some future benefit because "the administrative costs of conceptual rigor are too great."⁴³ This continues to be the case after *INDOPCO*, which did not create a "talismanic rule" that all expenditures with *any* element of future benefit are capital.⁴⁴ Capitalization is ultimately a question of "clear reflection" and matching income with the associated expense,⁴⁵ and tracing the benefits of a lot of little outlays does not contribute much.

On the other hand, it is equally well established that "an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset."⁴⁶ The rule excusing routine expenditures from capitalization ordinarily applies to outlays being examined for "future benefit" in isolation. Costs incurred in acquiring an asset will normally be capital if the useful life of the *asset* is long enough to warrant capitalization, regardless of the nature of the cost. For example, while current deductions are generally allowed for periodic maintenance of tangible property if the outlays are recurring and relatively modest,⁴⁷ the same analysis does not apply to the original costs of acquisition.

In arguing for current deductions for loan costs,⁴⁸ banks relied heavily on the reluctance to capitalize routine business expenditures illustrated in such cases as *Encyclopedia Britannica*. The Seventh Circuit distinguished between "the normal, recurrent expenses of operating a business that happens to produce capital assets" and outlays "unambiguously identified with specific capital assets," and observed that "[t]he distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those

capital expenditures that can feasibly be capitalized and those that cannot be."⁴⁹ *Encyclopedia Britannica*, however, required capitalizing a specific outlay identified with a particular project, and the court withheld judgment about whether the distinction between recurring and "unusual" costs "breaks down where . . . the firm's entire business is the production of capital assets."⁵⁰ The basic question remains: do the outlays form part of the cost of the asset or are they to be examined on their own?

Recurring Assets: PNC Bancorp

These issues began to reach the courts in the late 1990s. In *PNC Bancorp, Inc. v. Commissioner*⁵¹ the Tax Court upheld the IRS in requiring two banks to amortize employee compensation and "related costs" attributable to negotiating, evaluating, and closing loans. The Third Circuit, reversing, held the costs deductible as ordinary expenses of conducting business.

The two courts' differing approaches were illustrated by their treatment of several older cases allowing deductions for banks' expenditures in expanding their credit card activities.⁵² These cases, dating from after *Lincoln Savings* but before *INDOPCO*, note with varying degrees of emphasis that the expenditures were not associated with "separate and distinct assets,"⁵³ but fit most closely with the authorities holding that the expenses of expanding an existing business, as distinguished from starting a new one, are currently deductible.

The Tax Court brushed these "credit card cases" aside on the grounds that those courts had found that the challenged outlays "did not create or enhance a separate and distinct asset," while in *PNC* they did.⁵⁴ Arguably, loans are assets while credit card *accounts* are not, but the court did not seem to be making this formalistic distinction. The outlays involved were basically the same,⁵⁵ and the IRS extends the same capitalization requirement to credit facilities such as "home equity lines of credit."⁵⁶ The thrust of the Tax Court opinion was that the salaries and other outlays were "direct costs" because the banks would not have incurred them had they not made loans.

The Third Circuit, by contrast, cited the credit card cases as authority that the loan costs in *PNC* did not “create or enhance” any asset either. Loans are obviously assets, although the court implied that they might be distinguishable from the reserve fund in *Lincoln Savings*. The crucial part of the court’s holding was its conclusion that only actual advances that form part of the principal “created” loans.⁵⁷ The general rule is that capitalization is required if an outlay *either* relates to an “asset” or produces a “more than insignificant” future benefit. Having decided the loan costs did not relate to assets, the Third Circuit found *Encyclopedia Britannica* squarely on point, because recurring business expenses do not produce the type of “future benefit” that requires capitalization under *INDOPCO*.

Isolated Transactions: Norwest/Wells Fargo and Dana Corporation

Norwest Corporation v. Commissioner,⁵⁸ captioned as *Wells Fargo & Co. v. Commissioner* on appeal, was about the treatment of an acquisition target’s legal fees and \$150,000 of its officers’ salaries that it capitalized on its books as relating to its acquisition. The Tax Court concluded that both items had to be capitalized as providing a “future benefit” under *INDOPCO*. The Eighth Circuit, however, while upholding capitalization of some of the legal fees, held that the salaries were deductible because they were not “directly related” to the acquisition. The critical factor was that the officers’ compensation was unaffected by the acquisition.⁵⁹ Distinguishing *Acer Realty Co. v. Commissioner*,⁶⁰ one of the early construction cases, the court held that only “extraordinary and incremental expenses” associated with the capital activity had to be capitalized.

In between *PNC* and *Wells Fargo* came the Federal Circuit’s decision in *Dana Corporation v. United States*.⁶¹ Dana paid a \$100,000 annual retainer to a prominent law firm. The retainer “locked out” the firm from hostile representation, but was also credited against any legal fees during the year. During 1984, the firm

charged Dana \$265,000 in connection with an acquisition of its own. The taxpayer capitalized \$165,000 but sought to deduct the \$100,000 that was due regardless of whether legal services were provided. The Federal Circuit held that a legal fee was distinct from a protective retainer, and regardless of past payments, the \$100,000 paid in 1984 was for legal services related to an acquisition. Some read this decision, following closely on the heels of the Tax Court’s holding in *Norwest*, as portending a trend away from incremental costing,⁶² although the opinion did not address the issue directly.

Against this background, the Eighth Circuit’s forthright application of incremental costing in *Wells Fargo* was widely read as a caution not to take *INDOPCO* to extremes.⁶³ Although it has not formally acquiesced, the IRS seems largely to have accepted the Eighth Circuit’s analysis. Indeed, a divisional “non-docketed service advice review” later the same year cited *Wells Fargo* in approving a deduction for management salaries in similar circumstances.⁶⁴ The review memorandum noted that the executives involved were all long-term employees, would have received the same compensation in any case, and spent only a relatively insignificant amount of time (about 7 percent) on the three separate capital transactions involved. After consulting with the National Office, area counsel concluded that “it was clear” that, on these facts, a deduction would be allowable. The memorandum cautioned that the same rule would not apply to compensation of employees “hired for the specific purpose of participating in a capital transaction” or bonuses “based solely upon an employee’s significant participation in a capital transaction.”⁶⁵

The Tax Court Tries Again: Lychuk v. Commissioner

By contrast, the IRS persisted in its efforts to capitalize labor and overhead costs “directly related” to routine business assets like loans. A 2000 field service advice made clear the National Office disagreed with the Third

Circuit's *PNC* holding, while speculating that its rationale (that only advances of principal "create" a loan) might not apply to taxpayers that bought loans rather than making them.⁶⁶ *Lychuk v. Commissioner*⁶⁷ appears to have been the same case.⁶⁸ *Lychuk* involved a subchapter "S" corporation ("ACC") that financed auto dealers' credit sales. The corporation would normally investigate potential buyers and advise the dealer before closing whether or not it would be willing to buy the installment contract. Several employees spent from 40 to 100 percent of their time on these "credit review activities," and the issue was whether a corresponding portion of their salaries and associated overhead should be capitalized. (The parties agreed the expenses of *servicing* the contracts were deductible.)

The full Tax Court addressed the issue in a total of five opinions. The court began from the premise that, contrary to the Third Circuit's holding in *PNC*, the capitalization requirement extended to expenditures "directly related" to the acquisition of an asset with a useful life exceeding one year. Applying this standard, all the judges agreed that the labor costs were capital because "but for ACC's anticipated acquisition of installment contracts, ACC would not have incurred the salaries and benefits attributable to those [credit review] activities."⁶⁹ This fact distinguished the case from *Wells Fargo*, where the employees spent relatively little time on the acquisition and their compensation was unaffected.⁷⁰

A nine-judge majority allowed deductions for the overhead items, however, because "[n]one of these routine and recurring expenses originated in the process of . . . acquisition of installment contracts, nor, in fact, in any anticipated acquisition at all. ACC would have continued to incur most of these expenses in the ordinary course of its business had its business only been to service the installment contracts."⁷¹ The remaining seven judges would have capitalized the overhead as well as the compensation expense on the grounds that ACC's credit review activities were too signifi-

cant to be "incidental": "Logic would indicate that if ACC no longer engaged in credit analysis activities, then its need for office space would decrease, and it would take steps to reduce its rental and utility costs. The same logic would apply even more to printing, telephone, and computer costs."⁷² Both the majority's and minority's analyses thus revolved around a "but for" test, although they reached different conclusions.

The Regulations

Analytical Problems

The drafters faced a potentially difficult job in coming up with suitable rules for internal costs associated with intangible property. The precedents concerning real and tangible personal property offer some but not a great deal of assistance, because there are a number of key differences. A basic distinction is that some intangibles historically have only been treated as assets when purchased. Purchased goodwill and workforce in place are unquestionably assets, but the outlays that produce them have been consistently held deductible for over 70 years. Where the line is to be drawn excluding these self-developed "goodwill-type" intangibles from capitalizable assets is not always clear. The controversy in *PNC* was essentially about whether to treat the loans as assets like the Tax Court, or like good-will type intangibles that were not "separate and distinct assets," as the Third Circuit did.

Even when an asset clearly exists, confusion remains about how to treat "the normal, recurrent expenses of operating a business that happens to produce capital assets,"⁷³ especially when they are not associated under a "but-for" analysis with a particular asset or transaction. The tangible property precedents would support allocating "direct labor" and variable overhead to recurring transactions, but the case for allocating anything but "directly related" incremental costs to isolated transactions is considerably weaker. Those labels are in any event somewhat arbitrary. As the Tax Court

observed in *Coors*, “invariable” costs have a way of becoming “variable” depending on the scale of the activity. As distilled from the cases and rulings, the rule seems to be that employees’ compensation is capitalized if a “significant” portion of their time is spent on capital activities, and overhead is capitalized if capital activities are sufficiently “significant” in relation to the taxpayer’s overall activities. These are not principles easily translated into “bright-line” rules.

Moreover, analogies to tangible property have their limits. For example, purchasing department costs are not part of the basic “acquisition cost” of purchased inventory. Does this suggest loan acquisition costs (as distinguished from loan *origination* costs) should not be capital? Capitalizing the indirect costs of manufactured, but not purchased goods, makes some sense: making widgets generally involves more internal costs than buying them. But what if the “widgets” are bank loans? *PNC* arguably supports exactly the opposite distinction. The IRS suggested the Third Circuit’s rationale for deducting loan costs—that only the actual advances “create” loans—would not apply to purchased loans. That would suggest that perhaps loan acquisition costs should be deducted, while loan origination costs should be capitalized. Neither distinction makes much policy sense.

A final wild card is the prospect that the “matching principle” may sometimes override the “normal” capitalization rules. In *Johnson v. Commissioner*,⁷⁴ automobile dealers were required to report service contract revenues upon receipt even though they were partially held in escrow. The Eighth Circuit allowed the dealers to deduct the escrow agent’s fees, which would ordinarily have been capital, because “[i]f taxpayers are going to be required to take into income the entire amount paid into the escrow fund in the year of receipt and payment, we think, as a matter of fairness, that they should also be allowed to deduct, in that year, the entire amount of the fee.”⁷⁵ The IRS has been hostile to the idea that matching prin-

ciples can trump capitalization.⁷⁶ However, taxpayers might invoke the *Johnson* holding to argue, for example, that loan costs should be deducted when the taxpayer recognizes income from the fees.

The Proposed Regulations’ Solution

Trying to codify the prevailing law, much less impose “full absorption” costing, would have risked a return to the semantic hairsplitting the Supreme Court frowned upon in *INDOPCO*, and a final product that looked like the UNICAP regulations.

As in several other aspects of the proposed regulations, the drafters opted for a modestly taxpayer-favorable form of “rough justice.” The internal costing rules draw heavily on the “*INDOPCO* Coalition” proposal,⁷⁷ which was drafted with the case law very much in mind. (Indeed, both PNC and Wells Fargo were coalition members.)

The Coalition proposal generally divided occasions for capitalization into two categories, the acquisition of traditional “separate and distinct assets” and “ACORN” (“acquisition, creation, organization, reorganization, and new . . . business”) transactions. The proposal would have allowed taxpayers to deduct employee compensation costs and “general and administrative costs” (including general overhead, support costs, and “costs for overall management or policy guidance functions”) connected with either.⁷⁸ The coalition also expressed support for a *de minimis* threshold of “at least” \$5,000 for expenses associated with any single transaction.⁷⁹

The regulations also divide capital outlays into two basic categories, although along somewhat different lines. The first category comprises costs incurred to “acquire, create or enhance” a laundry list of intangible assets.⁸⁰ “Created intangibles” are defined more narrowly than “acquired intangibles,” effectively excluding self-created goodwill-type assets from capitalization.⁸¹ The second category comprises those costs that “facilitate”:

- the acquisition, creation, or enhancement of

an intangible asset, as described above;

- restructuring or reorganization of a business entity; or
- the acquisition of capital, such as a borrowing or stock issuance.⁸²

The Advance Notice of Proposed Rulemaking had stated that "facilitative" outlays to be capitalized would exclude employee compensation (except bonuses and commissions paid specifically for that transaction) and "fixed overhead" such as rent, utilities, and depreciation, and costs below a *de minimis* threshold "such as \$5,000." Comments were requested about how the threshold should be applied, and whether certain expenditures should be ineligible for exclusion as *de minimis*.⁸³

The proposed regulations drop the special rule for employee bonuses and commissions specifically attributable to the transaction and exclude employee compensation completely. The reference to "fixed overhead" is replaced with the bare term "overhead." The \$5,000 *de minimis* exclusion appears as promised, together with a similar *de minimis* rule for payments to suppliers or customers to induce them to enter into a contract, although certain outside commissions are ineligible for exclusion. Naturally, taxpayers have to compute attributable costs to apply the threshold, but similar transactions may be pooled and the average cost used.⁸⁴ The preamble states that "[t]hese simplifying conventions are intended to be rules of administrative convenience, not substantive rules of law," and requests comments on a possible book conformity requirement.

Outlook

The proposals make a reasonable attempt at administrative simplicity without working too radical a departure from existing authorities. The drafters are likely to have to flesh out the term "overhead" to target the "internal" costs that were presumably intended. They may also want to fine-tune the safe harbors with an eye to minimizing steps in a typical taxpayer's calculations. Rules that are harder to explain may prove easier to apply.

There is a case to be made that very small individual outlays (under \$100 or \$500) should simply be expensed because they are not worth analyzing. Once a taxpayer has to go to the trouble of figuring out what an outlay is, though, there is no reason to misclassify it just because it is not very big all by itself. Further simplifying conventions should look to the transaction and the taxpayers' bookkeeping as a whole. The proposed regulations' safe harbor does this to an extent by basing the threshold on the total expenses attributable to the transaction, but may require some tweaking to achieve the goal of requiring capitalization only when it counts.

If the goal is to reduce difficulties in allocation, one possible option is a more generous exclusion for a narrower category of costs. The regulations could provide that expenses incident to employees' activities, like travel and telephone costs, need not be capitalized if the employees' actual compensation is not capitalized. If this were thought too generous, then both compensation and associated costs could be required to be capitalized for employees that spent the bulk (say 80 percent) of their time on capital matters. One commentator asked whether whatever rule is adopted for employees should be extended to contract employees and independent contractors, provided that they were not hired for, and not predominantly engaged in, capital activities.⁸⁵

On the other hand, payments to counterparties, bonuses, and commissions to outsiders, and similar payments are generally pretty easy to attribute, and the proposed regulations require taxpayers to do so anyway to determine whether the threshold is met. If these types of outlays are to be excluded from capitalization it has to be for some other reason, such as avoiding the nuisance of tracking relatively minor amounts. For example, the overall *de minimis* exclusion could allow expensing if the total facilitative costs attributed (after applying the exclusion for specified types of costs) fell below some percentage of acquisition cost, or expected contract revenues or outlays.

Other changes to the internal costing exclusions might reduce the likelihood of whipsaws and associated disputes. Taxpayers might be permitted to apply the threshold to recurring transactions based on past years' results, or a periodic study, so they could know before the year began whether they would have to track particular costs. They might also be permitted to elect to capitalize otherwise deductible costs, or capitalize regardless of the *de minimis* threshold, provided they did so consistently. Finally, the regulations should probably make clear that once a taxpayer capitalizes particular costs, capitalization (not "following the regulations") becomes its method of accounting and it cannot

go back to expensing without permission.

A final option would be to require (or permit) taxpayers to follow their own books, as suggested in the preamble. The utility of book treatment as a point of reference is likely to vary sharply, and the drafters might be unwilling to start distinguishing between isolated and recurring capital transactions, and possibly between different types of each. There might also be problems in defining which financial statements are reliable enough to follow. The IRS has even more than the usual regulatory latitude in accounting matters, and it will be interesting to see how it handles internal costs in the next round.

1. *E.g.*, *All-Steel Equipment, Inc. v. Commissioner*, 54 T.C. 1749 (1970), *aff'd on this issue, rev'd and rem'd on another*, 467 F.2d 1184 (7th Cir. 1972); *Dearborn Gage, Inc. v. Commissioner*, 48 T.C. 190 (1967).

2. See Reg. § 1.471-3(c).

3. *E.g.*, *Algernon Blair, Inc. v. Commissioner*, 29 T.C. 1205 (1958), *acq.* 1958-2 C.B. 4.

4. See Reg. § 1.451-3(b), *prior to amendment by* T.D. 7397, 1976-1 C.B. 115.

5. *E.g.*, *Louisville & Nashville Railroad Co. v. Commissioner*, 66 T.C. 962 (1976), *modified and aff'd on this issue*, 641 F.2d 435 (6th Cir. 1981).

6. 418 U.S. 1 (1974).

7. *E.g.*, *All-Steel* and *Dearborn*, cited note 1.

8. See, *e.g.*, *All-Steel*, 54 T.C. at 1761; *Photo-Sonics, Inc. v. Commissioner*, 42 T.C. 926, 933-34 (1964), *aff'd*, 357 F.2d 656 (9th Cir. 1966); see also, *e.g.*, *Mulholland v. United States*, 28 Fed. Cl. 320, 335-36 (1993), *aff'd without published opinion*, 22 F.3d 1105 (Fed. Cir. 1994) (*memorandum opinion*, 73 A.F.T.R.2d 94-1693).

9. See, *e.g.*, *Northern Pacific Railway Co. v. Commissioner*, 83 F.2d 508 (8th Cir. 1936).

10. *E.g.*, *Acer Realty Co. v. Commissioner*, 45 B.T.A. 333 (1941), *aff'd*, 132 F.2d 512 (8th Cir. 1942); *Perlmutter v. Commissioner*, 44 T.C. 382 (1965), *aff'd on other issues*, 373 F.2d 45 (10th Cir. 1967).

11. *E.g.*, *Wilmington Trust Co. v. United States*, 610 F.2d 703 (Ct. Cl. 1979); *Dixie Frosted Foods v. Commissioner*, 6 T.C.M. (CCH) 586 (1947).

12. See generally I.R.C. §§ 263A, 460 and associated regulations.

13. 1968-2 C.B. 117.

14. Gen. Couns. Mem. 33784 (Mar. 29, 1968).

15. 1969-1 C.B. 87.

16. 1973-2 C.B. 86.

17. See also Gen. Couns. Mem. 36917 (Nov. 10, 1976); Gen. Couns. Mem. 35681 (Feb. 19, 1974).

18. *DuPont v. Commissioner*, 34 B.T.A. 1059 (1936), *aff'd sub nom. Peirs v. Commissioner*, 96 F.2d 642 (9th Cir. 1938).

19. *General Spring Corp. v. Commissioner*, 12 T.C.M. (CCH) 847 (1953).

20. 1974-1 C.B. 70.

21. Gen. Couns. Mem. 36917 (Nov. 10, 1976).

22. 74 T.C. 1377, 1425-28 (1980), *rev'd on another issue*, 670 F.2d 785 (8th Cir. 1982).

23. 49 T.C. 275 (1967), discussed in J. Salles, "Tax Accounting," 4(8) Corp. Bus. Tax'n Monthly 52 (May, 2003).

24. 685 F.2d 212 (7th Cir. 1982).

25. I.R.C. § 263A(b)(2); Reg. § 1.263A-3.

26. See Reg. § 1.263A-3(a)(1).

27. See generally Reg. § 1.263A-1(e).

28. Reg. § 1.263A-1(e)(2)(ii), citing Regs. § 1.471-3. Regs. § 1.471-3 applies to inventory, but the same principles apply to other types of property.

29. Reg. § 1.263A-1(e)(3)(ii)(A).

30. *INDOPCO, Inc. v. Commissioner*, 503 U.S.79 (1992).

31. IRS Industry Specialization Program Coordinated Issue Paper, "Capitalization of Lease-Related Expenses," 1991-95 CCH IRS Positions ¶ 100,095 (June 18, 1993); Settlement Guidelines, 1991-95 CCH IRS Positions ¶ 180,165 (Jan. 15, 1993).

32. Industry Specialization Program Coordinated Issue Paper, "Capitalization of Cable Franchise Costs," 1991-95 CCH IRS Positions ¶ 135,095 (Oct. 31, 1991).

33. See Gen. Couns. Mem. 36917 (Nov. 10, 1976).

34. Cf. Reg. § 1.1273-2(g).

35. Rev. Rul. 70-540, 1970-2 C.B. 101.

36. Financial Accounting Standards Board, Statement of Financial Accounting Standards 91, Dec. 1986 ("SFAS 91"), ¶ 6.

37. IRS Market Segment Specialization Program, "Audit Technique Guide for Commercial Banking," ["MSSP Paper"], 1996-98 CCH IRS Positions ¶ 203,101 at 102,662 (July, 1997); see also, *e.g.*, FSA 199910012 (Dec. 4, 1998) regarding identification of related costs.

38. See *PNC*, 110 T.C. at 368 n.18 ("petitioner does not argue that the direct costs of the loans, as reflected in the banks' financial accounting records, were inaccurately or improperly allocated"); cf. *Idaho Power*, 418 U.S. at 14 (taxpayer capitalized depreciation on its books); *Ford Motor Co. v. Commissioner*, 102 T.C. 87, 1003-05 (1994) (discounted liability recorded for financial reporting purposes clearly reflected income).

39. PLR 9024003 (March 2, 1993).

40. Ann. 93-60, 1993-16 I.R.B. 9.
41. See, e.g., Henry Ruempler & Paul V. Salfi, "Tax Treatment of Loan Origination Costs and Fees," 60 Tax Notes 1745 (Sept. 27, 1993); MSSP Paper, cited above; see also Stanley I. Langbein, "Federal Income Taxation of Banks and Financial Institutions," ¶ 6.07 & fn. 566 & authorities cited.
42. TAM 199952069 (Sept. 20, 1999); cf., e.g., *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998), requiring a mutual fund advisor to capitalize the costs of "launching" new funds, much of them apparently internal, although their calculation was not in dispute.
43. *Encyclopedia Britannica*, 685 F.2d at 217.
44. *A.E. Staley Manufacturing Co. v. Commissioner*, 119 F.3d 482, 489 & n.5 (7th Cir. 1997).
45. See generally *Idaho Power*, 418 U.S. at 11-14.
46. *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982); see also, e.g., *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974).
47. E.g., *Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987) (hotel refurbishing rooms on a rotating 3-5 year cycle); *Ingram Industries, Inc. v. Commissioner*, 80 T.C.M. (CCH) 532 (2000) ("towboats" overhauled every 3-4 years); Rev. Rul. 2001-4, 2001-3 I.R.B. 295 (most costs of periodic "heavy maintenance" of aircraft every 8 years deductible).
48. See, e.g., Ruempler & Salfi, cited above; Letter from John E. Chapoton, Vinson & Elkins, to Tax Legislative Counsel Joseph Mikrut (Nov. 8, 1999), Tax Analysts Doc. No. 1999-36509, 1999 TNT 222-17; Letter from John E. Chapoton, Thomas A. Stout, Jr., and Laura B. Phillips of Vinson & Elkins to Annette Smith of Treasury, April 12, 1999, Tax Analysts Doc. No. 1999-17890, 1999 TNT 97-36; Donald B. Susswein, "Report to the IRS on Behalf of the Savings and Community Banks of America (1994), Tax Analysts Doc. 94-5099, 94 TNT 105-38.
49. 685 F.2d at 216-17.
50. *Id.*; cf. *Silberman v. Commissioner*, 47 T.C.M. (CCH) 778 (1983), *aff'd without published opinion sub nom. David Whin, Inc. v. Commissioner*, 770 F.2d 1068 (3d Cir. 1985), *Giordano v. Commissioner*, 770 F.2d 1069 (3d Cir. 1985), *Malanko v. Commissioner*, 770 F.2d 1072 (3d Cir. 1985), and *Stamato v. Commissioner*, 770 F.2d 1075 (3d Cir. 1985) (requiring "one-shot" movie production partnership to capitalize expenses).
51. 110 T.C. 349 (1998), *rev'd*, 212 F.3d 822 (3d Cir. 2000).
52. *Iowa-Des Moines National Bank v. Commissioner*, 592 F.2d 433 (8th Cir. 1979); *First Security Bank of Idaho v. Commissioner*, 592 F.2d 1050 (9th Cir. 1979); *First National Bank of South Carolina v. United States*, 558 F.2d 721 (4th Cir. 1977) (*per curiam*); *Colorado Springs National Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974).
53. E.g., *First National*, 558 F.2d at 723.
54. 110 T.C. at 365.
55. See Ruempler & Salfi, 60 Tax Notes at 1748.
56. See, e.g., PLR 9024003 (March 2, 1990); IRS MSSP Paper at 102,659.
57. 212 F.3d at 830.
58. 112 T.C. 89 (1999), *aff'd and rev'd sub nom. Wells Fargo & Co. v. Commissioner*, 224 F.2d 874 (8th Cir. 2000).
59. See 112 T.C. at 96, 224 F.3d at 888.
60. 132 F.2d 512 (8th Cir. 1942).
61. 174 F.3d 1344 (Fed. Cir. 1999).
62. Burgess J.W. Raby & William L. Raby, "Direct vs. Absorption Allocation of Takeover Costs," 83 Tax Notes 537 (Apr. 26, 1999).
63. See, e.g., D. Lupi-Sher, "Tax Bar Applauds Eighth Circuit's Decision in *Wells Fargo*," 88 Tax Notes 1303 (Sept. 11, 2000).
64. 2000 IRS NSAR 0287 (Dec. 5, 2000).
65. See also Announcement 2002-9, para. C.7, 2002-1 C.B. 536, 539 (noting advance notice of proposed rulemaking consistent with *Wells Fargo*); IRS NSAR 0478 (Nov. 8, 2001) (citing the case in connection with the "directly related" standard).
66. FSA 200109001 (Aug. 7, 2000); see also FSA 200136010 (June 1, 2001) (similar analysis; taxpayer acquired and syndicated credit card receivables).
67. 116 T.C. 374 (2001) (reviewed).
68. There was also a separate Tax Court case involving successor owners of the same "S" corporation. *Balan v. Commissioner*, Tax Ct. Docket No. 4367-01, petition filed Mar. 30, 2001, Tax Analysts Doc. No. 2001-17136, *stipulation of settled issues filed* Oct. 9, 2002.
69. 116 T.C. at 392.
70. 116 T.C. at 405.
71. 116 T.C. at 393.
72. See 116 T.C. at 427 (Ruwe, J., concurring and dissenting).
73. Cf. *Encyclopedia Britannica*, 685 F.2d at 216.
74. 184 F.3d 786 (8th Cir. 1999), *aff'g and rev'g* 108 T.C. 448 (1997), discussed in J. Salles, "Tax Accounting," 1(2) Corp. Bus. Tax'n Monthly 28 (Nov. 1999).
75. 184 F.3d at 789.
76. See, e.g., FSA 200016002 (Jan. 13, 2000), discussed in J. Salles, "Tax Accounting," 1(10) Corp. Bus. Tax'n Monthly 32, 34-35 (July, 2000).
77. "INDOPCO Coalition Proposed Capitalization Principles," Tax Analysts Doc. No. 2001-26125, 2001 TNT 198-44 (Sept. 6, 2001) ("Proposal").
78. Proposal, III.B.3.d.
79. Letter From Fred T. Goldberg, *et al.* to Assistant Secretary Weinberger (Apr. 8, 2002), Tax Analysts Doc. No. 2002-9947, 2002 TNT 80-38.
80. Prop. Reg. § 1.263(a)-4(b)(1).
81. Prop. Reg. § 1.263(a)-4(c), (d).
82. Prop. Reg. § 1.263(a)-4(b)(1)(iii).
83. Ann. 2002-9, para. C.7, 2002-1 C.B. 536, 538.
84. Prop. Reg. § 1.263(a)-4(d)(6)(ii), (e)(3)(ii)(C).
85. Comments of David P.W. Orlin of the Investment Company Institute, Mar. 19, 2003, Tax Analysts Doc. 2003-8756, 2003 TNT 69-76.