Tax Accounting

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BANK'S LOAN ORIGINATION COSTS EMERGE AS A HIGH-PROFILE ISSUE

PNC Bancorp, Inc. v. Commissioner, 110 T.C. 349 (1998), held that a bank's costs of originating loans had to be capitalized and amortized over the estimated lifetime of the loans. The decision remains on appeal. The outcome may mark a significant step in the evolution of the IRS's and the Tax Court's approach to capitalization issues.

Two months ago, this column examined the continuing fallout from *INDOPCO v. United States*, 503 U.S. 79 (1992), specifically *Norwest Corporation v. Commissioner*, 112 T.C. No. 9 (1999). *Norwest* held that indirect costs, including investigatory costs and a portion of the target company's officers' regular salaries, had to be included in the amount capitalized in connection with a corporate acquisition. The direct holding of *INDOPCO* was confined to a rejection of some courts' holdings that the government had to be able to point to a "separate and distinct asset" to require capitalization of an expenditure. The Supreme Court reaffirmed the regulatory standard that an expenditure must be capitalized if it produces a benefit "extending substantially beyond the taxable year."[1] *INDOPCO* prompted the IRS and the courts to revisit capitalization principles. *INDOPCO* encouraged the IRS to be more aggressive both in requiring different types of expenditures to be capitalized as free-standing "assets" and in requiring expenditures indirectly associated with intangible assets to be capitalized into basis.

PNC Bancorp, Inc. v. Commissioner held that a bank's costs of originating loans had to be capitalized and amortized over the estimated lifetime of the loans. The key Supreme Court cases are, again, *INDOPCO* and, in a supporting role, *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974). The court in *Idaho Power* held that the capitalizable cost of self-constructed improvements to the taxpayer's plant included overhead such as depreciation on the taxpayer-owned equipment that was used in the project. The uniform capitalization rules (Code Section 263A and accompanying regulations) now cover the capitalization of expenditures in connection with self-constructed tangible property, but intangible property continues to be governed by *Idaho Power* and its progeny to the extent its principles can be applied.

The "Recurring Business Expense" Doctrine

In analyzing *PNC*, it is important to realize that, notwithstanding *INDOPCO,* some expenditures with consequences outside the taxable year remain currently deductible. For example, the Treasury regulations expressly provide that selling expenses are currently deductible,[2] even though these in a sense relate to inventory property and may be incurred before the goods are removed from inventory and the associated cost of goods sold recognized as an offset to receipts.

Since *INDOPCO*, the IRS has issued revenue rulings providing that in normal circumstances, advertising expenses,[3] incidental repairs,[4] and employee training costs[5] remain currently deductible, although considered in isolation they might have impact beyond the year of expenditure. In the case of advertising expenditures, this reasoning has received Congressional imprimatur in the legislative history accompanying the enactment of Code Section 197 in 1993.[6] The theoretical underpinning behind this sensible approach appears to be a "rule of reason": Expenditures that regularly recur in the course of the taxpayer's trade or business should be deductible because the overall result will be a clear reflection of income. Capitalization, after all, is ultimately a reflection of the principle that income should be matched with associated expenses. See, e.g., Comm'r v. Idaho Power Co., 418 U.S. 1, 16 (1974).

In *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 384 (1983), the Supreme Court itself implied approval of the holding in *Zaninovich v. Commissioner*,

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616 F.2d 429 (9th Cir. 1980), that prepayments of recurring period costs extending less than 12 months beyond the taxable year may be deducted currently, at least by cash-basis taxpayers. The primacy of "clear reflection" has been recognized by the courts both before and after *INDOPCO*. See, e.g., Moss v. Comm'r, 831 F.2d 833 (9th Cir. 1987), in which a hotel's ongoing remodeling expenses were deductible even though a particular unit might only be remodeled every three to five years; cf. Cox v. Comm'r, 64 T.C.M. (CCH) 1123, 1126 (1992), in which there was no demonstration that asserted maintenance expenses did not have a "more than incidental" future benefit under *INDOPCO* or that a current deduction would otherwise clearly reflect income.

PNC Bancorp

As in *Norwest*, the taxpayer's problems in PNC started when an accounting method change to conform to financial accounting standards provided the IRS with a handy road map to an adjustment. Before 1988, PNC recognized current income from origination fees received at the inception of a loan, and likewise currently deducted the associated expenses. Starting in 1988, PNC changed its method of accounting for financial statement purposes to comply with SFAS 91. SFAS 91 required that PNC take the fees into income ratably over the lifetime of the loan, and required that the associated expenses—principally a portion of the payroll cost of personnel engaged in marketing loans—be segregated and amortized. In practice, the net amount was amortized into income over the lifetime of the loan. The result was a Schedule M item too tempting for the IRS to ignore.

Both the IRS and the taxpayer recognized that the receipt of up-front loan fees created immediate income under *Schlude v. Commissioner*, 372 U.S. 128 (1963), and allied authorities. The controversy in *PNC* concerned whether expenses associated with the receipt of front-end revenue could be immediately deducted or had to be included in the loans' basis.

The taxpayer argued that "everyday, recurring" business expenses did not have to be capitalized, relying on a series of cases in the 1970s that so held as to banks' expenses (for credit investigations and the like) incurred in setting up credit card accounts. These credit card cases antedated *INDOPCO*, but significantly, the Tax Court did not hold that *INDOPCO* had changed the law. Instead, *PNC* held the facts of *PNC* distinguishable because in the credit card cases the courts had held the expenditures were not capitalizable because they did not create a "property interest" and were not associated with a "separate and distinct asset." In contrast, the bank loans in *PNC* were separate and distinct assets, as the taxpayer conceded. The court observed that "expenditures which otherwise might qualify as currently deductible must be capitalized if they are incurred in the acquisition of a separate and distinct asset regardless of their recurring nature," 110 T.C. at 367, and concluded that PNC had to capitalize its loan acquisition costs.

PNC represents the Tax Court's acknowledgment that recurring routine expenses are ordinarily deductible, even if these expenditures provide some future benefit. On the other hand, *PNC* demonstrates that this rule does not apply in connection with the acquisition of a separate and distinct asset, such as a bank loan. *PNC* resurrects the pre-*INDOPCO* notion of a separate and distinct asset, albeit in another context. Rather than holding that there is no capitalization if there is no separate and distinct asset, the court held that there must be capitalization if there is a separate and distinct asset. This conclusion would seem in keeping with the Supreme Court's holding in *INDOPCO*.

If the Tax Court's holding on this "separate and distinct asset" point is good law, which it probably is, the contours of the post-*INDOPCO* capitalization analysis are becoming clear. When confronted with whether a taxpayer has a potentially capitalizable expenditure, the first inquiry should be whether the expenditure relates to the creation or acquisition of a separate and distinct asset, a concept whose outer bounds are vague but that is probably coterminous with a separately salable property interest. See 110 T.C. at 366. If there is no separate and distinct asset, however, the taxpayer is not home free. The next step is to examine whether the expenditure provides a "more than incidental" benefit that extends "substantially" beyond the taxable year.

Capitalization is often required under *INDOPCO*. An expenditure may be deducted, notwithstanding some future benefit, if the taxpayer can establish that the result clearly reflects income and the expenditure is a routine business cost that is being incurred relatively evenly over time. The expenditure can represent repairs to a physical structure, such as the "routine" room renovation costs in *Moss*, or an expenditure that provides an intangible benefit, such as advertising expenses or employee training costs. The expenditure must be capitalized if the expenditure is a larger cost that is incurred relatively infrequently. The amount may be amortized if the taxpayer can establish a useful life.

If *PNC* is upheld, banks will be required to recognize income from loan origination fees right away while being compelled to amortize the associated expenses over the term of the loan. Their income will be distorted, rather than clearly reflected. It can be argued, however, that the distortion results not from the requirement to capitalize the expenditures, which is in accord with financial accounting and common sense, but from *Schlude. Schlude* requires that the origination fees be recognized up front in defiance of financial accounting.

One possible solution is suggested by *Johnson v. Commissioner*, 184 F.3d 786 (8th Cir. 1999), discussed in last month's column. In *Johnson*, the IRS argued that administration fees incurred in connection with vehicle service contracts should be amortized over the term of the contracts. Arguably, "economic performance" had not occurred in connection with the fees, and in any event, considered in isolation, they were clearly capital expenditures—and the taxpayer faced the prospect of a whipsaw because the *Schlude* doctrine required immediate recognition of the associated income. The Eighth Circuit, however, held that the taxpayer was entitled to an immediate deduction because the ultimate question was "whether the method of accounting proposed by the Commissioner clearly reflects income. Both income and deductions must be considered to answer that question. If the income is to be recognized . . . the deduction directly associated with it should also be recognized."

Exactly the same argument can be made in *PNC*, in which the taxpayer has appealed to the Third Circuit. It will be interesting to see whether that court follows the Eighth Circuit's lead by recognizing an exception from ordinary capitalization rules for expenditures that are directly associated with an income item that is required to be picked up immediately under *Schlude*. Doing so might permit the court to avoid imposing a whipsaw on the taxpayer without impeding the Tax Court's fleshing out a coherent framework for analyzing capitalization issues in the aftermath of *INDOPCO*.

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1. Treas. Reg. § 1.461-1(a)(1).

2. Treas. Reg. §§ 1.162-1(a), 1.263A-1(e)(3)(iii)(A).

3. Rev. Rul. 92-80, 1992-2 C.B. 57.

4. Rev. Rul. 94-12, 1994-1 C.B. 36.

5. Rev. Rul. 96-62, 1996-2 C.B. 9.

6. "[T]here is no need at this time to change the . . . treatment of self-created intangible assets such as goodwill that is created through advertising and other similar expenditures." H.R. Rep. No. 111, 103d Cong., 1st Sess. 760 (1993); Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways & Means, W&M Comm. Prt. 11, 103d Cong., 1st Sess. (1993); Reconciliation Submissions of the Instructed Committees Pursuant to the Concurrent Resolution on the Budget, S. Prt. 103-36, 103d Cong., 1st Sess. 216 (1993); Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Finance.