Tax Accounting

BY JAMES E. SALLES

Two recent administrative developments highlight the IRS's difficulty in refining and explaining its position on capitalization issues, particularly the question of when capitalization is required in the absence of a "separate and distinct asset" under the U.S. Supreme Court's decision in INDOPCO v. United States, 503 U.S. 79 (1992).

POST-*INDOPCO* LAW

Post-*INDOPCO* law seems to have developed along the following lines: Any cost relating to development or acquisition of a separate and distinct asset—an identifiable property interest of some sort, tangible or intangible—must be capitalized. See the discussion of *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349 (1998), in the December column. As PNC illustrates, what costs are included are subject to argument, but the principle is indisputable.

The courts and the IRS have moved toward a two-prong test if there is no separate and distinct asset. The first issue is whether the benefit is more than an "insubstantial" future benefit. If there is such a benefit, the next inquiry is whether it would better to "clearly reflect income" by capitalizing the expenditure rather than treating the expenditure as a current expense. Both the IRS and the courts have recognized that "normal" recurring business expenses may be currently deducted, even though on a rigorous analysis the expenditures may provide some future benefit.[1] The IRS will require capitalization, however, if the expenditure is sizable and nonrecurring, or recurs at irregular intervals.

This analysis sounds neat enough, but capitalization remains a fact-driven inquiry. Two recent administrative pronouncements shed some light on how the IRS fits the framework with the facts in the case of marketing and promotional expenses. A recent field service advice allows a current deduction for marketing and promotional expenses even though the products were not yet actually on the market. On the other hand, the IRS has announced its nonacquiescence in *RJR Nabisco, Inc. v. Commissioner*, T.C. Memo 1998-252, 76 T.C.M. (CCH) 71 (1998), in which a cigarette manufacture's graphic design costs and associated promotional expenses were held deductible.

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DEDUCTING PRE-APPROVAL MARKETING COSTS

Field Service Advice 199939035 (Aug. 9, 1999) concerned a taxpayer that regularly undertook marketing campaigns to build up the market for future products while the products awaited regulatory approval. The campaigns were designed to raise consumer awareness of the need for the products and promised that the products would be "coming soon." An example of a typical context in which these deferred marketing costs could occur is a pharmaceutical manufacturer's expenditures to promote a new drug pending approval of the Food and Drug Administration.

The IRS concluded that the costs of the promotional campaigns were "indistinguishable from those costs traditionally associated with ordinary business advertising" and these expenditures were currently deductible under Code Section 162. Advertising expenses have traditionally been deductible, both before and after *INDOPCO*.[2] The fact that advertising expenditures related to a product that the taxpayer was not yet selling made no difference. The IRS cautioned that advertising expenses might not be deductible when "the predominant purpose served thereby is the expenditure's contribution to acquisition of a capital asset." Thus, capitalization would probably be required if the campaign were part of a "public relations war" designed to secure regulatory approval for the drug or other product.[3]

PACKAGE DESIGN AND ADVERTISING COSTS UNDER *RJR NABISCO*

A counterpoint is provided by the IRS's adherence to its position requiring capitalization of package design and promotional costs in the face of its loss on the issue

in *RJR Nabisco*. At issue in that case was the treatment of "graphic design costs" relating to different brands of cigarettes—the cost of designing the packs, cartons, and the cigarettes themselves—and the costs of designing the related advertising campaigns.

Advertising copy was ordinarily copyrighted, but the Tax Court held that a copyright was "a traditional benefit associated with ordinary business advertising" and could not serve as the basis for capitalization. Moreover, the parties had stipulated that none of the expenses "were incurred in connection with the purchase, creation, acquisition, protection, expansion, registration, or defense of a trademark or trade name." 76 T.C.M. (CCH) at 84. Thus, there was no separate and distinct asset and the issue was to be resolved under general principles of future benefit and clear reflection.

The Tax Court began its analysis by noting that the U.S. Supreme Court had held in INDOPCO that a separate and distinct asset was a sufficient, but not a necessary, condition for capitalization. On the other hand, the Supreme Court also had said that an "incidental" future benefit did not necessarily require capitalization, although the presence of a future benefit was "undeniably important" in deciding whether capitalization was required.

The Tax Court noted that while there might be some theoretical basis for apportioning the expenses of an extended advertising campaign into those providing short-term benefits and those providing long-term benefits, the Treasury and the IRS have never required such an approach. Indeed, the Section 162 regulations expressly provide that "advertising and other selling expenses," including institutional or "goodwill" advertising, are deductible. See Treas. Reg. §§ 1.162-1(a), 1.162-20(a)(2). Thus, the issue was whether there was something different about the product and promotional design costs incurred in this case that warranted capitalization.

The Commissioner's argument on this score appears to have been rather diffuse. The IRS attempted to distinguish between the cost of developing an advertising campaign ("advertising campaign expenditures") for a particular brand and the cost of putting the campaign into effect ("advertising execution expenditures"), which the IRS conceded were deductible. See 76 T.C.M. (CCH) at 82.

An advertising "campaign" as such is not a form of property that qualifies as a separate and distinct asset. Expert testimony indicated that these advertising expenditures contribute to creating a "trade dress" intangible and contribute to goodwill. All effective advertising, however, does that. In the end, the Tax Court was unable to find anything to set apart the types of expenditures at issue from ordinary institutional advertising expenditures intended to promote a taxpayer's products, which are expressly deductible under the regulations. Thus, the court held for the taxpayer that all the challenged expenses were deductible. 76 T.C.M. (CCH) at 85.

The IRS tersely announced its nonacquiescence in *RJR Nabisco*. 1999-40 I.R.B. 1 (Oct. 4, 1999). It is unclear whether the IRS intends to continue to assert the alleged distinction between the cost of designing an advertising campaign and the cost of executing it, or whether the IRS's principal concern is with protecting its historical position concerning package design costs. See Rev. Rul. 89-23, 1989-1 C.B. 85.

Arguably the development and use of a package design, which would give the taxpayer some legal rights, creates an asset, even if the activity is part of the associated advertising campaign. The Tax Court does not appear to have expressly considered this issue. The IRS may have stipulated itself out of such an argument by conceding that the expenditures did not relate to the "protection, expansion, or defense" of a trademark or trade name.

LESSONS FOR THE FUTURE

It is clear, in any event, that considerable water remains to run under the legal bridge both as to freestanding capital expenditures in general and as to advertising and promotional expenditures in particular. Practitioners should continue to be aware of both the planning opportunities and the hazards presented by the twists and turns of post-*INDOPCO* developments.

1. E.g., PNC, supra; Rev. Rul. 96-62, 1996-2 C.B. 9 (employee training); Rev. Rul. 94-12, 1994-1 C.B. 36 (repairs); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising); see also, e.g., Moss v. Comm'r, 831 F.2d 833 (9th Cir. 1987) (hotel's room remodeling expenses deductible when "routine" renovations performed on a rotating schedule every three to five years).

2. See Treas. Reg. §§ 1.162-1(a), 1.162-20(a)(2); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising).

3. See the ruling's citation to Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985), concerning an advertising campaign undertaken to facilitate approval of a nuclear facility.

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