Tax Accounting

BY JAMES E. SALLES

In this month's column

- *King v. United States*[1] presents the issue of whether litigation costs incurred in pursuing a shareholder derivative suit are capital or ordinary;
- A Treasury official confirms that the long-promised proposed regulations on general capitalization principles are still under way;
- The Federal Circuit upholds the IRS' refusal to apply a revenue procedure dealing with deferred payments for services to credit card fees in *American Express Co. v. United States*[2]; and
- The Sixth Circuit affirms in *United Dairy Farmers, Inc. v. United States*,[3] requiring the taxpayer to capitalize environmental cleanup costs when the properties were contaminated when the taxpayer acquired them.

LITIGATION COSTS CAPITALIZED

A recent district court case, *King v. United States*,[4] discusses the treatment of litigation costs incurred in connection with capital transactions.

Background

Costs associated with "separate and distinct" assets are capitalized into the basis of the asset concerned. The capitalization requirement applies both to "ancillary" costs of acquiring the property[5] and (except for dealers) the costs of disposing of the property,[6] including the costs of litigation.

The same principle applies to the costs of pursuing the recovery of a capital asset or obtaining a recovery relating to an asset. For example, business disputes frequently involve allegations of impairment to goodwill in addition to, or in lieu of, lost income. The portion of the recovery that is attributable to the goodwill is capital, and represents gain to the extent that it exceeds available basis,[7] as the proceeds of a partial (or complete, as the case may be) disposition of the goodwill.[8] The associated costs are treated as additions to basis or offsets to the amount received or (what amounts to the same thing) the proceeds are apportioned net of costs.[9]

If the taxpayer retains ownership of the property, both the recovery and the related costs are treated as adjustments to basis. *Iowa Southern Utilities Co. v. Commissioner*[10] involved a successful shareholder derivative suit alleging, among other things, that the taxpayer had overpaid for certain property. The taxpayer treated the gross recovery as an adjustment to basis, but sought to deduct the attorneys' fees and costs as business expenses. The Eighth Circuit held that the expenditures were capital.

Recoveries of Cash

By contrast, in *California & Hawaiian Sugar Refining Corp. v. United States*,[11] the Court of Claims allowed a deduction for the cost of recovering unconstitutional "floor stocks taxes," although the refund itself was not includable in income, because "a tax refund, though it may be a return of capital, is not the kind of 'property' to which the statute and regulation [concerning capitalization] refer" and lacked a basis to adjust. The rule appears to be that an expenditure cannot be capitalized as relating to "property" if there is no property with a basis to adjust[12] (although this does not necessarily mean that the expenditure can be deducted).[13]

On similar reasoning, the taxpayer in *Newark Morning Ledger Co. v. United States*[14] was allowed to deduct the expenditures of a shareholders' derivative suit against the former management of a newly acquired newspaper. The dispute did not involve the acquisition or ownership, and the court held that the target corporation could have deducted the expenditures itself, because "[e]xpenses incurred to recover diverted operating revenue or false charges to operating revenues are not

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capital expenditures even though their aim is to recover an 'asset.'"[15]

King v. United States

In *King*, a minority shareholder sued claiming the majority shareholders had plundered the corporation. In settlement, he gave up his shares for a cash payment which (apart from the interest component) the parties agreed produced capital gain. The question was how to treat the associated litigation costs.

In a reversal of the traditional litigation postures, the taxpayer argued that the expenses were an addition to basis while the Government contended that they were currently deductible. The Government's argument was that the costs were not incurred in connection with the taxpayer's disposition of his stock but in an effort to preserve its value against the depredations of the majority shareholders. That theory would leave the taxpayer entitled to a deduction for investment expenses under Code Section 212, but that deduction would be subject to the 2 percent "floor" for regular tax purposes,[16] and not allowable in computing the alternative minimum tax at all.[17] The taxpayer was thus better off with an offset to capital gain.

The district court analyzed the issue under the "origin of the claim" test. The Supreme Court applied this test in *Gilmore v. United States*[18] to determine whether litigation was business-related or personal, and later extended it to the determination of whether litigation relates to a capital transaction.[19] The court in *King* concluded that the critical question was whether the taxpayer's suit "implicitly sought to terminate" his ownership of the stock or merely to restore its value. Citing *Brown v. United States*,[20] a similar case in which the government had successfully argued for capital treatment when the shoe was on the other foot, the court denied the government's motion for summary judgment. The parties will thus get to argue whether the facts more closely resemble *Newark Morning Ledger*, with its "garden-variety" shareholder derivative suit, or the various authorities dealing with dispositions of property.

PROSPECTIVE CAPITALIZATION REGS

The promised proposed regulations on capitalization[21] are still under active development, although the schedule appears to be slipping somewhat. Christine Turgeon of the Treasury's Office of Tax Policy discussed the prospects for regulatory guidance at a conference in early October.[22] She confirmed that guidance on "self-developed intangibles" and some form of "*de minimis*" threshold for capitalization were under consideration, and added a new wrinkle by suggesting that the regulations might cover not only what expenditures have to be capitalized but over what period they could be recovered. While the department had originally hoped to publish something by June 30, 2002 (hence the project's inclusion on the current business plan[23]), according to Turgeon present expectations are that the proposed regulations will be issued "in a year or so."

CREDIT CARD FEES NOT DEFERRABLE

In *American Express Co. v. United States*,[24] the Federal Circuit has upheld the Court of Federal Claims' decision that Revenue Procedure 71-21[25] did not entitle American Express to defer reporting income from its annual credit card fees.

Background

The IRS reads *Schlude v. Commissioner*[26] and its ilk as establishing that income from services must be reported when paid, when payment is due, or when the services are performed, whichever happens first.[27] Revenue Procedure 71-21, designed to ease the impact of this rule on common contractual arrangements, permits deferring most advance payments for services if the corresponding services are to be performed by the end of the year following receipt. However, the IRS does not consider credit card fees to be payments for services for this purpose. In this case, the Court of Federal Claims had sustained the IRS' refusal to grant permission for a change of accounting method so that American Express could use the procedure for its fees, and the taxpayer appealed.

Like the court below, the Federal Circuit declined to try to determine whether the fees paid were for services based upon the distinctions drawn in the Tax Court cases of *Barnett Banks of Florida v. Commissioner*[28] and *Signet Banking Corp. v. Commissioner*.[29] The court held that — regardless of whether the credit card fees might be considered a "fee for services" — the real question was whether the IRS had abused its discretion by issuing a relief procedure that it had consistently

interpreted to exclude such fees, and concluded that it had not.

ENVIRONMENTAL CLEANUP CAPITAL

In *United Dairy Farmers v. United States*,[30] the Sixth Circuit has affirmed the district court's holding that the costs of cleaning up pre-existing environmental contamination must be added to the basis of the property concerned. Like the district court, the court concluded that the rationale of Revenue Ruling 94-38,[31] which allows a current deduction for the cost of restoring property to its condition when acquired by the taxpayer, did not apply when the contamination had existed when the taxpayer bought the property. The court relied upon the Fourth Circuit's recent decision in *Dominion Resources, Inc. v. United States*,[32] requiring the capitalization of expenditures that render property fit for a new or different use. The court also affirmed other aspects of the district court opinion, including its holding that expenditures associated with a corporation's election to be taxed under subchapter "S" corporation had to be capitalized when the election occurred in the context of a corporate reorganization.

1. 2001-2 U.S.T.C. ¶ 50,561 (N.D. Oh., July 18, 2001).

2. 262 F.3d 1376 (Fed. Cir. Aug. 23, 2001).

3. ___ F.3d ___ (6th Cir., Oct. 3, 2001).

4. 2001-2 U.S.T.C. ¶ 50,561 (N.D. Oh., July 18, 2001).

5. *E.g., Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).

6. *Cf.* Reg. § 1.263(a)-2(e); *Spreckels v. Helvering*, 315 U.S. 626 (1942).

7. *E.g., Big Four Industries, Inc. v. Commissioner*, 40 T.C. 1055 (1963); *Telefilm, Inc. v. Commissioner*, 21 T.C. 688 (1954), *rev'd on another issue*, 55-1 U.S.T.C. ¶ 9453 (9th Cir. 1955); *see also Sager Glove Corp. v. Commissioner*, 36 T.C. 1173, 1180 (1961), *aff'd on other issues*, 311 F.2d 210 (7th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963) (citing cases).

8. *See, e.g., Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947); *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

9. *See, e.g., Big Four, supra.*

10. 333 F.2d 382 (8th Cir. 1964).

11. 311 F.2d 235 (Ct. Cls. 1962).

12. *Iowa Southern*, 333 F.2d at 387; *Spangler v. Commissioner*, 323 F.2d 913, 920 (9th Cir. 1963); *see also, e.g., Spector v. Commissioner*, 71 T.C. 1017, 1027-28 (1979), *rev'd and rem'd on other issues*, 641 F.2d 376 (5th Cir. 1981).

13. *See Spector, supra.*

14. 416 F.Supp. 689 (D.N.J. 1975), *aff'd*, 539 F.2d 929 (3d Cir. 1976).

15. 416 F.Supp. at 698.

16. I.R.C. § 67.

17. *See* I.R.C. § 56(b)(1)(A).

18. 372 U.S. 39 (1963)

19. *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels*, 397 U.S. 580 (1970).

20. 526 F.2d 135 (6th Cir. 1975).

21. *See* J. Salles, "Tax Accounting," 2(7) *Corp. Bus. Tax'n Monthly* 27, 27 (April, 2001); J. Salles, "Tax Accounting," 1(10) *Corp. Bus. Tax'n Monthly* 32, 33 (July, 2000).

22. *See* "Guidance on Capitalization Issues Likely in Next 12 Months, Official Says," *Daily Tax Report*, Oct. 3, 2001, at G-5.

23. *See* J. Salles, "Tax Accounting," 2(11) *Corp. Bus. Tax'n Monthly* 24, 24 (August, 2001).

24. 262 F.3d 1376 (Fed. Cir. Aug. 23, 2001), *aff'g* 47 Fed. Cl. 127 (2000), discussed in J. Salles, "Tax Accounting," 2(1) *Corp. Bus. Tax'n Monthly* 36, 39-40 (October, 2000).

25. 1971-2 C.B. 549.

26. 372 U.S. 128 (1963).

27. Rev. Rul. 74-607, 1974-2 C.B. 149.

28. 106 T.C. 103 (1996).

29. 106 T.C. 117 (1996), *aff'd*, 118 F.3d 239 (4th Cir. 1997).

30. ___ F.3d ___ (6th Cir., Oct. 3, 2001), *aff'g* 107 F. Supp.2d 937 (S.D. Oh. 2000), discussed in J. Salles, "Tax Accounting," 1(12) *Corp. Bus. Tax'n Monthly* 25, 26-28 (Sept. 2000).

31. 1994-1 C.B. 35.

32. 219 F.3d 359 (4th Cir. 2000), discussed in J. Salles, "Tax Accounting," 2(1) *Corp. Bus. Tax'n Monthly* 36, 36-38 (Oct. 2000).