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Tax Accounting

By James E. Salles

This and next month's columns explore one of several contentious issues addressed in the proposed regulations on the capitalization of intangibles costs issued last December. These regulations represent the latest stage in ongoing efforts by Treasury and the IRS to address the capitalization of costs associated with intangible assets following the Supreme Court's 1992 decision in *INDOPCO, Inc. v. Commissioner*.[1] The "*INDOPCO* Coalition," an industry group, made an extensive submission in December 2001.[2] Then came the IRS's "advance notice of proposed rulemaking,"[3] which provided an unusual window into the IRS's thinking on different issues and spawned another round of comments. The material included in the advance notice has now been refined and reformulated as proposed regulations, issued mainly under section 263.[4]

INDOPCO confirmed that capitalization could be required even if there was no "separate and distinct asset" in the sense of a formal property right, as there had been in *Commissioner v. Lincoln Savings & Loan Ass'n*,[5] so long as the outlays gave rise to a "future benefit" that was "not insignificant." Not surprisingly, the Supreme Court decision was followed by a spate of litigation about when there exists a "future benefit" sufficient to trigger capitalization of costs. In outline, the proposed regulations generally require capitalization when there is a "separate and distinct intangible asset," and in a laundry list of other circumstances in which capitalization has traditionally been followed, without delving deeply into the metaphysics of "assets" and "future benefits." The end result is something like the traditional "asset" approach, although with a broader reading of the term "asset" than some courts were inclined to give during the interval between *Lincoln Savings* and *INDOPCO*, so that, for example, the benefit conveyed by a change in corporate structure is treated like an asset.

Looming behind the threshold issue of when capitalization is appropriate is another question. Once an item—or some other "future benefit" requiring capitalization under *INDOPCO*, such as a corporate taxpayer's benefit from a reorganization—has been determined to be an intangible asset, which outlays are to be treated as associated with it and therefore capitalized? A particularly nettlesome problem in this connection has been how to treat a taxpayer's internal costs, such as employee compensation and indirect costs ("overhead"). The post-*INDOPCO* case law, developed in the absence of administrative guidance, offers inconsistent answers.

The new proposed regulations offer a "safe harbor" that is fairly simple and would allow current deductions in some situations where the IRS has argued, with some success, for capitalization. This "rough justice" approach—which is fairly taxpayer-favorable, assuming taxpayers to favor deduction over capitalization, as they generally do—has generally been well received, although some questions remain. The discussion below summarizes the evolution of the "common law" of capitalization as applied to real and tangible personal property. Next month's column will continue with a discussion of the authorities dealing with intangible property and the proposed regulations' approach.

Background

The Statute and Regulations Before 1986

Originally, taxpayers' capitalization practices were judged under traditional accounting principles. Section 446(a), in the first instance, requires

Jim Salles is a member of Caplin & Drysdale in Washington, D.C.

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taxpayers to compute taxable income "under the method of accounting [used] in keeping [their] books." Section 446(b) adds that "if the method used does not clearly reflect income," the computation "shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." Therefore, when the IRS seeks to modify a taxpayer's accounting method, the ultimate question is whether that method "clearly reflects income."

For half a century, such regulations as existed did not add much to the analysis. The regulations governing long-term contracts required only that taxpayers properly identify expenditures "made on account of" such contracts, with due account being taken of material and supplies on hand.[6] The inventory regulations offered only slightly more in the way of specifics, requiring that the cost of manufactured inventory include, besides direct materials and direct labor, indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses.[7]

Beyond these regulations, or in situations where they did not apply, courts looked to accepted financial accounting practices and the "common law" concerning "clear reflection of income."

In the 1970s and early 1980s, detailed regulations partly supplanted, and in some cases codified,[8] the case law. New inventory costing rules, the so-called "full absorption" regulations, were issued in 1973.[9] Similar costing rules for long-term contracts followed in 1976.[10] In 1982, concerned that "significant costs that were incident to and necessary for" performance under such contracts were being expensed as period costs rather than capitalized,[11] Congress ordered that stricter regulations be issued covering so-called "extended period long-term contracts," generally contracts of more than two years' duration.[12] These were issued in final form at the end of 1985, retroactive to 1983.[13] The new regulations, like the old ones, were not comprehensive. The "common law" continued to apply, for example, when a taxpayer produced property for use in its own business,[14] or a "spec builder" constructed homes for sale with no contract in place.[15]

1986 Statutory Changes

The Tax Reform Act of 1986 brought the "uniform capitalization" ("UNICAP") rules of section 263A and section 460, which governs accounting for long-term contracts. Those sections, supplemented by regulations, now generally cover all manufacturing and construction activity apart from farming.[16] Some manufacturing activity may continue to fall between the cracks in very narrow circumstances. For example, section 263A generally applies in determining the cost of "supplies" used in production,[17] assuming they have to be capitalized at all,[18] but it is not clear what rules apply to goods that would otherwise be "merchandise" (inventory) that the taxpayer elects to treat as supplies under Revenue Procedure 2002-28,[19] which are specifically excepted from the uniform capitalization rules.[20] Nonetheless, the old case law is mostly now only of historical value so far as applied to the production of real and tangible personal property.

Section 263A also includes "reseller rules" that require larger taxpayers to capitalize certain indirect costs relating to any kind of property acquired for resale to customers.[21] Otherwise, the "common law" continues to govern capitalization of costs, including internal costs, relating to transactions not involving production activity: for example, sales of capital assets that the taxpayer holds for investment or uses in its business.

The UNICAP reseller rules can apply if a taxpayer buys (not creates[22]) intangibles and sells them in the ordinary course of business,[23] although nowadays many such taxpayers will be exempt because they are subject to mark-to-market accounting.[24] Apart from such situations, however, until now the only authority addressing intangible property has been the case law. The old manufacturing and construction cases have thus continued to loom in the background as the courts have addressed capitalization of intangibles costs in the post-*INDOPCO* world.

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The "Common Law" of Cost

Inclusion of Indirect Costs

Over time, there grew up a consensus that some indirect costs (costs other than direct materials and labor) had to be included in a proper computation of cost. A series of cases in the 1960s, mostly in the Tax Court, enforced the regulations' requirement that at least some indirect costs be included in inventory cost, rejecting various incremental or "prime costing" methods employed by taxpayers.[25]

For a while, there was dispute about whether expenses that were expressly deductible under other provisions of the Code or regulations were subject to capitalization. The Board of Tax Appeals' decision in *Great Northern Railway Co. v. Commissioner*,[26] which allowed the taxpayer to deduct depreciation on equipment that the taxpayer used in making improvements to its own property, was read as holding that depreciation was always deductible.[27] Other courts[28] and the IRS[29] disagreed, and the issue was ultimately resolved by the Supreme Court. In *Commissioner v. Idaho Power Co.*,[30] the Court required a utility to capitalize depreciation on equipment that it used to make improvements on its plant, holding that section 263's mandate to capitalize applied, except where expressly otherwise provided.[31]

"Incremental" vs. "Full" Costing

The consensus that indirect costs had to be included in a proper measurement of "cost" did not resolve whether taxpayers need only capitalize the additional costs traceable to the manufacturing or construction activity ("incremental costs") or had to perform some sort of allocation of invariable costs ("full costing").

The issue was lurking in the inventory cases discussed above, which preceded adoption of the "full absorption" regulations. The courts upheld the IRS's "full absorption" calculation because the taxpayers' methods, which failed to take into account any indirect costs at all, were incorrect. However, both the Tax Court and the Ninth Circuit suggested that it would likely have been acceptable to capitalize only those overhead costs that varied with production, excluding invariable costs (like rent and real estate taxes) that would be incurred in the absence of any production at all.[32] Likewise, in *Algernon Blair, Inc. v. Commissioner*[33]—decided before the 1976 costing regulations—the Tax Court capitalized some of a contractor's general and administrative expenses but allowed current deductions for those that were not "reasonably related or incidental" to construction activities.

The courts also grappled with the incremental versus full costing issue in connection with railroads' "deadhaul costs." Railroads engaged in track construction commonly bring work crews and materials to location on their own trains. When this is done on regularly scheduled passenger or freight trains, some cost allocation is necessary. The Interstate Commerce Commission allowed railroads to capitalize a fixed amount per passenger-mile or ton-mile for regulatory purposes. There was some confusion about how the ICC computed this charge and a number of early cases upheld the IRS's requiring use of the ICC figure on the grounds that taxpayers had failed to prove any better measure of "actual cost."[34]

However, *Northern Pacific Railway Co. v. Commissioner*[35] expressly presented the issue of how "actual cost" was to be computed. The taxpayer argued that cost should be determined on the basis of its "out-of-pocket" (incremental) cost, while the IRS argued that the average cost should be used. After an extensive discussion of financial and regulatory accounting, the Eighth Circuit concluded that a railroad's fixed overhead was properly allocated to its "revenue traffic" but not to "auxiliary," non-revenue producing activity like track construction, and held for the taxpayer. Similarly, in *Union Pacific Railroad Co. v. Commissioner*,[36] the Board of Tax Appeals rejected the IRS's contention that all costs should be included, noting that items such as interest and railway taxes likely had "little or no relation" to the cost of transportation.[37]

Fort Howard Paper Co.

The case most frequently cited for incremental

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costing is *Fort Howard Paper Co. v. Commissioner.*[38] That case involved a paper manufacturer that used its repair and maintenance crews to make occasional renovations and improvements to its plant. The work was done during slack periods when it would not interfere with the workers' normal duties. The taxpayer capitalized overhead costs into its inventory, but capitalized only the direct costs of these "self-constructed items." The taxpayer had not hired additional staff or incurred additional overhead as a result of these activities.[39] After consideration of expert testimony and extensive reference to accounting treatises, the court concluded that the taxpayer had demonstrated that its method clearly reflected income. *Fort Howard* has sometimes been described as a departure from the principle that indirect costs must be capitalized.[40] However, later Tax Court decisions stressed that *Fort Howard* reflected the court's finding that there really were no incremental costs in that case.

Coors v. Commissioner[41] involved the well-known brewing company, which engaged in extensive self-construction activities. During the years before the court, its construction crew numbered over 500, comparable in size to its brewery work force, and spent over 80 percent of its time on capital projects as opposed to repairs and maintenance. In other words, while the taxpayer in *Fort Howard* had a maintenance crew that occasionally handled construction projects during slack periods, the taxpayer in *Coors* had a construction crew that also handled maintenance. The IRS argued that the taxpayer failed to properly capitalize its overhead. The taxpayer responded that its overhead was attributable to beer, not construction, citing *Fort Howard*. The Tax Court, however, held that the case "simply did not fit the mold or the rationale of *Fort Howard*" because the facts were so different. While Coors Co. argued that it only excluded "fixed" costs, which it could properly do, the court remarked that "certain 'fixed overhead' type activities vary considerably when in-house construction of such massive proportion is undertaken." The court upheld the IRS's adjustment because it concluded that the brewery was not using incremental costing, which would have been permissible, but an improper "prime costing" method.

In *Louisville & Nashville Railroad Co. v. Commissioner*[42] the Tax Court again emphasized that the critical fact in *Fort Howard* was that "it did not appear that there was any increase in overhead costs which could be directly identified with self-constructed assets."[43] The issue in *Louisville & Nashville* was what costs the taxpayer had to capitalize in connection with an ongoing program to upgrade its freight cars.

Both the Tax Court and the Sixth Circuit held that *Fort Howard* was inapplicable given the "magnitude and scale" of the taxpayer's activities—it had built and rebuilt about 8,000 freight cars over five years—and required it to the cost of transporting materials and various overhead items.

Labor Costs

The cases involving capitalization of employee costs exhibit the same basic philosophy. From earliest times, the courts have consistently required capitalization of payments to employees specifically traceable to capital projects.[44] "Regular" salaries are subject to allocation when the facts so justify. In *Acer Realty Co. v. Commissioner*,[45] the Board of Tax Appeals and the Eighth Circuit upheld the IRS in capitalizing the bulk of corporate officers' "regular" salary. These officers were overseeing construction on the land that was the corporation's sole asset, and the Board found that the payments were "for unusual, nonrecurrent services, the cost of which [was] represented in the value of the capital assets thus acquired."[46] Similarly, in *Perlmutter v. Commissioner*,[47] the court capitalized part of a homebuilder's salaries and overhead into the cost of a shopping center it constructed for its own account.[48] Clearly, therefore, when employees—including high-level managers—spend a material amount of time on capital activities, an allocation is required.

This does not mean that any time an employee might spend on production or other "capital" activities necessarily has to be tracked and capi-

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talized. The test seems to be whether compensation expense would be significantly lower in the absence of the "capital" activity. In *Acer Realty*, for example, the officers' activities apart from construction would have justified only a nominal salary. *Perlmutter* and similar cases involved allocating costs that the parties agreed were construction-related between the taxpayer's own properties and those that were sold to outside parties. By contrast, in *Dixie Frosted Foods v. Commissioner*,[49] corporate officers' incidental activities "looking toward the building of expanded facilities" were found insufficient for an allocation. In *Wilmington Trust Co. v. United States*,[50] the full Court of Claims refused to allocate salary expense to timber sales when these "had but a nominal effect on payroll and other management expenses" and were not "direct and substantial,"[51] reversing the trial court allocation of expenses that it found "would not have been incurred except for the sales."[52]

Summary

The bulk of the case law on real and tangible property suggests that, where the statute and regulations do not provide specific rules, incremental costing remains one of several acceptable methods for determining cost. Such an approach, sometimes referred to as "direct" or "variable" costing, generally entails some allocation of both labor costs and overhead. Whether a particular cost is allocated depends on whether it can be expected to vary materially as a result of the particular activity concerned. When multiple similar activities (for example, various construction projects, or ongoing track construction or timber sales) are involved, then the question is whether those activities *taken together* materially affect the cost item.

While *Idaho Power* made clear that all indirect costs were potentially subject to capitalization, that case did not rule out incremental costing. The taxpayer did not dispute the IRS's calculation of the depreciation attributable to its construction activity, once the Court had held that it had to capitalize depreciation at all. Notably, in *Louisville & Nashville*, a post-*Idaho Power* case, the Tax Court observed that the parties had agreed that there were three acceptable methods for determining the cost of self-constructed assets, and that one of them was the "incremental cost method," which the court described as requiring capitalization of direct costs plus "the increments in overhead which result from the construction activities."[53]

1. 503 U.S. 79 (1992).

2. Letter from Fred T. Goldberg, Jr., *et al.* to Commissioner Rossotti, Sept. 6, 2001, Tax Analysts Doc. No. 2001-26122; Summary of Proposed Capitalization Principles, Tax Analysts Doc. No. 2001-26123; Outline of Proposed Capitalization Principles, Tax Analysts Doc. No. 2001-26124; *INDOPCO* Coalition Proposed Capitalization Principles, Tax Analysts Doc. No. 2001-26125 ("Proposal"). *See* J. Salles, "Tax Accounting," 3(3) Corp. Bus. Tax'n Monthly 38 (Dec. 2001).

3. REG-125638-01, RIN 1545-BA00, 67 Fed. Reg. 3461 (Jan. 24, 2002), discussed in J. Salles, "Tax Accounting," 3(8) Corp. Bus. Tax'n Monthly 33, 33-35 (May, 2002).

4. REG-125638-01, 2003-5 I.R.B. 373.

5. 403 U.S. 345 (1971).

6. *Compare* Regs. 45, Art. 36 (1921) and Regs. 69, Art. 36 (1926) *with* Reg. § 1.451-3(b), T.D. 6282, 1958-1 C.B. 215, 223-24, *prior to amendment by* T.D. 7397, 1976-1 C.B. 115.

7. *Compare* Regs. 45, Art. 1583(2)(c), *with* Regs. § 1.471-3(c), *prior to amendment by* T.D. 7285, 1973-2 C.B. 163. (The language is retained in Reg. § 1.471-3(c) with a cross reference to the UNICAP rules.)

8. *See* T.D. 7397, preamble, 1976-1 C.B. at 115 (contract costing rules "essentially restate[d] the . . . case and ruling authority").

9. Reg. § 1.471-11, T.D. 7285, 1973-2 C.B. 163 (Sept. 14, 1973).

10. Reg. § 1.451-3(d)(5), T.D. 7397, 1976-1 C.B. 115 (Jan. 19, 1976).

11. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, JCS 38-82 (December 31, 1982) at 153.

12. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 229, 96 Stat. 324, 493, *as amended by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 712(m), 98 Stat. 494, 955.

13. T.D. 8067, 1986-1 C.B. 218 (Dec. 30, 1985).

14. *See, e.g., Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

15. Real property is not "inventory" even if held for sale. *E.g., W.C. & A.N. Miller Development Co. v. Commissioner*, 81 T.C. 619 (1983); *Atlantic Coast Realty Co. v. Commissioner*, 11 B.T.A. 416 (1928).

16. I.R.C. § 263A(d), Reg. § 1.263A-4. Contracts exempt from section 460's general costing rules fall either under § 263A or an alternative regulatory scheme. *See* Regs. § 1.460-5(d).

17. *See, e.g.,* LTRs 200152012-13-14 (Sept. 25, 2001), 200146033 (Aug. 14, 2001), and 200146009 (June 20, 2001), all dealing with power plants' costs of transporting coal.

18. *See* Reg. § 1.162-3.

19. 2002-18 I.R.B. 815.

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20. Rev. Proc. 2002-28 § 4.04.

21. *See* I.R.C. § 263A(b)(2); Regs. § 1.263A-3.

22. *See* I.R.C. § 1.263A-1(b)(13).

23. *See* Regs. § 1.263A-3(a)(1).

24. *See* I.R.C. §475 (d)(1); Regs. § 1.263A-1(a)(3)(iv).

25. *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); *Photo-Sonics, Inc. v. Commissioner*, 42 T.C. 926 (1964), *aff'd*, 357 F.2d 656 (9th Cir. 1966); *Frank G. Wikstrom & Sons, Inc. v. Commissioner*, 20 T.C. 359 (1953).

26. 30 B.T.A. 691, 707-08 (1934) (reviewed).

27. This was debatable. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1, 7 n.5 (1974).

28. *E.g., Southern Natural Gas Co. v. United States*, 412 F.2d 1222, 1266-68 (Ct. Cl. 1969).

29. Rev. Rul. 59-380, 1959-2 C.B. 87, *clarified by* Rev. Rul. 77-325, 1977-2 C.B. 67.

30. 418 U.S. 1 (1974).

31. *See, e.g.,* I.R.C. §§ 173 (a) (circulation expenditures), 263(a)(1) (various other exceptions).

32. *See All-Steel Equipment*, 54 T.C. at 1763; *Dearborn Gage*, 48 T.C. at 193 n.2; *Photo-Sonics*, 42 T.C. at 932, 357 F.2d at 357 F.2d at 658.

33. 29 T.C. 1205 (1958), *acq.* 1958-2 C.B. 4.

34. *E.g., Missouri Pacific Railroad Co. v. Commissioner*, 22 B.T.A. 267, 286-87 (1931); *Gulf, Mobile & Northern Railway Co. v. Commissioner*, 22 B.T.A. 233, 245-47 (1931) (reviewed), *aff'd on other issues*, 71 F.2d 953 (D.C. Cir.), *aff'd*, 293 U.S. 295 (1934); *Great Northern Railway Co. v. Commissioner*, 8 B.T.A. 225 (1927) (reviewed), *aff'd*, 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930).

35. 83 F.2d 508 (8th Cir. 1936), *on remand*, 1937 B.T.A. Mem. (P-H) ¶ 37,124 (1937), *aff'd*, 105 F.2d 730 (8th Cir. 1939).

36. 32 B.T.A. 383, 384-88 (1935), *aff'd on another issue*, 86 F.2d 637 (2nd Cir. 1936).

37. *Id.* at 387, *accord, e.g.,* I.T. 2196, IV-2 C.B. 112 (1925) (capitalize only overhead "actually incurred in connection with the construction).

38. 49 T.C. 275 (1967).

39. *See id.* at 282, 285 n.5.

40. *See, e.g., General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987), at 505 n.7.

41. 60 T.C. 368 (1973), *aff'd sub nom. Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976).

42. 66 T.C. 962 (1976), *modified and aff'd on this issue*, 641 F.2d 435 (6th Cir. 1981).

43. 66 T.C. at 1015.

44. *DuPont v. Commissioner*, 34 B.T.A. 1059 (1936), *aff'd sub nom. Peir v. Commissioner*, 96 F.2d 642 (9th Cir. 1938) (commission paid president of liquidating corporation); *Federal Plate Glass Co. v. Commissioner*, 6 B.T.A. 351, 357-58 (1927) (bonuses paid general manager and plant superintendent for services in connection with plant construction "in addition to remuneration for services connected with operation of the enterprise").

45. 45 B.T.A. 333 (1941), *aff'd* 132 F.2d 512 (8th Cir. 1942).

46. 45 B.T.A. at 337. *Accord, e.g., General Spring Corp. v. Commissioner*, 12 T.C.M. (CCH) 847 (1953) (salaries for services stemming from taxpayer's previous sale of its sole asset).

47. 44 T.C. 382 (1965), *aff'd on other issues*, 373 F.2d 45 (10th Cir. 1967).

48. *E.g., Variety Construction Co. v. Commissioner*, 21 T.C.M. (CCH) 1391 (1962) (contractor required to allocate overhead to projects built for itself and affiliates); *see also, e.g., Chevy Chase Motor Co., Inc. v. Commissioner*, 36 T.C.M. (CCH) 942 (1977) (sole shareholder-manager's salary capitalized to the extent his property-related services related to projects under construction).

49. 6 T.C.M. (CCH) 586, 589 (1947).

50. 610 F.2d 703 (Ct. Cl. 1979), *rev'g* 79-1 U.S.T.C. ¶ 9223 (Ct. Cl. Tr. Div.).

51. 610 F.2d at 708.

52. 79-1 U.S.T.C. at 86,446.

53. 66 T.C. at 1014 n.34.