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Tax Accounting

BY JAMES E. SALLES

This month's column discusses the "proposed capitalization principles" recently submitted to the IRS by the "*INDOPCO* coalition." The coalition is a group of large corporate taxpayers,[1] some of which have litigated capitalization issues in the recent past.[2] Its proposal was submitted under cover of a letter to Commissioner Rossotti on September 6, and became public in October.[3]

Although not written in full-blown regulatory format, the voluminous proposal was clearly designed as a possible outline for pending proposed regulations. Christine Turgeon, the Treasury point person on the regulations project, has since informally responded at the annual meeting of the Tax Executives Institute in late October.[4] The discussion that follows touches on some of the highlights of the coalition proposal.

GENERAL PRINCIPLES

Timing of Capitalization

The proposal contains an overview of capitalization and how it works. Significantly, given its source and generally pro-taxpayer complexion, the proposal explicitly adopts the government position that an expenditure may be "taken into account" by capitalization only when it would otherwise become allowable as a deduction. In no event will this be sooner than when the expenditure is "incurred," which the regulations define by reference to the "all events" test that applies to deductions by accrual basis taxpayers.[5]

Since the economic performance rules were enacted in 1984, the IRS position has been that accrual taxpayers cannot capitalize outlays until the full "all events" test, including the economic performance requirement, has been met. The regulations under Code Section 461, since they were rewritten to reflect the economic performance requirement, have so provided explicitly. The regulations governing long-term contracts,[6] which apply to all taxpayers, provide likewise, although special rules apply in determining "economic performance" in relation to such contracts.[7]

This proposition is not beyond question, however. The "economic performance" rules added a third element to the traditional two-prong "all events" test: that "all events" have occurred which determine the fact of liability and that its amount be determinable with "reasonable accuracy."[8] However, although the applicable rules were very similar, there was authority that, strictly speaking, the "all events" test for deductions did not apply to inclusions in basis.[9] There was thus some doubt about whether the "economic performance" rules could affect the timing of capital outlays. Application of the regulations' approach to overturn the well-settled case law that allowed real estate developers to include estimated future costs to complete "common improvements" in the basis of lots sold[10] was very controversial. The IRS wound up applying the new rule prospectively[11] and issuing a taxpayer-favorable revenue procedure allowing the first expenses incurred in a given development to be attributed to the first lots sold.[12] The issue has never been fully thrashed out in court.

Cash Basis Taxpayers

The timing rules in the proposal have implications for cash basis taxpayers as well. Cash basis taxpayers cannot take a deduction for money that they merely owe, even if they give a note which might be taxable to the recipient. Can they include it in the basis of property? As discussed above, the regulations make clear that accrual taxpayers cannot include a liability in basis until it is "incurred" under the "all events" test. However, the corresponding rules for cash basis taxpayers refer only to *deductions*[13] and do not expressly address inclusion in basis.

The government nonetheless argued successfully in *Owen v. United States*[14] that cash basis taxpayers, like accrual taxpayers, should not be able to capitalize costs

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before they would otherwise become deductible. The court agreed, and held that an individual could not claim additional basis for property improvements for which he had only "paid" by issuing a note. However, the court distinguished purchase money indebtedness that represents the initial consideration paid for the property, which has traditionally been treated as part of basis regardless of payment.[15] The proposal as written would codify the *Owen* holding without mention of the exception, leaving the status of seller financing uncertain.

"ACORN" TRANSACTIONS

The first major section of the coalition proposal requires capitalization of expenditures incurred in connection with a class of transactions given the catchy name of "ACORN transactions." ACORN is short for Acquisition, Creation, Organization, Reorganization, and the cumbersome phrase "New separate trade or business investigation and creation." ACORN expenditures are therefore those that have to do with acquiring or creating a business, with or without an accompanying legal entity.

From Small ACORNs . . .

Such expenditures are clearly capital under existing law, but the proposal breaks modest new ground in providing a list of factors to be considered in determining whether a taxpayer is creating a new business or simply expanding an old one, which is not cause for capitalization.[16] The listed factors include, generally, whether goods or services provided are "related" or substantially similar; whether "substantially similar" processes, equipment, or personnel are involved; and, in the case of taxpayers with geographically dispersed operations, whether there is a "high degree of duplication and overlap" between the products produced and/or sold in different locations.[17] These factors largely reflect existing law, although one example would reverse the holding in *Cleveland Electric Illuminating Co. v. United States*,[18] that a utility's nuclear power plant represented a different business separate from its conventional power plants.[19]

If the proposed regulations adopt the same approach, the list of factors may be streamlined a bit: Ms. Turgeon noted that she thought that "the focus should be on the product that is being delivered or the service that is being delivered, rather than who is delivering it and who actually receives it." The proposal also in its present form does not address whether and how these rules might relate to the determination of whether the taxpayer has "separate trades or businesses" entitled to use different methods of accounting.[20]

. . . Do Big Issues Grow

A more striking departure from present law is the prescription of a general five-year amortization period for expenditures capitalized under the ACORN rules (except for the actual consideration paid for property).[21] This treatment would seem to be appropriate for certain "free-standing" expenditures and would contribute to simplification. For example, providing for amortization of all expenditures capitalized in connection with a new business may head off some disputes about Code Section 195's definition of "start-up costs." Similarly, allowing all organization- and reorganization-type costs to be amortized would effectively extend Code Sections 248 and 709, which already permit such amortization for the organizational expenditures of corporations and partnerships. However, there might be confusion if the regulations were to provide for five-year amortization for expenditures that traditionally have been capitalized into the basis of specific property with its own recovery period, such as "ancillary costs" of acquisition.

ACORN costs would be deductible if the associated transaction is abandoned, as under existing law,[22] but the drafters slipped in that a deduction would be permissible "even if the [abandoned] transaction is an alternative to other, mutually exclusive transactions," which would resolve a long-running dispute in the taxpayers' favor. The IRS recognizes that an abandonment loss is appropriate if there are several potential independent transactions, some of which are consummated and others not. However, if the transactions are alternatives to one another, the current IRS position seems to be that the costs associated with *all* the potential transactions must be capitalized if *any* of them go through.[23]

BUSINESS OPERATIONS

The next section of the proposal addresses expenditures incurred in operating an ongoing business. The proposal begins with the assumption that such expenditures are deductible, and then carves out a series of exceptions that require capitalizing costs associated with:

- the acquisition of any asset;[24]
- "defending and perfecting title" to any asset;[25]
- the production of a tangible asset;[26] or
- the creation of a "separate and distinct intangible asset."[27]

The Demise of "Future Benefit"?

As the weighty citations indicate, the above exceptions are uncontroversial. The likely controversy concerns the exception that does *not* appear on the list. The Supreme Court in *INDOPCO*[28] rejected the taxpayer's argument — based upon language in its earlier decision in *Commissioner v. Lincoln Savings & Loan Ass'n*[29] — that expenditures had to "create or enhance . . . a separate and distinct . . . asset" in order to be capital. The court held that even if there was no identifiable "asset," capitalization could still be required if the expenditures produced a "future benefit" that was more than "incidental." The taxpayer in *INDOPCO* was the target in a successful corporate acquisition. The Court held that it was required to capitalize the associated costs because it had benefited from the transaction. The proposal omits mention of "future benefit" completely.

The ACORN rules discussed above incorporate the core holding of *INDOPCO* — that expenses of a corporate transaction are capital, even if the particular taxpayer involved acquires nothing. However, the elimination of "future benefit" as an independent ground for capitalization invites the possible criticism that the drafters are trying to win in the regulatory arena the argument that the taxpayer lost before the Supreme Court: that capitalization ordinarily requires some kind of an "asset." At the TEI meeting, Jody Brewster, former IRS assistant chief counsel for income tax and accounting and now representing the coalition, forthrightly defended the junking of the "future benefit" standard on the grounds that it did not provide "a practical or satisfactory basis for identifying costs that need to be capitalized." Ms. Turgeon, on the other hand, questioned whether the "separate and distinct asset" rule would prove any easier to administer.

"Separate and Distinct Assets"

On the other hand, the drafters evidently tried to compensate for abandoning the "future benefit" test as an independent ground for capitalization by an expansive interpretation of the term "separate and distinct asset." In general, the proposal seems designed to provide a practical set of rules while accommodating as much as possible of the existing case law. However, in some cases the shift in the analysis from benefit to the *business* to a focus on a purported "asset" might produce some unintended side effects.

Even under the *INDOPCO* two-step analysis, whether there is an "asset" may make a difference. One of the hallmarks of a "separate and distinct" asset is that costs incurred either in connection with its acquisition, or in the "protection and defense" of title to it, are capital, regardless of whether, standing alone, they would meet the *INDOPCO* threshold for capitalization. If there is an "asset," then not only is its original cost capital, but so are any subsequent expenditures that relate to it. On the other hand, if there is no asset, then each outlay must be tested for "future benefit" under *INDOPCO*.

The proposal defines a "separate and distinct asset" as a "distinct and recognizable intangible property interest" that

- has a useful life in excess of twelve months,
- has an ascertainable and measurable value in money or money's worth in and of itself, and
- commonly is acquired separately from a trade or business or could be so acquired if restrictions on assignability were ignored.

The definition is then fleshed out with a list of examples, including memberships, covenants not to compete, business licenses, and certain supplier and customer contracts.[30] Capitalization has certainly been required in connection with all of these, but the status of some of them as "separate and distinct assets" under existing law is doubtful.

Franchises, Licenses, and Memberships

While costs associated with securing business licenses have consistently been held to be capital,[31] the reason seems to have been because the costs were incurred in connection with a new business, and not because the license itself was a "separate and distinct" asset. Thus, the court in *All States Freight, Inc. v. United States*[32] allowed a trucker that had to get a new license to *stay* in its existing business to deduct the associated expenses. The court reasoned that the outlays could not be an "investment in new property" because the taxpayer had no more after the proceedings than it had before.

Although the costs of defending the validity of a patent or trademark, for example, are capital because they relate to "protection or defense of title,"[33] in *B.H.A. Enterprises, Inc. v. Commissioner*,[34] the Tax Court allowed a radio station to deduct the cost of defending an action brought to revoke its broadcast license. The court reasoned that no asset was involved and the costs had been incurred to defend the right to engage in an existing business rather than to start a new one. The same analysis appears to apply to franchises[35] and likely to similar "assets," such as trade association memberships.

Input Contracts

Employment contracts, and other "input" contracts, which the proposal collects under the heading of "supplier-based intangibles," present the same issues. The courts, and even the IRS, have been a bit ambiguous about whether supplier-based intangibles (input contracts) — as distinguished from customer or "output" contracts, which directly generate gross income — are full-fledged "separate and distinct assets." For example, when the IRS concluded that, contrary to early case law,[36] the costs of standard form baseball players' contracts had to be capitalized and amortized, it stated that for this purpose "the cost of a player contract . . includes (a) amounts paid or incurred upon the purchase of a player contract and (b) bonuses paid to players for signing player contracts, but does not include working agreement development costs."[37]

The real issue concerning employee contracts seems to be whether costs attributable to future periods are being paid in advance rather than whether the contracts themselves are properly "separate and distinct assets." The same observation can be made about covenants not to compete, another item on the proposal's list of assets. It would not seem a foregone conclusion, for example, that expenses to enforce an employment contract midway through its term would have to be capitalized on the grounds that it related to the "protection and defense of title" to an asset.

Similarly, while the IRS has from time to time required capitalizing costs related to other types of supplier contracts, these instances usually involve large transactions out of the usual course of business and it is not always clear whether the IRS is treating the contracts as "separate and distinct assets" or merely applying the general "future benefit" standard.[38] Again, it would seem to be at least uncertain whether existing law would require capitalizing the cost of any later dispute with the supplier that does not give the taxpayer any new rights.

Prepayments

The coalition includes prepayments on its list of "separate and distinct assets," although again, their technical status might be debated. In any event, assets or not, prepayments have always had to be capitalized, except, possibly, if they qualify under a *de minimis* rule. Some courts have recognized a "one-year rule" of convenience when cash basis taxpayers prepay period costs such as rent,[39] but the Tax Court recently refused to extend that treatment to accrual taxpayers in *USFreightways Corp. v. Commissioner*.[40] The proposal would define "an expense that is prepaid for more than twelve months" as a capitalizable asset, thus prescribing the same rule for both cash and accrual taxpayers and effectively overturning the Tax Court's holding. The Seventh Circuit recently reversed.[41]

Attributing Expenditures to Capital Transactions

As to both "ACORN transactions" and "separate and distinct assets," the proposal exempts certain "recurring costs" from the requirement to capitalize.[42] Firstly, taxpayers would be permitted to expense "general and administrative costs," including general overhead, support costs, and "costs for overall management or policy guidance functions." There would also be a flat exception from capitalization for employee-related costs. Adoption of these provisions would resolve an ongoing and high-profile dispute about the degree to which such costs have to be capitalized in connection with capital transactions,[43] or "self-developed intangibles" such as loans made by a bank.[44]

Secondly, the coalition proposes a general *de minimis* rule allowing deduction of small expenditures even if they might otherwise be capital. A number of authorities have endorsed expensing particular assets on the grounds of very low value combined with relatively short useful lives. Nevertheless, most courts (and the IRS) have been unwilling to commit themselves to a *de minimis* rule based on size alone. While the Court of Claims permitted two railroads to follow their regulatory accounting and expense outlays under $500 when the effects were immaterial,[45] the Tax Court recently refused

to permit a smaller taxpayer to adopt the same $500 threshold.[46] The coalition would propose to permit taxpayers to write off small expenditures if they follow a written policy that applies "for all significant non-tax purposes (e.g., financial, SEC, and regulatory reporting purposes)."

REPAIRS AND IMPROVEMENTS

The proposal's final major section addresses the perennially troublesome area of repairs and improvements to tangible property. The most significant innovation is a proposal to revive a system of repair allowances.[47] This option has been discussed previously by Treasury officials and was also backed by the American Bar Association Tax Section in recent Congressional testimony.[48] A similar system in effect from 1971 to 1980 allowed taxpayers to deduct most repair-type costs that did not exceed a certain percentage of property basis.[49] That system was used in conjunction with the elective ADR (asset depreciation range) depreciation method then in use,[50] and the allowance percentages were based upon the "ADR classes" of property used under that method.[51] Repair allowances were abandoned with the introduction of the Accelerated Cost Recovery System (ACRS) in 1981.

The coalition proposal (the "Modified Repair Allowance System" or MRAS) represents an updated version of the pre-1981 system. The allowance percentages would be either be based on the old ADR classes, or — if the taxpayer elects, or the property was not eligible for an allowance under the ADR — on the broader depreciation categories in current Code Section 168. As in the past, expenditures beyond the indicated percentages would be automatically capital, while most expenditures under the percentage thresholds would be currently deductible. (Certain expenditures for so-called "significant capital improvements" would always have to be capitalized.)

For non-electing taxpayers, the general rules would continue to apply. Taxpayers would continue to have to capitalize "improvements" that materially increased the property's original value or initially contemplated useful life,[52] or fitted it for a new or different use.[53] Other repairs could generally be deducted, unless they formed part of a "plan of rehabilitation."[54]

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1. Members include Alleghany Corp., American Airlines, AT&T, BankOne, BellSouth, Bristol-Myers Squibb, Caterpillar, Citigroup, Coca-Cola, DaimlerChrysler, Delphi Automotive Systems, Eli Lilly, Exxon Mobil, FedEx, Fidelity, General Motors, Household International, Mars, Marsh & McLennan, Microsoft, PNC Financial Services Group, Qwest Communications, SBC Telecommunications, TECO Energy, United Technologies, Verizon, and Wells Fargo.

2. See, e.g., Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000); *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000); FMR *Corp. v. Commissioner*, 110 T.C. 402 (1998); *see also generally* Lee A. Sheppard, "The INDOPCO Grocery List," 93 Tax Notes 320 (Oct. 15, 2001).

3. 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 ("Summary"); Outline of Proposed Capitalization Principles, Tax Analysts Doc. No. 2001-26124; INDOPCO Coalition Proposed Capitalization Principles, Tax Analysts Doc. No. 2001-26125 ("Proposal").

4. See "Treasury Official Assesses *INDOPCO* Proposal," 2001 TNT 206-3 (October 24, 2001); "Parts of Coalition Capitalization Proposal May be Overly Broad, Treasury Official Says," Daily Tax Report, Oct. 25, 2001, at G-4.

5. Reg. § 1.263(a)-2(b).

6. See Reg. § 1.460-1(b)(8); see also Notice 89-15, Q&A 33.

7. Reg. § 1.461-4(d)(2)(ii).

8. I.R.C. § 461(h).

9. E.g., Molsen v. Commissioner, 85 T.C. 485; 502 (1985) (Although [inventory] purchases are an 'expense' in the colloquial sense, it is well settled that they are not a 'deduction' within the meaning of section 461 and that they are not subject to the rules governing deductions under that section"); see also, e.g., Transamerica Corp. v. United States, 999 F.2d 1362 & n.3 (9th Cir. 1993) ("the Government has cited no case that has applied the 'all-events' test governing the determination of deductiblity of ordinary expenses under section 461 to the determination of what liabilities may be included in the cost basis for depreciation under section 1012.")

10. E.g., Mount Vernon Gardens, Inc. v. Commissioner, 298 F.2d 712 (6th Cir. 1962); Cambria Development Co. v. Commissioner, 34 B.T.A. 1155 (1936), nonacq. 1937-1 C.B. 31; see also Haynsworth v. Commissioner, 68 T.C. 703 (1977), *aff'd in unpublished opinion*, (5th Cir., Dec. 28, 1979).

11. See Notice 91-4, 1994-1 C.B. 315.

12. Rev. Proc. 92-29, 1992-1 C.B 748.

13. *Compare* Regs. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1) (cash basis) *with* Regs. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2) (accrual).

14. 34 F. Supp.2d 1071 (W.D. Tenn. 1998).

15. 34 F. Supp.2d at 1078, and authorities cited; *see also* unnumbered FSA, 1995 WL 1770825, *but see* TAM 199904036 (9/30/98) (discussion suggests inclusion might only be proper if there was *third-party* financing).

16. E.g., NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982).

17. Proposal, II.C.2.

18. 7 Cl. Ct. 220 (1985).

19. Proposal, II.C.3.g, Summary, II.B.

20. Reg. § 1.446-1(d).

21. Proposal, II.E.1.

22. Proposal, II.E.2.

23. See, e.g., PLR 9402004 (9/10/93), discussed in J. Salles, "Tax Accounting," 2(8) Corp. Bus. Tax'n Monthly 23, 25-26 (May, 2001).

24. E.g., Woodward v. Commissioner, 397 U.S. 572 (1970); United States v.

Hilton Hotels Corp., 397 U.S. 580 (1970).

25. Regs. § 1.263-2(c); e.g., Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971); *see also, e.g.*, Reg. § 1.212-1(k).

26. Commissioner v. Idaho Power Corp., 418 U.S. 1 (1974).

27. Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).

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

29. 403 U.S. 345, 354 (1971).

30. Proposal, III.D.2.

31. E.g., WHEC, Inc. v. Commissioner, 37 T.C. 821 (1962); *Radio Station WBIR, Inc. v. Commissioner,* 31 T.C. 803 (1959).

32. 72 F. Supp. 673 (N.D. Oh. 1947).

33. E.g., Georator Corp. v. United States, 485 F.2d 283 (4th Cir. 1973).

34. 74 T.C. 593 (1980), acq. in result on this issue, 1982-2 C.B. 1.

35. See, e.g., All States, 72 F. Supp. at 674, noting in connection with "franchises and licenses" that "[t]he investment by which the property or license is acquired is a capital investment, but the expenditure necessary to maintain the property and protect it from attack or loss is expense."

36. E.g., Helvering v. Kansas City American Ass'n Baseball Co., 75 F.2d 600 (8th Cir. 1935); Commissioner v. Chicago National League Ball Club, 74 F.2d 1010 (7th Cir. 1935); Commissioner v. Pittsburgh Athletic Co., 72 F.2d 883 (3d Cir. 1934).

37. Rev. Rul. 67-379, 1967-2 C.B. 127, 129.

38. E.g., PLR 9334005 (May 14, 1993); see also, e.g., the discussions in PLR 9240005 (6/12/92) and PLR 9552014 (9/29/95) (which allowed deductions).

39. E.g., Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980), cited with approval in Hillsboro National Bank v. Commissioner, 460 U.S. 370, 384 (1983).

40. 113 T.C. 329 (1999), discussed in J. Salles, "Tax Accounting," 1(7) Corp. Bus. Tax'n Monthly 33, 35-36 (Apr. 2000).

41. __F.3d__ (7th Cir., Nov. 6, 2001).

42. Proposal, III.B.3.d (and various cross-references).

43. See Wells Fargo Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000), discussed in J. Salles, "Tax Accounting," 2(2) Corp. Bus. Tax'n Monthly 35, 35-36 (Nov. 2000).

44. See PNC Bancorp v. Commissioner, 212 F.3d 822 (3d Cir. 2000), discussed in J. Salles, "Tax Accounting," 1(11) Corp. Bus. Tax'n Monthly 26, 26-28 (Aug. 2000); *see also Lychuk v. Commissioner*, 116 T.C. 374 (2001) (installment contracts).

45. Union Pacific Railroad Co. v. United States, 524 F.2d 1343, 1347-48 (Ct. Cl. 1975); Cincinnati, New Orleans, and Texas Pacific Ry. Co. v. United States, 424 F.2d 563 (Ct. Cl. 1970).

46. Alacare Home Health CareServices, Inc. v. Commissioner, 81 T.C.M. (CCH) 1794 (2001), discussed in J. Salles, "Tax Accounting," 2(11) Corp. Bus. Tax'n Monthly 24, 26-27 (Aug. 2001).

47. Proposal, IV.B.

48. Statement of Richard M. Lipton, on behalf of the ABA Section of Taxation before the Senate Finance Committee on April 26, 2001, *reprinted in* 54 Tax Lawyer 617, 626-27 (Spr. 2001).

49. Revenue Act of 1971, Pub. L. No. 92-178, § 109(b), *codified* as I.R.C. § 263(f), *renumbered* as I.R.C. § 263(e) by Tax Reform Act of 1976, Pub. L. No. 94-455, § 1904(b)(10)(A)(i), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(c), for property placed in service after December 31, 1980; Reg. § 1.263(f)-1.

50. Revenue Act of 1971, Pub. L. No. 92-178, § 109(a), codified as I.R.C. § 167(m), amended to terminate application to new property, Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 203(b), codified *as* I.R.C. § 167(m)(4), *repealed*, Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11812(a)(1)-(2); Reg. § 1.167(a)-11, -12.

51. See Rev. Proc. 83-35, 1983-1 C.B. 745.

52. See, e.g., Ingram Industries v. Commissioner, 80 T.C.M. (CCH) 532 (2000) and Vanalco Industries v. Commissioner, 78 T.C.M. (CCH) 251 (1999), discussed in J. Salles, "Tax Accounting," 2(5) Corp. Bus. Tax'n Monthly 32 (Feb. 2001).

53. See, e.g., Dominion Resources, Inc. v. United States, 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).

54. See, e.g., United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968).