# Tax Accounting

**BY JAMES E. SALLES**

## IRS WINS BEFORE THE TAX COURT IN NORWEST

A recent IRS victory before the Tax Court in *Norwest Corporation v. Commissioner*[1] fleshes out the law concerning the capitalization of expenditures in connection with corporate acquisitions. The case has broader implications as well, since it follows *INDOPCO v. Commissioner*.[2]

### *INDOPCO*

In *INDOPCO*, the U.S. Supreme Court clarified that its earlier decision in *Commissioner v. Lincoln Savings & Loan Association*[3] did not require that an expenditure "create or enhance . . . a separate and distinct original asset" in order to be capital. *INDOPCO* required a target company to capitalize expenditures associated with a friendly acquisition. The *INDOPCO* Court stressed that the overriding goal of tax accounting was to reflect income clearly.[4] *INDOPCO* referred to the traditional regulatory standard that requires capitalization when "an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year" under Treasury Regulations Section 1.461-1(a)(1).

Post-*INDOPCO* courts frequently follow a two-step analysis, inquiring first whether there is a "separate and distinct asset," and if there is not, whether there is an asset with a useful life extending "substantially beyond" the taxable year.[5] The language of the opinion in *INDOPCO*, particularly the Court's observation about deductions being "exceptions to the norm of capitalization,"[6] was sweeping. The IRS has repeatedly felt itself constrained to issue revenue rulings to assure taxpayers that it will not read *INDOPCO* to overturn 60 years of case law concerning such matters as deductions for advertising expenses,[7] incidental repairs,[8] severance payments,[9] and employee training costs.[10]

*INDOPCO* has encouraged a variety of litigation and other activity relating to various capitalization issues. Its first and most obvious implication relates to the issue of what is a capital asset. Most directly, the *INDOPCO* holding has spawned a series of controversies about unfriendly takeovers, and in what circumstances a target company does, and does not, realize a benefit "extending substantially beyond the taxable year."[11]

More broadly, *INDOPCO* has prompted the courts to rethink when exactly an "asset" with "value" is created in the absence of an identifiable tangible or intangible "property". Courts' reliance on the "separate and distinct . . . asset" concept was never taken to logical extremes. No one seriously argued, for example, that prepaid expenses were not capitalizable. As the *INDOPCO* court pointed out,[12] the concept of an asset is itself somewhat "flexible and amorphous"— but it provided a handy hook on which courts so inclined could hang a conclusion that a debatable expenditure was not subject to current capitalization. *INDOPCO* has cast a shadow on such cases as *Briarcliff Candy Corp. v. Commissioner*,[13] where the court relied in part on the "separate and distinct . . . asset" concept to hold a wholesaler's marketing expenditures relating to an ongoing business currently deductible.

## IDENTIFYING EXPENDITURES ASSOCIATED WITH CAPITAL ASSETS

Self-developed assets, or acquired assets in which the taxpayer expends significant amounts in connection with the acquisition, present a further inquiry: Once an asset has been determined to exist, what kinds of expenditures, incurred over what time period, are includible in its basis? These issues are not new, but have a higher profile than in the past because they are

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more likely to be troubling in connection with the more amorphous assets that are likely to be identified in the wake of *INDOPCO*. Both were addressed by the Tax Court in *Norwest*.

The IRS recently addressed the timeline issue in Revenue Ruling 99-23,[14] a ruling under Code Section 195. Code Section 195 allows amortization of start-up expenditures that "if paid or incurred in connection with the operation of an existing active trade or business . . . would be allowable as a deduction for the taxable year in which paid or incurred." The IRS, with support from the courts,[15] reads this language as requiring an *INDOPCO* analysis be performed first. If the expenditure would pass muster as a current expense except for the absence of an ongoing trade or business, it is subject to amortization under Code Section 195. Otherwise, the expenditure must be capitalized, and is amortizable, if at all, under normal rules. Consequently, the same principles apply as in the normal capitalization context.

Revenue Ruling 99-23 featured a series of fact patterns involving costs incurred by a taxpayer in connection with corporate acquisitions. The general principle is that investigatory costs are deductible (or, in the Section 195 context, amortizable) and costs attributable to a particular acquisition must be capitalized. The IRS chose to draw the line between investigatory costs and costs deemed attributable to an acquisition at the moment when the acquiring taxpayer makes a decision to focus its efforts on a particular target. Costs incurred strictly to facilitate a potential acquisition are capital, regardless of whether the identity of the target is known when they are incurred. Revenue Ruling 99-23 made the IRS's view clear that it is the taxpayer's decision, not the manifestation of that decision (for example, the signing of a letter of intent), that matters.

This somewhat controversial attempt at formulating a bright-line test has received a boost from the court's analysis in *Norwest*. The taxpayer in *Norwest*, the subject of a friendly acquisition, sought to deduct investigatory expenses incurred up until the day that the target's board approved the merger and negotiated a conditional agreement. Amounts paid for services directly relating to the actual transaction, such as negotiating price, preparing the fairness opinion, and handling the necessary regulatory filings, were not at issue.

Citing *INDOPCO* and the matching principle, the Norwest court held that the expenses had to be capitalized because "[t]he disputed expenses are mostly preparatory expenses that enabled [the target] to achieve the long-term benefit it desired from the transaction, and the fact that the costs were incurred before DBTC's management formally decided to enter into the transaction does not change the fact that all these costs were sufficiently related to the transaction." The target's benefit from the transaction, of course, created a capitalizable asset under *INDOPCO*. Thus, the Tax Court clearly subscribes to the principle that there is no particular magic associated with the date on the paperwork.

How far to reach in determining what kinds of expenditures are attributable to an acquisition or other capital transaction has also been somewhat hazy. In *Commissioner v. Idaho Power Co*.,[16] the U.S. Supreme Court held that indirect costs, and specifically depreciation attributable to the use of the taxpayer's equipment, had to be capitalized into the cost of improvements of the taxpayer's plant. The uniform capitalization rules now provide specific rules for self-constructed tangible property, but intangibles continue to be governed by *Idaho Power,* to the extent its principles can be applied.

The court in *Norwest* lined up on the side of the Commissioner on a key point. Besides outside professional fees, the Commissioner also asserted that some $150,000 of the target company's officers' regular salaries should be capitalized as relating to services performed in connection with the acquisition. The parties stipulated that the officers were regular employees of the target and that they would have been paid exactly the same if there had been no merger at all. Nonetheless, the court upheld the Commissioner in requiring capitalization. Although the court did not specifically discuss the point, this is significant because it means that a direct cost or incremental approach to determining the amount of expenses attributable to a capital transaction is not acceptable. In the future, taxpayers may face a revenue agent sifting through what they would consider ordinary operating expenses in search of expenditures to attribute to contemporaneous capital transactions.

In *Norwest*, the executive salaries and other overhead-type costs attributable to the acquisitions were conveniently laid out in the taxpayer's financial statements. Financial reporting has gotten taxpayers into trouble in the tax accounting arena before.[17] The depreciation issue in *Idaho Power* appears to have been brought to the IRS's attention by the fact that the taxpayer was required to capitalize the depreciation for regulatory accounting purposes.[18] The holding in *Norwest*, however, did not hinge on accounting conformity, and the same principle would apply to a company that did not separately identify these types of expenditures, or had no occasion to prepare formal GAAP financial statements at all. Consequently, in the future, taxpayers may have to be prepared to develop and defend some reasonable method of allocation (on a time basis or otherwise) of salaries and other overhead in determining the expenses attributable to a potentially capital transaction.

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1. 112 T.C. No. 9 (1999).
2. 503 U.S. 79 (1992).
3. 403 U.S. 345 (1971).
4. 503 U.S. at 84.
5. See, e.g., FMR Corp. v. Comm'r, 110 T.C. 402, 416-17 (1998).
6. 503 U.S. at 84.
7. Rev. Rul. 92-80, 1992-2 C.B. 57.
8. Rev. Rul. 94-12, 1994-1 C.B. 36.
9. Rev. Rul. 94-77, 1994-2 C.B. 19.
10. Rev. Rul. 96-62, 1996-2 C.B. 9.
11. E.g., A.E. Staley Mfg. Co. v. Comm'r, 119 F.3d 482 (7th Cir. 1997), rev'g and remanding 105 T.C. 166 (1995).
12. 503 U.S. at 87 n.6.
13. 475 F.2d 775 (2d Cir. 1973).
14. 1999-20 I.R.B. 3.
15. See, e.g., FMR, Corp. v. Comm'r, 110 T.C. 402, 428-29 (1998).
16. 418 U.S. 1 (1974).
17. See, e.g., Ford Motor Co. v. Comm'r, 102 T.C. 87, 104 (1994), aff'd, 71 F.3d 209 (6th Cir.1995) (where the taxpayer's argument that discounting its deductions for future payments would create too much complexity and uncertainty was somewhat handicapped by the fact that it had done exactly that on its financials).
18. See 418 U.S. at 5-6.