1999

Capitalization in the Nineties

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Repository Citation
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CAPITALIZATION IN THE NINETIES

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CAPITALIZATION IN THE NINETIES

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§1.01 INTRODUCTION

At the forefront of tax law controversy today is the perennial question of whether various types of expenditures must be capitalized under section 263 or may be currently deducted as a business expense under section 162. This basic issue has been present since the first income tax law was enacted. In this connection, over sixty years ago, writing for the Supreme Court, in Welch v. Helvering, 290 U.S. 111, 115 (1933), Justice Cardozo uttered these famous words:

One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

More recently, this issue has been addressed by the Supreme Court in Indopco v. United States, 112 S. Ct. 1039 (1992), which dealt with the consequences of certain expenses incurred in connection with an acquisition. The Indopco decision has had an impact in all areas of the law. This discussion will focus on the new guidance for solving this riddle and how the decision has affected capitalization according to the Internal Revenue Service (IRS). Thus, the paper will pay close attention to IRS pronouncements and court decisions since the Indopco decision.

§1.02 THE INDOPCO DECISION

[1] Facts

Indopco, Inc., (formerly named National Starch and Chemical Corporation) was approached in 1977 by Unilever United States, Inc., about the possibility of a friendly takeover. Pursuant to its fiduciary duty to ensure the fairness of the transaction, Indopco's board of directors engaged an investment banking firm to evaluate the transaction and render a fairness opinion. Indopco paid the investment banking firm $2.2 million and deducted this on its tax return. The IRS disallowed the deduction, as well as deductions for legal fees paid in connection with the takeover, claiming that the expenditures resulted in a benefit that extended into future years.

[2] The Lower Court Decisions

The Tax Court ruled that the expenditures were capital in nature and therefore not deductible under section 162(a) as ordinary and necessary business expenses. The court began its analysis by stating that the distinction between a deductible current expense and a
nondeductible capital expenditure can, at times, be unclear. When making the distinction, the court emphasized that it must be kept in mind that deductions are a matter of legislative grace, deduction statutes must be strictly construed, and the taxpayer bears the burden of showing the right to the claimed deduction. The court went on to find that the expenditures related to Indopco's permanent betterment and thus were capital in nature. The court reasoned that long-term benefits accrued to Indopco from the takeover. The court relied heavily on the fact that Indopco's board determined that it would be in Indopco's long-term interest to shift ownership to Unilever; thus, the expenditures could be expected to produce returns for many years in the future. The Tax Court also found that the transaction provided at least two inherently permanent benefits to Indopco: (1) the availability of Unilever's enormous resources as indicated by Indopco's annual report to shareholders, and (2) the opportunity for synergy created by Unilever's affiliation with Indopco as indicated by the investment banker's opinion on the takeover. The U.S. Court of Appeals for the Third Circuit affirmed, agreeing with the Tax Court's analysis. Both courts rejected Indopco's contention that the expenses were deductible because (1) they did not enhance or create a separate and distinct asset, or (2) the dominant purpose for the expenditures was to enable the board of directors to satisfy their fiduciary duties.

[3] The Supreme Court Decision

The Supreme Court affirmed the Third Circuit holding that the investment banking, legal, and other expenses incurred in the friendly takeover did not qualify for deduction as ordinary and necessary business expenses, but rather had to be capitalized. Rejecting the taxpayer's contention that any future benefit would be entirely speculative or merely incidental, the Court concluded that the takeover would produce significant benefits to Indopco that extended beyond the tax year in which the deductions were taken. The Court's factual determination was based in part on the 1978 "Progress Report" to shareholders indicating that Indopco would greatly benefit from Unilever's enormous resources and in part on the investment banking firm's fairness opinion on the takeover indicating that some "synergy may exist with Unilever." As further evidence of future benefit, the Court noted that Indopco would no longer be a publicly held corporation and would no longer be subject to "shareholder relations" expenses, including reporting and disclosure requirements, proxy battles, and derivative suits. In concluding that the expenditures had to be capitalized, the Court articulated four principles as the basis for its decision:

[a] Clear Reflection

At the outset of its analysis, the Court couched the issue as one of clear reflection of income. Referring to sections 162, 263, and 167, the Court said "[t]hrough provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."

[b] Capitalization is the Norm

After affirming the lower courts' statements that an income tax deduction is a matter of legislative grace and the burden of establishing a claimed deduction is on the
taxpayer, the Court went on to state a new principle never articulated before, i.e., deductions are exceptions to the norm of capitalization. The Court said:

The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See sections 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a 'complete list of nondeductible expenditures', Lincoln Savings, 403 U.S. 358 (1971)..., section 263 serves as a general means of distinguishing capital expenditures from current expenses. [112 S. Ct. at 1043]

[c] "Separate and Distinct" Test

The Supreme Court clarified that Commissioner v. Lincoln Savings & Loan Association, stands for the proposition that the creation of a separate and distinct asset may be a sufficient but not a necessary condition to classification of an expenditure as capital. In Lincoln Savings, the Court addressed whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary expenses under section 162(a), or capital expenditures under section 263. The "additional" premiums provided FSLIC with a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations, i.e., created or enhanced for Lincoln what was essentially a separate and distinct additional asset. As an inevitable consequence, the Court concluded, the payment was capital in nature and not an expense.

[d] "Future Benefit" Test

Finally, in an attempt to clarify its statement in Lincoln Savings that "the presence of an ensuing benefit that may have some future aspect is not controlling [for capitalization purposes]," the Court stated that the presence of a future benefit is a means of distinguishing an ordinary expense from a capital expense. The Court went on to state that: "[a]lthough the mere presence of an incidental future benefit -- some future aspect -- may not warrant capitalization, a taxpayer's realization of benefits beyond the year the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." 112 S. Ct. 1044. As will be explained later in this outline, it is this "future benefit" language in the opinion that is the source of much controversy on capitalization issues arising today.

[4] Confusing Points of the Supreme Court's Analysis

[a] Clear Reflection

Although the Supreme Court indicated that sections 162, 263, and 167 endeavor to match expenses with related revenues to result in a more accurate calculation of net income, the Court failed to explain exactly how matching would be accomplished in Indopco. Thus, taxpayers are left with solving this riddle in future cases. However, notwithstanding this shortcoming of the opinion, it appears that the Court's emphasis on matching has helped the
IRS reach the proper conclusion in Revenue Ruling 94-38, I.R.B. 1994-25. For over two years, the IRS struggled with whether land cleanup costs had to be capitalized — concluding that the costs had to be capitalized in one Technical Advice Memorandum (TAM) but noting at the top of the TAM that the conclusion would be reconsidered in connection with a study project. In Rev. Rul. 94-38, after reiterating in its analysis the Supreme Court's statement that provisions such as sections 162 and 263 endeavor to match expenses with related revenues, the IRS concluded that such costs are currently deductible. The ruling's conclusion appears to be based in large part on achieving a clear reflection of income. This concept is really the only new element of the IRS' new and improved analysis.

[b] Capitalization is the Norm

The Supreme Court's logic behind the statement that deductions are exceptions to the norm of capitalization is questionable and needs further explanation as well. It could be argued that section 162 provides, as a general rule, that all ordinary and necessary business expenses are currently deductible. Section 263 simply sets out exceptions to that general rule. Thus, by enumerating specific deductions under section 162, Congress was not necessarily trying to convey that items are not deductible unless specifically described in the statute. See e.g., Peter L. Faber, "Indopco: The Still Unsolved Riddle," The Tax Lawyers 47 (1994): 607-640. Notwithstanding the lack of compelling logic by the Court, this statement by the Court may well be the reason the IRS has arguably become more aggressive when challenging the deductibility of various expenditures.

[c] Separate and Distinct Asset

The Supreme Court's future benefit test coupled with its clarification of Lincoln Savings that the creation of a separate and distinct asset is not a prerequisite to capitalization raises the question whether the separate and distinct asset test has any future significance. At first blush, it appears that the future benefit test seems to subsume the latter. However, there may be occasions where the separate and distinct asset test may result in capitalization where the future benefit test would not. For example, in Rev. Rul. 94-38, the IRS held that the cost of a facility used to treat contaminated groundwater had to be capitalized. On the other hand, the costs of treating the contaminated land could be deducted. Even though the two costs are substantially analogous (i.e., both equally relating to the production of prior year revenues) the IRS seemingly felt compelled to require capitalization of the costs of the treatment facility because of the creation of a separate and distinct asset. See also §1.263(a)-(2)(a) (capital expenditures include the "cost of acquisition, construction, or erection of buildings, machinery, and equipment"). However, the IRS should not feel bound to apply the separate and distinct asset test in a vacuum. In Fort Howard Paper Company v. Commissioner, 49 T.C. 275 (1967), for example, the Tax Court refused to require capitalization under section 263 in a manner inconsistent with the clear reflection principle underlying that section, even though a separate asset was created. There the IRS argued that the portion of the taxpayer's overhead that was attributable to certain self-constructed assets had to be capitalized under section 263. Disagreeing with the IRS, the Court said:

We are satisfied that, under the circumstances involved herein, sections 263 and 446 are inextricably intertwined. A contrary view would encase the general provisions of section 263 with an inflexibility and sterility neither mandated to carry out the intent of
Congress nor required for the effective discharge of respondent's revenue-collecting responsibilities. Accordingly, we turn to a determination as to whether petitioner's method of accounting "clearly reflects income" pursuant to the provisions of section 446.

[d] Future Benefit

Finally, the Supreme Court's reliance on future benefit when requiring capitalization in *Indopco* leaves taxpayers with a number of riddles to solve. First, although the Supreme Court said that a future benefit is undeniably important, it did not describe the type of benefit that could require capitalization. Second, although the Supreme Court said that capitalization would not be required if the future benefit is only incidental, it did not bother defining what is incidental. The test could well require a comparison of current benefits with long-term benefits. If the amount of long-term benefit is substantial as compared to current benefits, capitalization could be required. Alternatively, it could be one of focus. That is, a future benefit is regarded as incidental if the principal purpose of an expense is to produce a current benefit and any future benefit is just an incidental result or by-product of the current benefit. The Court really did not provide any clues as to whether either of these approaches is viable. However, the latter view is more consistent with the definition of "incidental" in *Webster's Collegiate Dictionary*, (Tenth Edition), which defines the term as: "occurring merely by chance or without intention or calculation." In addition, as indicated a little later, the IRS may well share the latter view. See Rev. Rul. 92-80, 1992-2 C.B. 57 (where IRS stated that "[o]nly in unusual circumstances where advertising is directed towards obtaining future benefits beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising must the costs of that advertising be capitalized." (emphasis added) See also Rev. Rul. 94-97 I.R.B. 1994-51 (severance pay deductible because payments principally relate to previously rendered services).

§1.03 PROGENY OF INDOPCO

Costs incurred in connection with the defense of a business have long been held to be deductible under section 162. See *Welch v. Helvering*, 290 U.S. 111 (1933). The Supreme Court's remarks in *Indopco* that capitalization is the norm and that the presence of a future benefit is undeniably important in determining whether to capitalize an item have clearly created a wave of confusion over whether the *Indopco* decision articulated a new capitalization standard -- i.e., any item providing future benefits must be capitalized. However, the clear message from upper levels of the IRS and Treasury is that *Indopco* did not change the rules on capitalization. Not only have a number of high ranking IRS and Treasury officials stated this in public speeches, but also the IRS officially stated in Rev. Rul. 94-12, I.R.B. 1994-8, that "*Indopco* did not change the fundamental principles governing capitalization." Notwithstanding this statement, however, many taxpayers feel that the IRS is re-examining many of its long-established positions in light of *Indopco*. Has the IRS or courts changed their stance on capitalization in light of *Indopco*?

[1] Hostile Takeover Expenses

[a] Prior to the Indopco Tax Court Decision
Prior to the Indopco Tax Court decision, the IRS took a very taxpayer favorable view towards the deductibility of costs to defend against a hostile takeover. In PLR 8927005, for example, the IRS held that the expenses incurred by a corporation to successfully defend against a hostile takeover by getting a White Knight to acquire the corporation were deductible. The bulk of the expenses incurred were associated with the White Knight's acquisition of the corporation. The IRS found that the expenses were deductible because they were incurred to insure the continued profitability of the business and to protect the interests of the shareholders. The IRS felt that the taxpayer's expenditures were not made pursuant to an alteration or change in the capital structure of the taxpayer for an extended period of time. Rather, the amounts expended by the taxpayer were in fulfillment of the Directors' fiduciary duties to it and to fight off, what the Directors believed to be, a tender offer that was not in the best interests of the corporation or its shareholders to accept.

After the Indopco Tax Court Decision

Shortly after the Tax Court's opinion in Indopco, however, the IRS quickly reversed the position it had taken in PLR 8927005 regarding the deductibility of hostile takeover defense expenses. In PLR 8945003, the IRS revoked PLR 8927005 concluding that the Tax Court's long-term benefit reasoning in Indopco applies with equal force in the case of a hostile takeover that is successfully resisted by locating a White Knight. IRS said that there is no less a long-term benefit to the target of the hostile takeover in such situation than there is to the target of a friendly takeover as in Indopco.

TAMs 9043003 and 9043004 also involved the deductibility of expenses incurred to defend against a hostile takeover by locating a White Knight. The expenses in question were incurred for (1) investment banker fees for a fairness opinion and defense strategies (e.g., poison pill plan), and (2) a standstill agreement with the unwanted acquirer. The IRS ruled that purely defensive expenditures are deductible in the year incurred as ordinary and necessary business expenses because they do not provide a substantial long-term benefit. However, expenditures made in anticipation of, or with the potential for, long-term betterment of the corporation must be capitalized - such expenditures included the fairness opinion, appraisal fees, and proxy solicitation or printing costs, relating to the sale of target's stock to the friendly acquirer. The IRS concluded that the standstill agreement payments to the unwanted acquirer had to be capitalized because the agreement was arranged to facilitate the friendly acquirer's smooth acquisition of the taxpayer.

These TAMs arguably advocate a bifurcation approach for classifying costs associated with defending against a hostile takeover by using a White Knight as deductible or capitalizable. That is, to the extent that expenditures are incurred to purely maintain the status quo, the expenditures are deductible. However, to the extent that expenditures are incurred to facilitate the acquisition of the corporation by the White Knight, those expenses have to be capitalized. This approach is arguably consistent with a long line of precedents. For instance, the former type of costs would seem to be deductible under well established precedent that expenditures to maintain one's property in efficient operating condition or to protect one's business are deductible. In both of these situations, costs are incurred simply to maintain the status quo with any future benefit being a by-product of that objective. See Rev. Rul. 94-12, supra (where incidental repair costs to keep property in ordinary efficient operating condition could be deducted even though the expenditure might result in
some benefit) and Rev. Rul. 73-226, 1973-1 C.B. 62, (expenses paid by a taxpayer on behalf of a related corporation to protect the taxpayer's business reputation and goodwill are deductible even though the payments may help the related corporation continue in business).

The latter type of costs are arguably capitalizable under the well established theory that expenses that relate to an alteration or change in the capital structure are capitalizable since they relate to the corporation's operations and betterment for the duration of its existence. See, e.g., McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981); Bilar Tool and Dye v. Commissioner, 530 F.2d 708 (6th Cir. 1976); E. I. duPont de Nemours & Co. v. United States, 432 F.2d 1052 (3rd Cir. 1970); General Bankshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964), cert. denied, 379 U.S. 832 (1964) (reorganization expenses are treated as capital because they relate to the corporation's operations and betterment into the indefinite future, as distinguished from income production or other current needs). In Indopco for example, the Supreme Court noted that courts have long recognized that professional fees incurred for the purpose of changing the corporate structure for the benefit of future operations are not deductible as ordinary and necessary business expenses since the expenditures have to do with the corporation's operations and betterment for the duration of its existence, a period of time longer than a year.

[c] After the Indopco Third Circuit Decision

[i] In TAM 9144042, after the Third Circuit's opinion in Indopco, the IRS seemingly backed off the above approach that defensive expenditures incurred purely to maintain the status quo are deductible even though they might result in some future benefit. In that TAM, the taxpayer incurred various costs in successfully defending against a hostile takeover. The fees included (1) professional fees for services rendered in connection with filing administrative and judicial actions to stop the takeover attempt; (2) professional fees for services performed in connection with rendering the fairness opinion; and (3) professional fees for services rendered in connection with the taxpayer's self tender offer and the counter tender offer of the raider stock. Based on the two lower court Indopco decisions, the IRS National Office concluded that

[T]he nature of a proposed corporate takeover (i.e., whether it is friendly or hostile) is not determinative of the proper tax treatment afforded to expenditures for professional fees. Rather, the proper inquiry to be made with respect to these expenditures is whether the target corporation obtained a long-term benefit as a result of making the expenditures. The burden is on the taxpayer to demonstrate that it did not obtain a long-term benefit. Thus, expenditures for professional fees incurred in a hostile or friendly takeover attempt will not uniformly be classified as either currently deductible under section 162 or capitalizable under section 263. Each case will turn on its own specific set of facts and circumstances.

The National Office ultimately left it to the revenue agent to make the factual determination of whether the target corporation realized a significant long-term benefit.

[d] Cases subsequent to the Indopco Supreme Court Decision

[i] Unsuccessful Defenses Against Hostile Takeovers
A.E. Staley Manufacturing v. Commissioner, 97-2 USTC ¶50,521, (1997), rev'g 105 T.C. 166 (1995), is the most significant case addressing the treatment of hostile takeover defense expenses, and merits being examined in detail. It concludes that expenses incurred in defending a hostile takeover, that is eventually successful, should be bifurcated into deductible and capitalizable categories. Staley was member of a group of affiliated corporations. Until 1984, Staley’s primary business was corn wet milling, and its principal product was a high-fructose corn syrup. In 1984, Staley made a strategic business decision to diversify by entering the food service business. In 1986, fearing a hostile takeover, Staley retained a law firm, which recommended the implementation of various anti-takeover measures. These measures were adopted. In addition, Staley retained the services of several investment bankers to prepare and advise Staley in the event of an uninvited takeover attempt. Early in 1987, Staley also retained the investment bankers to represent Staley if an offer was made to buy the company.

Staley agreed to a “success fee” arrangement with the investment bankers – that a fee would be paid if a merger took place. Under the fee arrangement, the investment bankers would receive a quarterly fee for their services, and an additional fee upon completion of certain specified transactions. Specifically, the retainer agreements provided that the fees for such services were: (1) $500,000 in cash payable upon execution of the agreement; (2) if at least 50 percent of the fully diluted voting power of Staley were acquired, an additional fee of 0.40 percent of the aggregate value of all such transactions; (3) if Staley effected a recapitalization, an additional fee of 0.40 percent of the value of the recapitalization; and (4) additional quarterly fees of $500,000 for the next four years if no fees were paid under (2) or (3).

In March 1987, Staley began implementing some defensive strategies to avoid a hostile takeover. One of these measures involved finding a “white knight” investor. Staley originally believed that Tate & Lyle, which was in a similar line of business to Staley’s main business, could be a part of this defense strategy. Staley approached Tate & Lyle to discuss Tate & Lyle’s possible acquisition of 20 percent of Staley’s stock. Tate & Lyle subsequently began purchasing Staley’s stock on the open market, presumably as a white knight. However, Tate & Lyle’s intent quickly changed. In June 1987, Tate & Lyle refused to sign a standstill agreement, openly evidencing their intent to become a hostile acquirer, and filed papers with the SEC indicating its intent to acquire 25 percent of Staley’s stock. In April 1988, Tate & Lyle made a public tender offer to Staley’s shareholders, without the knowledge or approval of Staley’s board. Tate & Lyle made it clear that they intended to break up Staley and change Staley’s business strategy.

After Tate & Lyle made its tender offer, Staley engaged the investment bankers to evaluate the offer. The investment bankers concluded that the price was below market and Staley’s board advised the shareholders to reject the offer. In addition, the investment bankers considered several defensive strategies. Among the defense strategies considered by the investment bankers were an outright sale of Staley, the sale of a division, a recapitalization, a stock placement, a leveraged buy-out, a spin-off, a stock offering and an offer to acquire Tate & Lyle; however none of these strategies was fruitful. The investment bankers ultimately advised Staley’s board that they would not be able to defeat the takeover after Tate & Lyle revised its offering to a fair price.
Staley incurred substantial investment banking costs as well as other related costs that it deducted on its federal tax return. The IRS disallowed the deduction, and suit was filed in Tax Court. The Tax Court held that the expenses were capital in nature and could not be deducted. Staley appealed the Tax Court decision, and the Seventh Circuit reversed.

Staley deducted the investment bankers fees and other related costs as the ordinary and necessary expenses of defending its operations under section 162, or alternatively as losses under section 165. Because the takeover was hostile, Staley argued that its case was distinguishable from Indopco, which involved a friendly takeover. However, the IRS argued that all the investment banker fees should be capitalized under section 263 because: (1) the fees paid to the investment bankers related to a completed capital transaction; and (2) the takeover was not hostile because Staley’s board was merely exercising its fiduciary obligation to the shareholders by securing the highest dollar value for its shares.

On May 24, 1994, Judge Mary Ann Cohen, the trial judge, ruled from the bench that Staley had made a prima facie case for deducting a portion of the expenses. Judge Cohen’s statement indicated that the Tax Court would either require bifurcation or allow a full deduction. Judge Halpern, however, rendering the decision for the court, held that all the expenses had to be capitalized. Following Indopco, Judge Halpern stated that the fees were made in connection with an ownership change which had extended consequences for Staley’s operations, and were capital in nature. Under the “origin of the claim” test, the Tax Court reasoned that these expenses arose in connection with a capital transaction that changed the corporate structure. Because the acquisition affected Staley for the indefinite future, Indopco required capitalization. In addition, the Tax Court believed that the hostile nature of the takeover did not distinguish this case from Indopco. The Tax Court implied that because Staley’s board recommended acceptance of Tate & Lyle’s offer, it must have determined that the offer was in the best interests of the corporation.

The Tax Court also rejected Staley’s section 165 argument, holding that in order for section 165 to apply, a taxpayer must be able to allocate fees to separate and distinct proposals that were abandoned. The Tax Court concluded that it could not allocate the fees to separate and distinct proposals under Staley’s fee arrangement with the investment bankers.

The Seventh Circuit reversed and remanded the Tax Court decision. It first addressed the deductibility of the fees under section 162, noting the “well worn notion that expenses incurred in defending a business and its policies from attack are necessary and ordinary - and deductible - business expenses.” The court stated that the line of cases supporting the costs of defending an established business was “neither abrogated nor even addressed by Indopco.” The Seventh Circuit went on to state that the Indopco holding “was unremarkable; indeed, the Court was merely reaffirming settled law that costs incurred to facilitate capital transactions are capital costs.”

In analyzing the applicability of section 162, the court stated that it must be determined whether the costs incurred by Staley are more properly viewed as costs associated with defending a business, or as costs associated with facilitating a capital transaction. The Seventh Circuit felt that the costs incurred by Staley were costs associated with defending against the takeover in an effort to maintain the status quo. It stated that it is
the nature of the services performed by the investment bankers that determines the proper tax treatment. According to the court, none of the defensive strategies considered by the investment bankers served to facilitate the acquisition. Rather, most of the services rendered by the investment bankers consisted of failed attempts to engage in alternative transactions.

The Seventh Circuit also addressed the treatment of the investment bankers' fees as costs associated with abandoned capital transactions under section 165. Because Staley considered a number of capital transactions that were never implemented, the Seventh Circuit held that the fees paid to the investment bankers in connection with these transactions were deductible as abandonment losses under section 165. As previously noted, the IRS argued that, because Staley's fee arrangement provided that the investment bankers would be paid whether the hostile acquisition or some other acquisition occurred, the fees related solely to Staley's acquisition by Tate & Lyle. The Seventh Circuit rejected this argument, stating that while the form of the fee arrangement was relevant, the substance of the transaction controls. The court concluded that the bulk of the costs at issue were related to Staley's defense of it business and corporate policy, and were therefore deductible under section 162. In the alternative, the court stated that those costs properly allocable to efforts to engage in alternative transactions were deductible under section 165.

According to the Seventh Circuit, the costs should be allocated based on the nature of the services provided. Only the fees associated with the evaluation of Staley's stock and the few hours of facilitative work performed by the investment bankers at the time of the acquisition by Tate & Lyle must be capitalized. The balance of the fees were related to services to defend the status quo or to seek alternative transactions that were later abandoned, which were deductible under section 162 or section 165. The Seventh Circuit then remanded the case to the Tax Court to allocate the fees, noting that given Staley's fee structure, allocation may be difficult.

[ii] Costs Associated with a White Knight

In Federated Dept. Stores, 92-1 USTC ¶50,097 (B.C., S.D. Ohio 1992), aff'd, 94-2 USTC ¶50,430 (S.D. Ohio 1994), in which two bankrupt taxpayers' cases were consolidated, expenses incurred in connection with failed attempts to prevent a hostile takeover of each taxpayer by Campeau Corporation were held to be deductible. Each taxpayer agreed to pay a White Knight certain fees if the White Knight's attempted friendly acquisition failed. The expenses were called "break up" fees, including a $1.00 per share fee for each share purchased by the White Knight and all out-of-pocket costs of the White Knight if a friendly merger failed. The IRS was of the view that the fees were associated with the corporate restructuring since they were part of the Board's ongoing determination to obtain the greatest value for the shareholders. Distinguishing the lower courts' decisions in Indopco, the Bankruptcy Court said that the attempted friendly mergers with the friendly acquirers never materialized and the later hostile takeovers resulted in the very antithesis of long-term future benefits. Thus, the fees were deductible under section 162. The Court analogized the fees to costs incurred to defend a business against attack. Furthermore, the Bankruptcy Court found that the break-up fees constituted deductible abandonment losses under section 165 since the fee expenses were not compensated by insurance or otherwise and did not result in future benefits.
The IRS appealed the Bankruptcy Court's decision, which was rendered several weeks before the United States Supreme Court issued its decision in Indopco. On appeal, the IRS asserted that Indopco required the Bankruptcy Court's decision to be overturned. The District Court for the Southern District of Ohio, however, disagreed. The District Court found that the subject hostile takeovers could not, and did not, provide the taxpayers with the type of synergy found in Indopco. In Indopco, National Starch (target) was the supplier of Unilever (acquirer). The Tax Court and the Third Circuit Court of Appeals found that the synergy created by National Starch's newly acquired access to Unilever's resources and distribution network would provide significant long-term benefits. \[\text{Indopco, 112 S. Ct. at 1045.}\]

By contrast, the District Court said that such synergy was not created in the takeover of the taxpayers by Campeau. Both of the taxpayers were large department store chains. Campeau was inexperienced in the retailing field. Thus, the court concluded that no synergy resulted from the merger of two companies with wholly unrelated business operations. The District Court agreed with the IRS that expenditures incurred to change a corporation's structure must be capitalized. See General Bancshares Corp. v. Comm'r, 326 F.2d 712, 715 (8th Cir.), cert. denied, 379 U.S. 832 (1964). It noted, however, that in Federated the break-up fees were not incurred to restructure the corporation in hopes of some future benefit. The Bankruptcy Court specifically found that the "taxpayers engaged in protracted and strenuous defensive tactics when faced, involuntarily, with the threat of Campeau's hostile acquisition."

The District Court agreed with the IRS that expenditures incurred to change a corporation's structure must be capitalized. See General Bancshares Corp. v. Comm'r, 326 F.2d 712, 715 (8th Cir.), cert. denied, 379 U.S. 832 (1964). It noted, however, that in Federated the break-up fees were not incurred to restructure the corporation in hopes of some future benefit. The Bankruptcy Court specifically found that the "taxpayers engaged in protracted and strenuous defensive tactics when faced, involuntarily, with the threat of Campeau's hostile acquisition."

The Federated case raises a number of questions. First, it is unclear why the Bankruptcy Court and the District Court addressed whether the hostile takeovers resulted in long-term benefits to the taxpayers. Each failed White Knight defense measure seems to be separate and distinct from the ultimate hostile takeover. The White Knight defense costs were incurred to prevent the takeover (i.e., to maintain the status quo) and should not be considered a part of the hostile takeover transaction. Second, this case implicitly raises the question as to how expenses incurred after it is determined that a hostile takeover will be successful are to be treated. In this regard, it may be that the expenses should be bifurcated, i.e., expenses incurred to fight the takeover are deductible and expenses incurred after it became clear that the takeover would be successful must be capitalized because they relate to the corporation's operations' and betterment in the indefinite future. However, this bifurcation approach may not be required under Federated — especially where the Board resists the takeover to the bitter end and there are no perceived long-term benefits from the hostile takeover.

[iii] \[\text{Redemptions of Stock}\]
In order to prevent a hostile takeover, a target corporation may offer to purchase the acquiring corporation's stock at a premium. This is often referred to as "greenmail." Section 162(k) was enacted as part of the 1986 Tax Reform Act to prevent corporate-level deductions for so-called "greenmail" payments — payments to redeem stock held by hostile shareholders. Prior to this change, taxpayers were relying on Five Star Mfg. v. Commissioner, 355 F.2d 724 (5th Cir. 1966). In that case, in order to have a license reinstated a corporation had to redeem one shareholders' stock. The court held that the payment to redeem the shareholder was deductible because it was necessary to the business of the corporation. Contrary authority, however, existed. See, e.g., Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974).

Section 162(k) was ultimately enacted to provide generally that no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption of its stock. Exceptions were made for any deduction allowable under section 163 (relating to interest), deduction for dividends paid (within the meaning of section 561), and any amount paid or incurred in connection with the redemption of any stock in a regulated investment company that issues only stock that is redeemable upon the demand of the shareholder.

In 1995, Congress amended section 162(k) to clarify that redemption expenses properly allocable to debt and properly deductible over the term of the loan are not subject to section 162(k). This provision is effective as if included in the 1986 Act. A second part of this provision expanded the scope of section 162(k) to any amounts paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person as defined in section 465(b)(3)(C). This provision is effective for amounts paid or incurred after September 13, 1995. Thus, for example, the denial of a deduction applies to any reacquisition (i.e., any transaction that is in effect an acquisition of previously outstanding stock) regardless of whether the transaction (1) is treated as a redemption, (2) is treated as a sale of the stock or as a dividend, or (3) is a reorganization or other transaction.

These amendments to section 162(k) settled a dispute between two divergent lines of authority as to whether loan fees paid to obtain funds to effect a redemption were deductible under section 162(k). Generally, loan fees are amortized over the period of the loan, irrespective of the life of the property purchased with the proceeds of the loan. See, e.g., Enoch v. Commissioner, 57 T.C. 781, 799-95 (1972) acq. on this issue, 1974-1 C.B. 1; Plaza Investment Co. v. Commissioner, 5 T.C. 1295 (1945).

In Kroy v. Commissioner, 27 F.3d 367 (9th Cir. 1994), the Ninth Circuit held that the loan fees paid to effect a leveraged buy-out were amortizable and not capitalizable under section 162(k), stating that the leveraged buyout should be divided into two separate and distinct steps — a borrowing transaction and a stock redemption. However, the Tax Court disagreed with the Ninth Circuit decision in Kroy. In Fort Howard Corporation v. Commissioner, 103 T.C. 345 (1994), rev'd, 107 T.C. 187 (1996), the Tax Court originally held that numerous costs incurred by the taxpayer in obtaining debt financing used to complete a leveraged buyout were not deductible under section 162(k); however, because of the 1996 amendment to Section 162(k), which were effective as if originally enacted, the Tax Court, upon a joint petition by both parties, reconsidered its earlier opinion and held that the costs were deductible.
Pac-Man Defense

In 1991, the IRS issued a position paper indicating that expenses incurred in a "Pac-Man" defense — a target acquires an acquirer pursuant to a counter offer — must be capitalized if successful. In essence, they are costs of acquiring the stock.

Poison Pills

Similarly, the IRS's LBO ISP, indicates that expenses associated with poison pills — rights issued to existing shareholders to buy stock at below market prices if a corporate raider obtains a certain amount of stock — must be capitalized.

Abandoned Transactions

a. Section 165.

In general, costs incurred in connection with a capital transaction that is ultimately abandoned may be deducted under section 165. See Staley, supra; Ellis Banking, 688 F.2d 1376 (11th Cir. 1982); Doernbecher Mfg. Co. v. Commissioner, 30 B.T.A. 973 (1934); Rev. Rul. 73-580, 1973-2 C.B. 86; Rev. Rul. 67-125, 1967-1 C.B. 21. However, the Service appears to draw a distinction between multiple separate and distinct transactions and multiple alternatives to the same transaction. In TAM 9402004, the IRS addressed when costs associated with a failed friendly acquisition of a taxpayer have to be capitalized to a subsequent successful friendly acquisition of the taxpayer. The taxpayer decided to sell its business and identified potential buyers. The taxpayer incurred professional fees (legal, accounting, financial advice) in locating seven potential merger prospects and negotiating with them. The taxpayer eventually merged with one of the companies and deducted, as an abandonment loss, 6/7ths of the professional fees incurred as part of the merger negotiations. The National Office ruled that the portion of taxpayer's professional fees related to the abandoned merger transactions were not deductible. Rather, all of the costs were part of a single plan, the ultimate merger. The IRS noted that the case law allows a deduction upon the abandonment of a merger even though the taxpayer subsequently merges in a similar transaction, provided the subsequent transaction is independent of the first. However, an abandonment loss is not allowable for proposals that are mutually exclusive alternative methods of reaching the desired goal. The IRS found that the taxpayer was not pursuing seven separate and distinct plans all of which could have been completed. Rather, finding seven potential acquirers was part of the effort to accomplish a single transaction. The IRS based this conclusion, in part, on the investment advisor's method of being compensated. Its compensation was based on the total price obtained by the taxpayer.

The ruling involved the additional issue of whether taxpayer had to capitalize to the merger transaction its costs of obtaining a five-year insurance policy for its officers. Under the merger agreement, the taxpayer was required to buy before the merger five years of insurance for its officers, rather than the one year of insurance it normally purchased. The insurance did not cover any acts following the merger. The prepaid insurance
arrangement led to a reduction in the price of taxpayer’s stock. Citing Indopco, the field office argued that the insurance payments had to be capitalized to the merger because the origin of the payments was the merger. The National Office disagreed, reasoning that the payments held their origin in taxpayer’s normal business operation.

This TAM raises the question whether, the taxpayer could have deducted a portion of its expenses if the costs were bifurcated and associated with each specific proposed transaction, rather than deducted as 6/7ths of total plan. For example, in TAM 9402004, if the taxpayer had used a different investment banker for each deal, the IRS may have treated each transaction as separate.

b. Section 162.

Costs incurred in connection with abandoned capital transactions may also be deducted under section 162. For example, in Staley the court stated that certain defensive strategies adopted by the target corporation which were ultimately abandoned could be deducted under section 162 as business protection costs. See also, Sibly, Lindsay & Cur, Co. v. Commissioner, 15 T.C., 106 (1950)(expenses attributable to abandoned reorganizations are deductible).


[a] In General

As discussed above, the Staley case addressed the deductibility of investment bankers' fees in the context of a hostile takeover that was ultimately successful. It was unclear, however, whether the bifurcation analysis set forth in Staley applies outside the hostile takeover scenario. A strong argument could be made that the bifurcation approach enunciated in Staley is not limited to the hostile takeover context, but instead represents a broad general principle to be applied in determining the deductibility of all acquisitions costs, including those incurred in a friendly acquisition. Indeed, as is made clear by the Seventh Circuit, it was not applying a new or novel analysis in making this determination. Rather, the Seventh Circuit viewed as well-established the determination that treatment of costs should be based on the nature of services provided, citing Honodel v. Commissioner, 76 T.C. 351 (1981). See also, Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Gilmore, 372 U.S. 39 (1963); Deputy v. DuPont, 308 U.S. 488 (1940).

The IRS has applied a bifurcation approach outside the context of a hostile takeover. In TAM 9641001, the IRS bifurcated investment banker fees incurred in connection with a consent solicitation and debt tender offer. The IRS held that the fees associated with the tender offer could be deducted and the fees associated with the consent solicitation must be capitalized. The recent release of Rev. Rul. 99-23, I.R.B. 1999-20, however, makes it clear that costs incurred in the expansion of a business or the start-up of a business could be bifurcated between investigatory costs, which are deductible under section 162 or amortizable under
section 195, and facilitative costs, which must be capitalized. The ruling examines three factual situations, none of which are in the context of a hostile takeover.

[b] Target Corporation's Expenses

[i] Norwest Corporation v. Commissioner

After the Indopco decision, there appeared very little to discuss regarding the deductibility of takeover costs incurred where a target corporation's board willingly approves a takeover. However, the Tax Court recently addressed the issue in Norwest Corporation v. Commissioner, 112 T.C. No. 9 (March 8, 1999). In Norwest, the Tax Court held that expenses incurred by a target corporation in connection with its acquisition by the acquiror, Norwest, were not deductible as investigatory costs incurred in a business expansion under Sec. 162. Under the facts of Norwest, target was consolidated with a subsidiary of the acquiror (the acquisition subsidiary). After the transaction, the acquisition subsidiary changed its name. The shareholders of the target received acquiror's stock in exchange for their stock in the target.

In connection with its acquisition by the acquiror, target incurred the following expenses which were at issue: (1) legal fees relating to due diligence services; (2) legal fees relating to investigating whether acquiror's director and officer liability coverage would cover target's directors and officers following the transaction; and (3) internal costs for salaries paid to employees attributable to services performed in connection with the acquisition. With respect to legal fees, the taxpayer argued that only the portion relating to due diligence services performed prior to the date the Board of Director's approved the transaction was deductible. The taxpayer argued that the expenses at issue were deductible under Sec. 162 because they were incurred primarily for investigatory and due diligence services related to the expansion of its business, citing Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2nd Cir. 1973) rev'g T.C. Memo. 1972-43, and NCNB Corp. v. United States, supra. The taxpayer also argued that Sec. 195 supported the deductibility of these costs as well.

The Tax Court rejected the taxpayer's arguments and held that the expenses at issue must be capitalized because they were sufficiently related to an event that produced a long-term benefit. The Tax Court stated "[a]lthough the costs were not incurred as direct costs of facilitating the event that produced the long-term benefit, the costs were essential to the achievement of that benefit." With respect to the taxpayer's reliance on Briarcliff Candy and NCNB, the Tax Court reasoned that the Supreme Court's decision in Indopco "displaced Briarcliff Candy and its progeny insofar as they allowed the deductibility of investigatory costs similar to that at hand, i.e., where an expenditure does not create a separate and distinct asset." Further, the Tax Court found that Sec. 195 did not support the deductibility of the costs at issue.

The facts of Norwest are essentially identical to the facts of Indopco, which addressed the deductibility of acquisition costs incurred by the target. In particular, the target's Board viewed the transaction as beneficial because it enabled target to become "part of a larger and more diversified financial institution that offers local, national and international resources." These are the same type of synergies that the Supreme Court focused on in
Indopco. Because of the factual similarities to Indopco, the holding of the Norwest decision is not surprising.

It is doubtful whether a target that is simply looking to be acquired would ever be viewed as expanding its business, as the taxpayer argued in Norwest. (Note, that in Norwest, the target never discussed joining or expanding with any other entity.) After the Indopco decision and the recent Norwest decision, there seems to be very little to discuss regarding the deductibility of takeover costs incurred where a target corporation’s board willingly approves a takeover. However, there may be a few remaining issues, which are discussed below.

[ii] Victory Markets v. Commissioner

In Victory Markets, Inc. v. Commissioner, 99 T.C. No. 34 (Dec. 23, 1992), the court considered whether a takeover approved by the Board was nevertheless a hostile takeover not producing any long-term benefits. The taxpayer argued that its Board of Directors did not anticipate nor did the taxpayer obtain any long-term benefit from the takeover. The Board approved the takeover only because of its duty to the taxpayer’s shareholders. The court found that the Board’s action did not indicate that the offer was hostile. The Board owed a duty of care to both the corporation and shareholder. In approving the offer, the Board must have determined that the takeover was in the best interest of both. In addition, the Court stated that the very same reasons for capitalization stated in Indopco were applicable in Victory Markets. Because the Tax Court found that the takeover was in fact friendly, it did not address whether a distinction should be drawn between hostile and friendly takeovers.

[iii] Payments to Terminate Unexercised Stock Options

a. In General

In TAM 9438001, the IRS ruled that a target corporation could deduct amounts the acquirer paid, as part of the tender offer for target’s shares, for incentive stock options, nonstatutory stock options, and stock appreciation rights previously granted to various employees and directors of target. The ruling states that although the payment made by the acquirer does constitute a capital expenditure for the acquirer, the compensation liability the payment discharged was one that existed with respect to the target prior to the tender offer. Under Rev. Rul. 73-146, 1973-1 C.B. 61, amounts paid by target to satisfy compensation obligations of a corporation existing before a reorganization are deductible and do not have to be capitalized to the reorganization. In reaching its conclusion, the ruling relied on principles established prior to Indopco making no mention of the Indopco decision. Thus, at least in this area, it seems that certain members of the IRS do not feel that Indopco requires the IRS to take a more aggressive stance with regard to capitalization.

b. Premium Payments to Terminate Unexercised Options
Target corporations may make payments to employees to terminate unexercised stock options that are in excess of the amount that would have normally been paid in the absence of the acquisition. In PLR 95440003 (June 30, 1995), the Service held that such premium payments are substantially the same as payments that were held to be deductible in Rev. Rul. 73-146.

[iv] **Golden Parachutes**

In TAM 9326001, the stock of a target corporation was acquired in a taxable purchase by a second corporation. As an incident of the acquisition, in order to provide adequate incentive for its officers and directors to remain with target, the target corporation renegotiated its officer’s employment contracts and directors’ retirement plan — both of which provided for a lump-sum payment if an officer or director left the employ of company within a certain period after an ownership change. Under the new agreements, target made lump-sum payments to its officers and directors and deducted the payments as compensation under section 162. However, according to the IRS agent, the expenditures had to be capitalized because they contributed to and originated from the creation of an intangible asset with long-term benefit — the altered corporate structure. However, the National Office disagreed. The TAM cited the Supreme Court’s language in *Indopco* that “deductions are exceptions to the norm of capitalization,” but went on to find that the payments were deductible (assuming reasonableness) because their origin or basis related to pre-existing employment relationships.

The TAM’s holding hinged on the fact that the payments were made pursuant to long-standing employment agreements or retirement plans that had been in effect before the acquisition (though they were modified subsequent to the acquisition). The payments did not have their basis in the purchase. That is, the costs were not incurred to satisfy a new obligation generated by reorganization itself. The IRS acquisition was the basis for the lump-sum payments. As such, the payments satisfied the criteria of section 162, notwithstanding the intervening acquisition.

[c] **Acquiring Corporation’s Expenses**

[i] **In General**

Although the facts of *Indopco* and *Saley* dealt only with the expenses of target corporations, similar principles apply to the costs of an acquiring corporation. Specifically, as made clear in the recent release of Rev. Rul. 99-23, the analysis in *Saley*, which focuses on the nature of the services provided, should apply in determining whether the costs incurred by an acquiring corporation are deductible or must be capitalized.

[ii] **Bifurcation of Cost Between Investigatory and Facilitative**

In the friendly acquisition context, the costs incurred may be bifurcated between those that are “investigatory” and, thus, deductible under section 162 as a business expansion cost or amortizable under section 195 as a start-up cost, or “facilitative” and, thus,
capitalizable under section 263. Throughout the past two years, IRS has released guidance on its position addressing when costs are "investigatory" and become "facilitative."

a. **TAM 9825005**

In TAM 9825005, the IRS ruled that investigatory costs incurred to acquire a bank are not amortizable as start-up expenditures under Sec. 195 of the Internal Revenue Code once a taxpayer has decided to try to acquire a business. According to the TAM, the taxpayer incurred salary expenses and travel, meal, and accommodation expenses in connection with having employees review property files, loan files, credit files, and trust files of the bank. Taxpayer also incurred legal expenses associated with negotiations and drafting applications to federal regulators; merger and acquisition department expenses associated with modeling; accounting expenses associated with financial statement reviews; and expenses for due diligence. The taxpayer represented that these investigatory expenditures were incurred prior to its final decision to acquire the bank.

It appears that in deciding that these expenditures are not amortizable under section 195, the IRS looked at whether the expenditure was "allowable as a deduction" under section 195(c)(1)(B). In applying the "allowable as a deduction test" the IRS said the test is applied by assuming the expenses described in section 195(c)(1)(A) were paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in section 195(c)(1)(A)). However, the IRS stated that the assumption must be applied in the same context in which the expenses were actually paid or incurred. Thus, section 195(c)(1)(B) must be applied to the case at hand by assuming the same investigatory expenditures were incurred in connection with an acquisition that occurred in the operation of an existing active banking business.

The IRS stated that the purpose of this provision is to limit amortization to those expenditures that otherwise would not be deductible solely because the taxpayer did not meet the "carrying on" requirement of section 162 (i.e., because the expenses were incurred prior to the commencement of business operations). If an expenditure is not deductible because it would be a capital expenditure if incurred in the operation of an existing trade or business, the expenditure does not qualify for amortization under section 195. That is, section 195 does not override section 263. See, e.g., sections 161, 261. Thus, to determine whether a taxpayer's investigatory expenditures are otherwise "allowable as a deduction", and therefore eligible for section 195 treatment, the proper characterization of these expenditures as either ordinary or capital in nature must be made under sections 162 and 263.

In characterizing the expenditures, the IRS concluded that once a taxpayer has made a decision to acquire a specific business, all costs incurred in an attempt to acquire the business must be capitalized. The IRS stated that it is not necessary that a legally binding obligation to acquire the business exist at the time of the expenditure before the expenditure is treated as capital in nature. The IRS determined that the activities of the taxpayer had gone beyond a general search or preliminary investigation and the taxpayer had, in fact, decided to acquire the bank. Thus, the expenditures at issue were capital expenditures that would not be allowable as a current deduction if paid or incurred in connection with an
existing active trade or business in the same field as the acquired business. Accordingly, the IRS held that expenditures do not meet the requirement for start-up expenditures under section 195(c)(1)(B) of the Code.

In the TAM 9825005, the IRS equates the definition of nondeductible preopening expenses set forth in Rev. Rul. 77-254 with the term “investigatory expenses” as used in section 195. In Rev. Rul. 77-254, the IRS explains that expenses incurred in the course of a general search for, or preliminary investigation of, a business or investment include those expenses related to the decisions whether to enter a transaction and which transaction to enter. Once the taxpayer has focused on the acquisition of a specific business or investment, expenses that are related to an attempt to acquire such business or investment are capital in nature. However, in connection with the enactment of section 195, Congress specifically set forth a definition of “investigatory costs” that is, “costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business.” Therefore, to the extent that Rev. Rul. 77-254 can be said to provide a definition of “investigatory expenses” that is different from that set forth in the legislative history, its continuing viability as authority is questionable.

b. TAM 199901004

Several months after the release of TAM 9825005, the IRS issued another TAM addressing the deductibility of acquisition costs, TAM 199901004. In TAM 199901004, the IRS ruled that acquisition costs incurred after the signing of a letter of intent are not amortizable under section 195. Instead, IRS has held that these costs must be capitalized under section 263. This TAM is distinguishable from TAM 9825005 in that IRS has used the letter of intent as the turning point for determining when the costs are no longer investigatory in nature.

In TAM 199901004, an entity submitted a letter of intent to purchase a corporation. Pursuant to the terms of the letter of intent, all negotiations with other potential buyers were terminated following the acceptance of the letter of intent. The entity engaged in additional “investigatory activities” from the time the letter of intent was entered and up until the time the final agreement to purchase the corporation was ratified. These “investigatory activities” included additional due diligence that was performed by internal employees, a law firm, and an accounting firm.

The IRS rejected the taxpayers contention that all investigatory costs incurred before a “final decision”, i.e., before the taxpayer was legally obligated to acquire the corporation, are amortizable under section 195. The IRS stated the reference to the term “final decision” in the legislative history describes the point in which the taxpayer makes its own decision to acquire a specific business. In this analysis, the IRS failed to consider key legislative history, which states that investigatory expenses may be of a general or specific nature. The former are related either to businesses generally or to a category of businesses; and “the latter are related to a particular business” (Emphasis added).

In the TAM, IRS found that the submission of the non-binding letter of intent was the manifest point when the taxpayer decided “whether” and “which”
corporation to purchase. The IRS concluded that once a taxpayer has gone beyond a general search or preliminary investigation and made the "whether and which" determinations, all costs incurred in an attempt to acquire the business must be capitalized. In making its determination, IRS used an analysis similar to that in TAM 9825005 (i.e. whether the expenditure was "allowable as a deduction" under section 195(c)(1)(B)). Relying on this analysis, the IRS concludes that investigatory costs only include expenses incurred in the course of a general search for or preliminary investigation of a business or investment.

TAM 199901004 appears to relax the time for determining when costs become facilitative used in TAM 9825005. However, when considering the definition of "investigatory expense" set forth in the legislative history, its continuing viability as authority is also questionable.

c. **FSA 1998-438**

In contrast to the above TAMs is FSA 1998-438 (November 5, 1993), which was released in late 1998. In FSA 1998-438, the Parent corporation made a tender offer for shares of the Target corporation, as part of the acquisition of the Target corporation by the Taxpayer. Once the Parent corporation acquired a majority of the shares of the Target corporation, then the Target Corporation would be merged into a newly formed Acquisition subsidiary formed by the Taxpayer and the stock held by the Parent corporation would be cashed out. The Taxpayer incurred expenses related to both the tender offer and merger. The tender offer was partially financed with loans by the Taxpayer and the Target corporation was ultimately liable for the debt.

On the Taxpayer's consolidated return it elected to amortize investigatory and organizational expenditures incurred for the acquisition and merger under sections 195 and 248 respectively. The "investigatory expenses" were incurred by various law firms, investment bankers, and other financial/investment services for due diligence work in connection with the investigation of the proposed acquisition. The expenses were principally related to an investigation of the Target corporation with a view to an acquisition that would be part stock purchase and part redemption. The IRS stated that the investigatory and due diligence expenses are amortizable expenditures under section 195 until the final decision to make an acquisition is made. The point at which a final decision is made is dependent upon the facts and circumstances of the transaction. Based upon the facts available, the IRS determined that the final decision to make the acquisition was made when the Board of Directors approved the transaction.

This FSA appears consistent with the legislative history underlying section 195 and case law (i.e., that expenses incurred prior to a final decision to acquire a business are "investigatory"). As such, these costs are amortizable under section 195 or deductible as business expansion costs under section 162.
d. **Rev. Rul. 99-23**

The most recent guidance issued by the IRS on the treatment of investigatory costs of acquiring a business is Rev. Rul. 99-23. In the revenue ruling, the IRS appears to have departed from a more restrictive approach that was applied in the prior TAMs. Instead, the revenue ruling sets forth a facts and circumstances test for determining whether costs are incurred before a final decision has been made to acquire a business, and therefore are investigatory, or were incurred after the decision has been made, and therefore are facilitative.

The revenue ruling makes clear that the IRS views the "final decision" referred to in the legislative history of section 195 as the point at which a taxpayer makes its decision *whether* to acquire a business, and *which* business to acquire, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction. The revenue ruling states:

Accordingly, expenditures incurred in the course of a general search for, or an investigation of, an active trade or business, *i.e.*, expenditures paid or incurred in order to determine *whether* to enter a new business and *which* new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation), are investigatory costs that are start-up expenditures under §195. Alternatively, costs incurred in the attempt to acquire a specific business are capital in nature and thus, are not start-up expenditures under §195. The nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the *whether* and *which* decisions, or an acquisition cost incurred to facilitate consummation of the acquisition. The label that the parties use to describe the cost and the point in time at which the cost is incurred do not necessarily determine the nature of the cost.

Although this test includes an analysis of the nature of the services provided, the revenue ruling does not provide any guidance as to what facts and circumstances constitute the making of a decision. In the three factual situations examined, the IRS simply concluded that a decision was made. The test set forth in the revenue ruling is similar to the facts and circumstances test the IRS applied in FSA 1998-438, in which the IRS concluded the date a decision was made was the date of the board of director's approval.

In the first situation presented in Rev. Rul. 99-23, the corporation hires an investment banker in April 1998 to evaluate the possibility of acquiring an unrelated trade or business. The investment banker investigates several industries, but eventually narrows its focus to one industry. After evaluating several businesses within the industry, the banker decides to commission an appraisal of one business's assets, as well as an in-depth review of its books and records, to establish a fair purchase price. On November 1, 1998, the
corporation enters into an acquisition agreement to purchase all of the target's assets. Before executing the acquisition agreement, the corporation didn't enter into a letter of intent.

Applying the rules laid out in the revenue ruling, the IRS concludes in this example that the costs incurred prior to the time the corporation made its final decision, i.e., whether to acquire a business and which business to acquire, are investigatory costs. Thus, costs incurred to conduct industry research and evaluate publicly available financial information prior to the time the final decision was made are investigatory costs. Costs relating to the appraisals of the target's assets and the review of its books, however, are capital in nature, and therefore, are required to be capitalized.

In the second scenario, the corporation begins searching for a trade or business to acquire in May 1998. The corporation hires an investment banker to evaluate three potential businesses and a law firm begins drafting regulatory approval documents in anticipation that a suitable target will be found. Eventually, the corporation decides to purchase another corporation's assets and the two sign an acquisition agreement on December 1, 1998. In this scenario IRS concludes that costs incurred to evaluate potential businesses that related to the "whether" and "which" decision, i.e., the final decision, are investigatory costs. The costs incurred to draft regulatory approval documents before the acquiring corporation decided to purchase the target, however, were not. The IRS pointed out that even if those activities occurred while the acquiring corporation was engaged in a general search for a business, the costs would still have to be capitalized because the costs are capital in nature.

Finally, in the third scenario, the corporation hires a law firm and an accounting firm to perform certain "preliminary due diligence," including researching the potential target's industry and analyzing the target's financial projections for 1998 and 1999. In September, 1998, at the acquiring corporation's request, the law firm submits a letter of intent to the target stating that a binding commitment to proceed with the proposed transaction would result only when the parties executed an acquisition agreement. After submitting the letter, both the law firm and the accounting firm continue to assist the corporation in performing due diligence. On October 10, 1998, the corporation entered into an acquisition agreement with target.

In this scenario, IRS concludes that the costs incurred prior to the time the corporation made a decision to acquire the target, which was "around the time" the corporation instructed the law firm to prepare and submit the letter of intent, were investigatory. Any costs incurred after that point relate to the attempt to acquire the business and therefore must be capitalized. This example is significant in that the analysis indicates that the "final decision" was made "around the time" the taxpayer instructed the law firm to submit a letter of intent. Thus, it is clear from this example that the final decision was not the letter of intent, but rather that the final decision occurred in and around the time the letter of intent was submitted.

[iii] Applying Norwest to Acquiring Corporations

As discussed above, because the costs at issue were incurred by a target corporation, the holding in Norwest is not surprising. However, the Tax Court's decision in
Norwest did not clearly rest on the fact that the expenses were that of a target company, raising concerns that the IRS might extend the rationale of Norwest to an acquiring company. As discussed below, there are significant arguments to be made against such an extension. In addition, Rev. Rul. 99-23, supra, which was issued after the Norwest decision, makes it clear that the IRS National Office will not apply the Norwest rationale to acquiring corporations.

Norwest should not preclude an acquiring corporation from deducting investigatory costs attributable to acquiring a target corporation for several reasons. First, the Norwest case deals with the deductibility of a target corporation's investigatory costs, and not the deductibility of investigatory costs incurred by an acquiring corporation. As a result, Norwest should not be interpreted as concluding that Briarcliff Candy and NCNB cannot be relied on as authority after Indopco by an acquiring corporation. The Tax Court specifically stated that Indopco replaced those cases only "insofar as they allowed investigatory costs similar to that at hand." Arguably, the Tax Court was rejecting the application of those cases to situations involving a target corporation's costs where, like in Indopco, the costs did not create a separate and distinct asset, but did create substantial future benefit.

Second, Norwest only focuses on the "separate and distinct" asset aspect of the Briarcliff Candy and NCNB cases. The court did not address the holding in Briarcliff Candy and NCNB that investigatory expenses were deductible under Sec. 162 as costs incurred to protect the income and competitiveness of the taxpayer's business. The Seventh Circuit, in A.E. Staley, specifically noted that the business protection aspect of those cases was not abrogated or even addressed in Indopco. Thus, A.E. Staley reconfirmed the conclusion that investigatory expenses incurred to protect the income and competitiveness of a taxpayer's business are deductible under Sec. 162.

Third, if the Tax Court's rationale in the Norwest case were applied to an acquiring corporation, it would effectively preclude the deductibility of any investigatory costs -- including costs, such as feasibility studies, which the legislative history to Sec. 195 specifically recognized as amortizable investigatory costs. Such an interpretation would, in effect, render Sec. 195 inapplicable to many of the expenses to which it was clearly intended to apply.

Lastly, recently released Rev. Rul. 99-23 allows taxpayers to bifurcate costs incurred between those that are "investigatory" and, thus, deductible under section 162 as a business expansion cost or amortizable under section 195 as a start-up cost, or "facilitative" and, thus, capitalizable under section 263. This ruling makes it clear that the IRS National Office will not argue that Norwest precludes the amortization, and implicitly the deduction, of investigatory expenses by an acquiring corporation.

[iv] Stock Acquisition Costs


In United States v. Hilton Hotels Corp., 397 U.S. 580 (1970), the Supreme Court ruled that litigation expenses incurred by an acquiring corporation in connection with the valuation of stock must be capitalized. The acquiring corporation hired a
consulting firm to prepare a study to determine a fair price for stock of a target corporation. The dissenting shareholders of the target corporation disagreed with the price determined by the consulting firm, and began appraisal proceedings following the merger of the acquiring corporation and the target corporation. The Supreme Court reasoned that because these expenses arose out of the acquisition of a capital asset, that is, the target corporation's stock, the expenses must be capitalized. See also, Woodward v. Commissioner, 397 U.S. 572 (1970).

b. **Ellis Banking Corp. v. Commissioner**

In Ellis Banking Corp. v. Commissioner, supra, the Eleventh Circuit held that accounting fees incurred by an acquiring corporation to investigate the financial condition of a target corporation in connection with the acquisition of the target corporation's stock must be capitalized. The court stated that "expenses of investigating a capital investment are properly allocable to that investment and must therefore be capitalized."

c. **Section 195**

The legislative history under section 195, relating to the amortization of "investigatory costs" incurred in connection with a start-up business, indicates that expenses incurred to acquire the stock of a target corporation are amortizable under section 195 where the corporation becomes a member of acquiring's consolidated group or a section 338 election is made. While the Ellis Banking decision was rendered after the enactment of section 195, the factual setting occurred prior to its enactment. Therefore, the logic of Ellis Banking appears to have been overruled by section 195. See and compare Lee A. Sheppard, News Analysis: Notes from the War Against Indopco, Tax Notes Today (January 20, 1998).

[v] **Severance Pay**

a. **Rev. Rul. 67-408.**

In Rev. Rul. 67-408, supra, the Service held that severance payments made by acquiring corporation to employees who were terminated as the result of a merger are deductible. Under the facts of this revenue ruling, in order to facilitate a merger with the target corporation, an acquiring corporation was obligated to pay severance payments due to certain agreements with railroad unions. The IRS ruled that the payments were deductible by the target corporation reasoning that the obligation to make the severance payments arose out of the pre-existing employment relationship between the target corporation and its employees.

b. **Rev. Rul. 94-77**

In Rev. Rul. 94-77, 1994-2 C.B. 19, the IRS held that Indopco does not affect the treatment of severance payments made by a taxpayer to its employees, as business expenses which are generally deductible under section 162 and Treas. Reg. § 1.162-10 of the regulations. Treas. Reg. § 1.162-10 specifically provides a reasonable allowance for
ordinary and necessary business expenses paid for dismissal wages. The revenue ruling states that the "Indopco decision clarifies that the creation or enhancement of a separate and distinct asset is not prerequisite to capitalization. That clarification does not, however, change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized." The ruling goes on to state that "although severance payments made by a taxpayer to its employees in connection with the business down-sizing may produce some future benefits, such as reducing operating costs and increasing operating efficiencies, these payments principally relate to previously rendered services of those employees." (emphasis added) Therefore, such severance payments are generally deductible. The ruling notes, however, that the "ruling does not address, and no inference is intended regarding, the federal income tax treatment of severance payments made as part of the acquisition of property (including a deemed acquisition of assets)." As discussed below, the IRS has since issued two technical advice memoranda that do, in fact, permit an immediate deduction for severance payments made in connection with a corporate acquisition.

The IRS' "principal relationship" analysis indicates that the IRS may well be moving towards adopting the "principal purpose" test for distinguishing ordinary expenditures from capital expenditures where expenditures produce benefits in both current and future years. That is, an expenditure is deductible and regarded as only producing an incidental future benefit if the principal purpose of the expenditure is to generate a current benefit (or the expenditure principally relates to a current benefit). The ruling's analysis is clearly correct and should produce more taxpayer favorable IRS conclusions in the capitalization area in the future.

c. TAMs 9721002 and 9731001

TAMs 9721002 and 9731001 provide a taxpayer-favorable result regarding the deductibility of severance payments in the section 338 area. In TAM 9721002, the IRS held that severance payments made by target following its acquisition in a section 338 transaction were deductible. TAM 9731001, also in the section 338 context, appears to go a step further. In that TAM, the target's policy was to pay one week of severance pay for every year worked by an employee. As part of an acquisition of the target, the acquiring corporation negotiated with target that target would pay two weeks of severance pay for every year worked as an incentive for employees to remain after the acquisition. The IRS held that additional severance payments were deductible because they had their origin in the post-acquisition employment relationship with the employees. The latter TAM cites Rev. Rul. 73-146, supra, where target's payments made in cancellation of stock options as a condition of the reorganization were held to be deductible. In the latter instance where the acquirer actually pays the severance payments, the acquirer should be treated as making a capital contribution to target followed by the target's payment of severance pay. See and compare TAM 9438001. The above TAMs seem to be an outgrowth of the positions taken in the LBO context, based on TAM 9527005. The employer in that TAM 9527005 became involved in an LBO shortly after issuing stock options to employees. As a result of the LBO, the employees were forced to exercise the stock options. Because of the shortened time frame between when the options were issued and when they were exercised, the options generated ordinary income for the employees. Consequently, the employer gave bonuses to affected employees to cover any extra taxes. On audit, an IRS field agent took the position that the employer had to capitalize
the bonus payments because they were related to the LBO. However, in the TAM, the National Office rejected this position. Instead, the IRS said, the payments are deductible since they are part of a long-standing employer-employee relationship. According to the Service, the LBO only triggered the payments. See also TAM 9540003.

[d] **Shareholder Costs**

Again, the same principles set forth in *Indopco* and *Staley* should apply to costs incurred by shareholders. In *Woodward*, supra, nondissenting shareholders were required by state law to purchase the shares of dissenting shareholders. The two groups could not agree on a price for the stock and, consequently, the nondissenting shareholders initiated litigation to appraise the value of the stock. The Court, applying an origin of the claims test, held that the litigation expenses were nondeductible because they arose from a capital event — the acquisition of stock. See also, *Third National Bank v. United States*, 427 F.2d 343 (6th Cir. 1970) (extending the holding of *Woodward* to minority shareholders); Rev. Rul. 67-411, 1967-2 C.B. 124 (fees paid by shareholders in connection with a ‘C’ reorganization must be capitalized).

Personal guarantees by shareholders given to the acquiring corporation in order to facilitate a merger must be capitalized if ultimately paid. In *Estate of McGlothlin v. Commissioner*, 370 F.2d 729 (5th Cir. 1976), the court held the target corporation shareholder received the acquiring corporations stock in exchange for the target stock and the guarantees. Therefore, the guarantees were simply part of the acquisition costs of the acquiring corporation’s stock — a capital asset.

[e] **Bond Redemption Expenses**

Often in connection with a reorganization, a corporation incurs expenses related to redeeming its bonds. In TAM 9641001 (May 31, 1996), the IRS considered whether bond premium payment and consent solicitation payments made by a taxpayer were deductible. As part of a transaction involving a merger, the taxpayer incurred certain expenses in connection with a consent solicitation and debt tender offer. The consent solicitation and debt tender offer were necessary because the taxpayer’s bonds had certain covenants that would have restricted the taxpayer’s ability to engage in the merger. The merger agreement was expressly conditioned on the taxpayer obtaining a sufficient number of consents to amend the bond indentures, and the debt tender offer was conditioned on the consummation of the merger.

The IRS, citing *Denver & Salt Lake Ry. Co. v. Commissioner*, 24 T.C. 709 (1955), held that the consent solicitation payments must be capitalized in part, because they had their origin in the merger. That is, because the merger was expressly conditioned on the taxpayer obtaining a sufficient number of consents, the consents were “inextricably tied” to the merger. In contrast, the IRS held that the premiums paid by the taxpayer to redeems its bonds were deductible as interest under section 163. The IRS reasoned that these payments had their origin in the taxpayer’s preexisting debt obligations, rather than the merger.

[3] **Business Expansion Costs**
After the *Indopco* decision, taxpayers have been left with the question whether revenue agents are standing by ready to disallow a range of expenses incurred in connection with expanding an existing line of business. Such costs typically include advertising, training costs, investigatory, and market study costs. These costs were traditionally deductible because they did not result in the creation of a separate and distinct asset and they were incurred to keep a company competitive. For example, in *Briarcliff Candy*, supra, a candy company incurred costs in developing suburban markets for its products by entering into generally multi-year contracts with local proprietors to display its goods. In this connection, the company set up a separate division and added additional personnel to solicit the proprietors. The IRS argued that the costs of this intensive effort to get customers through agency or franchise means had to be capitalized. The Second Circuit, however, held that these costs were deductible. After concluding that the costs of expanding the taxpayer's existing business into new territory did not result in the creation of a separate and distinct asset, the court reasoned that the costs were incurred for the protection, continuation or preservation of an existing business and thus were deductible. *See also* *NCNB Corporation*, supra (expenses for locality studies, feasibility studies, and getting state approval to establish new branches throughout the state of North Carolina were deductible because the expenditure did not result in the creation of a separate and distinct asset).

It is unclear whether the *Indopco* decision reverses the result in these cases. The government's *Indopco* briefs indicate that the result in *Briarcliff Candy* may live. Citing *Colorado Springs National Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974), the government acknowledged in footnote 6 of the brief that under current law "the recurring costs incurred by a going concern in expanding its existing business generally are deductible, but the cost of entering a new line of business are capital expenditures." Further, later in Footnote 21 of the brief, the government noted that its rejection of the notion that the creation of a separate and distinct asset is a prerequisite to capitalization would not nullify section 195. In that footnote the government stated that as under present law "business expenses paid or incurred in connection with an expansion of an [existing] business...will continue to be deductible." These statements indicate that the IRS may not necessarily believe that the Second Circuit reached the incorrect result in *Briarcliff Candy* — although it disagrees with the court's separate and distinct asset reasoning. Indeed, these statements are consistent with the IRS' recent citation in Rev. Rul. 92-80 to *Cleveland Electric Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985), which arguably supports the result in *Briarcliff Candy* using a different rationale. Rev. Rul. 92-80 is discussed more fully below in the Promotion Expenses Section.

[a] *Cleveland Electric Illuminating Co. v. United States*

In this case, the taxpayer owned and operated four conventional power plants. The taxpayer constructed another conventional power plant and a nuclear power plant. Training costs were incurred in connection with opening each plant. The taxpayer argued that under *Lincoln Savings & Loan Ass'n* an expenditure must create or enhance "a separate and distinct asset" to be capital. Thus, both types of training costs were deductible. The Claims Court disallowed the deduction for the training expenses associated with the nuclear power plant venture, but allowed the deduction of training expenses associated with the conventional power plant venture. The court distinguished the two ventures by characterizing the nuclear plant venture as the opening of a new business, and the conventional plant venture as the
expansion of an existing business. The court said that the training expenditures for the nuclear power plant were analogous to start-up expenditures that could be expected to have value in the production of income over an extended period of years. On the other hand, the training costs relating to the additional conventional electric plant were similar to currently deductible costs of training employees to operate new equipment in an existing business. The Claims Court stated further that while there was obviously some future benefit that could be expected from the training expenditures relating to the additional conventional plant, there was immediate benefit as well and it would be impractical to make any division of the expenditures.

The Claim Court's analysis in Cleveland Electric in 1985 is very similar to the Supreme Court's analysis seven years later in Indopco. That is, the Claims Court rejected the notion that expenditures are capital only if they create or enhance a "separate and distinct asset." Rather, the court used a future benefit analysis to determine whether the costs were deductible or capitalizable. Nevertheless, the Claims Court found that the training expenses relating to the expansion of the taxpayer's existing line of business were deductible. If the Cleveland Electric line of reasoning is not followed by the IRS, it would seem that section 195 would become meaningless.

Section 195

Section 195 provides that no deduction is allowed for start-up expenditures; rather such costs must be capitalized and may be amortized over 60 months if the proper election is made. According to the legislative history underlying section 195, the term "start-up expenditure" means any amount paid or incurred in connection with creating or acquiring an active trade or business, provided that the amount would be allowed as a deduction if paid or incurred in connection with the operation of an existing active trade or business. The legislative history specifically provides that eligible start-up expenditures "include advertising, salaries, and wages paid to employees who are being trained and their instructors, travel and other expenses incurred in lining up prospective distributors, suppliers, or customers, and salaries or fees paid or incurred for executives, consultants, and for similar professional services" H.R. Rep. No. 1278, 96th Cong., 2d Sess. 10 (1980) at 10-11; S Rep. No. 1036, 96th Cong., 2d Sess. 11 (1980) at 11-12. The history goes on to say also that "eligible start-up expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible. The determination of whether there is an expansion of an existing trade or business or a creation or acquisition of a new trade or business is to be based on the facts and circumstances of each case as under present law." Id. Thus, according to the legislative history to section 195, in order for costs to be eligible for section 195 treatment, the costs must be deductible in a business expansion context. If the Indopco "significant future benefit" test would require the capitalization of business expansion costs, then no costs would be subject to the amortization rules under section 195 and that section would become meaningless.

Section 197

The legislative history to section 197 supports allowing a deduction for expansion costs after Indopco as well. Section 197, in general, allows taxpayers to amortize the
costs of acquiring certain intangibles. Such intangibles include goodwill, going concern value, workforce in place, and other intangibles. The process that led to the enactment of section 197 confirmed that the routine and recurring expenses and costs of developing goodwill, workforce in place, and other intangibles were currently deductible under the law at the time of the enactment of section 197 and would continue to be deductible after the enactment of that section. At that time, the Joint Committee on Taxation stated that, although taxpayers generally must capitalize the costs of acquiring intangible assets from another person, taxpayers generally may currently deduct the costs incurred to develop or maintain such intangible assets. By way of example, the Joint Committee stated that "advertising expenses generally may be deducted for the year paid or incurred." See, e.g., Treas. Reg. § 1.162-20(a)(2).

Likewise, costs incurred to train employees generally may be deducted for the year such costs are paid or incurred even though the training results in a more knowledgeable or valuable workforce. See, e.g., Knoxville Iron Co. v. Commissioner, 18 T.C.M. 251 (1959) (training costs held to be deductible when incurred); and Cleveland Electric Illuminating Co. v. Commissioner, supra (certain training costs were deductible when incurred; other training costs required to be capitalized because the costs related to the start-up of a new business)." Joint Committee on Taxation Description of H.R. 3035, H.R. 1456, and H.R. 563, September 30, 1991, page 18.

[d] Letter rulings

Subsequent to the Indopco decision, the IRS has addressed expansion expenditures in several private rulings.

[i] In PLR 9331001, the taxpayer manufactured and sold fragrances and cosmetics. The taxpayer opened a boutique to sell these items. The IRS ruled that when the manufacturer opened its first retail boutique, it was entering into a new trade or business. Further, the costs (e.g. salaries relating to hiring and training employees, and opening and stocking the boutique) must be capitalized and amortized in accordance with section 195. The IRS also ruled that if additional boutiques were opened, the taxpayer would be expanding an existing trade or business. However, the IRS created uncertainty regarding the deductibility of such expansion costs by stating that the expenditures "might not be currently deductible," citing Indopco.

This letter ruling indicates that at one time the IRS was examining what effect Indopco has on expansion costs – in particular, hiring and training costs incurred in connection with expanding an existing trade or business. However, this issue appears to have been resolved in TAM 9645002, discussed below.

[ii] In TAM 9310001, the taxpayer was in the management business deriving most of his income from salary and director's fees. Taxpayer started a consultant business which involved analyzing suggestions made by both customers and employees of a particular client. Taxpayer decided that this service would be more marketable if a mechanical data entry system was used. Taxpayer argued that creating the system was an expansion of his existing business; thus, certain costs of developing the system were currently deductible. The IRS ruled that the consulting activities were not an expansion of the taxpayer's existing trade or business. Accordingly, the taxpayer had to capitalize start-up expenses related to the consulting business. The IRS made no reference to Indopco or to requiring capitalization of otherwise deductible expenses relating to the expansion of an existing trade or business.
In TAM 9645002, the IRS specifically held that costs incurred in connection with opening new stores as part of a long-term expansion program were deductible under § 162. The specific costs deducted by the taxpayer included (1) salaries, wages and bonuses paid to employees for services performed in opening the new stores; (2) costs for maintenance, service and supplies; (3) expenses for electricity, gas, water and waste removal; (4) expenses for telephone and faxes; (5) office and janitorial supplies; (6) expenses for selling supplies such as paper and plastic bags; (7) rent; (8) expenses for relocating employees; (9) expenses to recruit new employees, such as advertising; (10) travel expenses; (11) expenses for security; (12) freight and postage expense; (13) employee relations costs; and (14) employee training costs. The IRS agent argued that Indopco required that these expenses be capitalized. Reasoning that the costs at issue were of a recurring nature and produced only a short-term benefit, the IRS concluded that these costs were deducted as business expansion costs under section 162.

Norwest Corporation v. Commissioner

As discussed above, Norwest is the most recent case addressing business expansion. Norwest is a rather unique case because the target corporation argued that expenses incurred in connection with its acquisition by the acquiror were deductible as investigatory costs incurred in a business expansion under Sec. 162, even though it had never sought to acquire or expand its business. In rejecting the taxpayer’s arguments, the Tax Court commented on the taxpayer’s reliance on Briarcliff Candy and NCB. The Tax Court reasoned that the Supreme Court’s decision in Indopco “displaced Briarcliff Candy and its progeny insofar as they allowed the deductibility of investigatory costs similar to that at hand, i.e., where an expenditure does not create a separate and distinct asset.” For the reasons discussed in the prior sections addressing Norwest, this decision should not preclude an acquiring corporation from deducting investigatory costs attributable to acquiring a target corporation.

FMR Corp. v. Commissioner

FMR Corp. v. Commissioner, 110 T.C. 30 (1998), is also a recent case discussing the deductibility of business expansion expenses. In that case, the taxpayer deducted the costs of developing and launching 82 new regulated investment companies (“RICs”). The activities giving rise to these expenses included developing the idea for the new RIC, drafting the management contracts, forming the RIC, obtaining the approval of the Board of Trustees, and registering the new RIC with the SEC. All the expenses were incurred before shares in the new RIC were offered to the public. The Tax Court held that all these expenses must be capitalized.

In arguing that the costs at issue were deductible, the taxpayer in FMR argued that these costs were costs incurred in expanding an existing line of business, citing Briarcliff Candy and NCB. In response to the taxpayer’s argument, the Tax Court questioned the continuing viability of those cases after Indopco because the holdings of those cases were premised on a finding that there was “no separate and distinct asset.” However, the Tax Court failed to realize that just as important to the holdings in Briarcliff Candy and NCB was the fact that the expenses incurred in those cases were for the protection of an existing business.
In addition, the taxpayer in FMR, citing NCB, argued that the legislative history underlying section 195 supported the deductibility of the expenses incurred in launching the RIC. The Tax Court in FMR responded to this argument as follows:

Although the court [in NCB] found that the investigatory expenditures in question in that case did not require capitalization, we find that neither that holding, nor the statutory language of section 195, requires that every expenditure incurred in any business expansion is currently deductible.

Under petitioner’s reasoning, any expenditure incurred in the expansion of an existing business would be deductible. Obviously this is not the proper interpretation of the law . . . Section 195 did not create a new class of deductible expenditures for existing businesses. Rather, in order to qualify under section 195(c)(1)(B), an expenditure must be one that would have been allowable as a deduction by an existing trade or business when it was paid or incurred.

Based on the foregoing, the better analysis of the Tax Court’s decision in FMR is that, rather than overruling the business expansion doctrine articulated in Briarcliff and NCB, it merely rejected the taxpayer’s argument that all costs incurred in connection with the expansion of a business are deductible. Instead, those costs that produce a long-term benefit, i.e., those costs that are facilitative as opposed to investigatory, must be capitalized.

However, it is not entirely clear what type of expenses the Tax Court would find to be deductible. Some of the costs incurred in connection with launching the RIC are clearly capital — for example, the costs incurred for forming the RIC and registering the RIC with the SEC. On the other hand, some of the costs are arguably investigatory to some extent — for example, developing the idea for the new RIC and the initial marketing plan. Unlike the Seventh Circuit in Staley, the Tax Court did not analyze the costs incurred in connection with launching the RIC based on the nature of the services provided. Rather, the Tax Court’s decision indicates that it felt it was faced with an all or nothing proposition — the expenses were either fully deductible or fully capitalizable.

Therefore, despite the Tax Court’s decision in FMR, an argument can still be made that the determination of which costs are deductible as business expansion costs and which costs must be capitalized because they are facilitative (i.e., they produce a long term benefit) is based upon the nature of the services provided. As a general rule, based on the legislative history underlying section 195, those costs incurred after the final decision to acquire a business is made are facilitative.

[4] Divisive Reorganizations

Although no cases have applied the rationale of Indopco to a section 355 transaction, costs incurred in connection with a divisive transaction have generally been held to be nondeductible. See, e.g., E.I. DuPont Nemours v. United States, supra; Farmers Union Corp. v. Comm’r, supra.
There is a line of authority holding that divestitures required by law are deductible under section 162. For example, in United States v. General Bancshares Corp., supra, a bank holding company needed to divest itself of its non-banking assets under the Bank Holding Company Act of 1956. In order to accomplish this, it formed a subsidiary, transferred all its nonbanking assets to the newly formed subsidiary, and distributed the stock of the subsidiary to its shareholders in a pro rata spin-off. The corporation incurred various fees including accounting fees, transfer agent fees, and transfer fees. The Eighth Circuit held that these expenses were deductible because the "dominant aspect" of the transaction was a divestiture of the nonbanking assets, not a reorganization of the company. The reorganization was merely incidental to the divestiture. See also, United States v. Transamerica Corp., 392 F.2d 522 (9th Cir. 1968) (expenses incurred in a partial liquidation and spin off are deductible); El Paso Corp v. United States, 694 F.2d 703 (Fed. Cir. 1982) (same).

[5] Bankruptcy Reorganizations

Hillsborough Holdings Corp. v. United States, 116 F.3d 1391 (Bankr. M.D. Fla. 1999), is recent case applying the rationale of Indopco to bankruptcy reorganization expenses. In that case, the taxpayer filed for relief under Chapter 11 of the Bankruptcy Code to manage asbestos-related personal injury claims. The taxpayers, as debtors in possession, continued to operate as an ongoing business. During the pendency of the bankruptcy cases, the taxpayer incurred professional fees for legal and accounting services. Although the taxpayer was responsible for any incurred professional fees that were awarded by the court, the professionals were retained not only by the taxpayer, but by the committees of the unsecured creditors and the bondholders.

The taxpayer and its successors filed consolidated tax returns for the fiscal years at issue, in which they deducted as ordinary and necessary business expenses the amounts of the professional fees incurred during those years. The IRS disallowed the deductions because the Plaintiffs had not established that the professional fees were ordinary and necessary expenses paid or incurred in carrying on a trade or business. The IRS argued that these fees should be capitalized because they represent creditor committee fees and/or fees which provided long-term future benefit beyond one year. Further, the expenses for the professional fees of the professionals who represented the taxpayers should be categorized according to the nature of the work performed according to the requirements of the Supreme Court in INDOPCO.

The taxpayers argued that since the purpose behind filing bankruptcy was to defend their business from the attack by the asbestos-related personal injury claimants, all professional fees related to the bankruptcy cases are necessary and ordinary business expenses deductible under section 162(a). The taxpayers claimed that the bulk of the professional fees related to the defense against the massive asbestos claims, and the bankruptcy made it possible to manage the massive tort problem. They argued that once a Chapter 11 case is filed, the expenses incurred, whether work performed by the debtor's professionals or the creditors' professionals, become ordinary and necessary because such expenses are incurred by all debtors-in-possession. The taxpayer's cited A.E. Staley as support.

The court, however, stated:
[t]hat in a Chapter 11 case . . . the services performed by court approved professionals serve different functions. It is the nature of the services performed by the professionals that determines the proper tax treatment of the costs of those services. See A.E. Staley (citations omitted). All the facts of the case, including the fee arrangement, must be reviewed to determine the context of the expenditures and the services for which the professionals were paid. Id. In fact, in A.E. Staley, the case upon which the [taxpayer] mainly [relies], the Court remanded the matter for the Tax Court to allocate a portion of the investment banker's fees connected with the evaluation of the taxpayer's stock and facilitative work for capitalization and the fees connected with protecting the taxpayer from a hostile takeover as deductible under section 162(a).

In analyzing the professional fees that were incurred specifically in connection with proceeding through bankruptcy, the court concluded that the fees at issues were not ordinary deductible expenses within the meaning of section 162(a). The court noted that the restructuring of a corporation is an "extraordinary" event outside the scope of the corporation's usual trade or business activities as well as an event that confers a long-term benefit on the reorganized entity, citing Mill Estate, Inc. v. Commissioner, 206 F. 2d 244, 246 (2nd Cir. 1953) (attorneys' fees incurred in partial liquidation and capital restructuring of corporation not deductible as ordinary and necessary business expenses) and Bilar Tool & Die Corp. v. Commissioner, 530 F. 2d 708, 710 (6th Cir. 1976) (attorneys' fees resulting from legal work devising and carrying out plan of reorganization that resulted in a corporate division were nondeductible capital expenditures). Moreover, the court stated that "[f]ees associated with a reorganization effected by debt restructuring should not be treated differently from other types of reorganizations." The court determined that the benefits of the expenditures on reorganization were long-term and indefinite because they would inure to the benefit of the corporation for the duration of its existence. The court also determined that that the services rendered by professionals retained by the various committees in these cases related solely to the bankruptcy reorganization and not to the day-to-day business of the taxpayer. But for the Chapter 11 reorganization, the professional fees would not have been incurred. Therefore, they are not deductible under section 162(a).

[6] Proxy Fight

In general, fees incurred in connection with a proxy fight are deductible under section 162. See Locke Mfg. Co. v. United States, 237 F. Supp. 80 (D. Conn. 1964); Rev. Rul. 67-1, 1967-1 C.B. 28; Rev. Rul. 64-236, 1964-2 C.B. 64. The IRS, however, has indicated that it will scrutinize proxy fights to determine if the costs are made primarily for the benefit of individuals rather than corporate policy. See Rev. Rul. 67-1. See also, Dyer v. Commissioner, 352 F.2d 948 (8th Cir. 1965) (no deduction where proxy fight would not affect dividend income or stock value).

[7] Promotion Expense

[a] In General
In the aftermath of the *Indopco* decision, IRS examiners have consistently wanted to challenge the deductibility of promotional costs incurred by taxpayers with more vigor. This is evident from the issuance of Rev. Rul. 92-80, addressing the deductibility of advertising expenses, the *Proposed ISP Coordinated Issue Paper on Slotting Payments* issued in 1994, the *Proposed ISP Coordinated Issue Paper on Cellular Service Contracts* also issued in 1994, and TAM 9813001 (December 3, 1997), addressing the treatment commissions paid by a cellular company to third-party distributors. However, neither the courts nor the IRS National Office always share the examiners' view.

[b] Advertising Costs: Rev. Rul. 92-80

Given the issuance of Rev. Rul. 92-80, IRS examiners obviously considered requiring the capitalization of traditional advertising costs. However, in that ruling, the IRS ruled that *Indopco* does not affect the treatment of advertising costs as business expenses that are generally deductible under section 162. The ruling states that advertising costs are generally deductible under section 162 even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. The IRS found that the expected future benefit from advertising generally falls within the incidental future benefit category of *Indopco*.

The ruling states that "[o]nly in unusual circumstances where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising must the costs of that advertising be capitalized." The ruling cites *Cleveland Electric*, supra, as an example of a situation where advertising costs must be capitalized. In that case, an electric utility company incurred substantial advertising costs prior to opening a nuclear power plant in order to reduce public opposition to the construction and licensing of the plant. The court held that the advertising costs had to be capitalized because the advertising was directed at securing the construction permit and operating license.

[c] Slotting Payments and Other Similar Costs

In the *Proposed ISP Coordinated Issue Paper on Slotting Payments*, examiners wanted the IRS to take the position that payments made by a manufacturer to a retail grocer for shelf space must be capitalized under section 263 even though the agreement may be for a year or less. The paper asserts that the payments should be capitalized because (1) they create a separate and distinct asset, and (2) because of the possible long-term shelf life for a product.

The *Proposed ISP Coordinated Issue Paper on Slotting Payments*, which was prepared at the examination level, was never approved by the National Office. In fact, a number of public statements by various IRS National Office officials strongly indicate that the National Office does not believe that *Indopco* affected the treatment of slotting payments. *Official Gives Update on Series of Guidance on Tax Accounting Issues, 1993 Daily Tax Report* 46 d6 (March 11, 1993)(remarks of Glenn Carrington)("That paper represents due diligence on the part of an agent to look into the issue. Surely, we do not think *Indopco* will change our analysis with respect to slotting allowances;" he said.); *accord, IRS Treatment of Issues in Post-INDOPCO Era to Turn on Facts, Circumstances, ABA Told, 1993 Daily Tax Report* 89 d14 (May 11, 1993)...
IRS Issue Paper on Slotting Allowances for Food Industry in Final Stages of Review, 1994 DAILY TAX REPORT 65 d3 (April 6, 1994)(about 75 businesses covered under the food industry segment of the ISP program; earlier version of ISP revised after gathering information; a slotting allowance/shelf space expenditure would have to be capitalized if a significant investment had been made in which the return from the investment would take more than one-year to be realized). On May 19, 1995 at a ABA Tax Section's Tax Accounting Committee, IRS representatives indicated that the proposed ISP Paper on Slotting would be withdrawn.

The IRS National Office does not agree with the analysis set forth in the paper for several reasons. In particular, slotting payments are typically made for new products for which the manufacturer does not have a proven track record. Further, slotting payments do not remove competing or alternative products (i.e. the consumer still has many choices). Thus, the future benefit is fairly speculative. Accord, IRS Looks to Improve Form 3115 Requesting Accounting Method Change, Officials Say, 1995 DAILY TAX REPORT 108 d13 (June 6, 1995)("A revenue ruling is under consideration, he [Irwin Lieb, deputy assistant chief counsel (Income Tax and Accounting)] said, but in general, the thinking currently is that if the relationship between the slotting allowance and the retailer is a short-term relationship, the allowance should not be capitalized. If a long-term relationship is shown, however, capitalization can be considered, Lieb said.").

Also, in dealing with stock lifting payments, examiners have taken a similar approach to that taken with regard to slotting payments. Stock lifting payments are made when a supplier or manufacturer pays a retailer to replace an existing line of products carried by that retailer with an alternative product. Examiners assert that stock lifting payments are typically associated with mature or proven products that the manufacturer knows will satisfy the consumers' needs. Otherwise the company would not pay the amount to buy out a competitor's product line. At this time, it is unclear whether the IRS National Office has adopted a view of stock lifting payments similar to that adopted for slotting payments.

Slotting payments, as well as stocklifting payments, seem to be analogous to advertising costs. The payments are made for marketing a company's goods and services. Like advertising, the marketing efforts employed by the retailer and the sales agent produce customer relationships and enhance the general goodwill of the company, but the long-term benefit from the marketing is uncertain and hard to measure, i.e., it is speculative and soft. Moreover, the efforts will not ultimately determine whether the customer continues to patronize the company. Rather, the quality of the service and other competitive factors will determine future patronage.

Thus, as in the case of advertising costs, it would seem the payments should be deductible unless the marketing efforts are directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product marketing intended to secure an immediate benefit. Neither slotting payments nor stock lifting payments seem to be directed at obtaining a future benefit beyond that traditionally associated with ordinary product marketing. The efforts are specifically directed at securing immediate sales to customers and not a fixed long-term benefit. Just as in the case of ordinary product advertising, some future patronage might be reasonably expected from the marketing efforts, but such patronage is not the main focus or result of their marketing efforts and is too
speculative to be considered a significant future benefit. See and compare Sun Microsystems, infra.

[d] Sun Microsystems, Inc. v. Commissioner

In Sun Microsystems, the Tax Court addressed whether stock warrants issued to a taxpayer's customer constitute a currently deductible sales discount when exercised equal to the value of the warrants at the time of their exercise. The taxpayer sought to develop a long-term contractual relationship with a customer for the joint development and manufacturing of computer work stations. Under an agreement with the customer, the taxpayer granted stock warrants to the customer that could be exercised, if the customer's purchases exceeded certain thresholds during a three-year period. The warrants were specifically regarded by the parties as an incentive for the customer to purchase goods from the taxpayer. In the year the warrants were exercised, the taxpayer deducted as a sales discount the difference between the fair market value of the stock and the warrant price for the stock. The IRS sought to disallow the deduction based, in part, on the theory that the warrants are attributable to the development of a long-term customer relationship and, thus, should be capitalized under Indopco.

Rejecting the IRS' analysis of Indopco, the court stated that the Supreme Court recognized that while realization of future benefits is important in determining existence of a capital expenditure, the "mere presence of an incidental future benefit -- 'some future aspect' -- may not warrant capitalization." The court's evaluation of the record established that the warrants were included in the agreement as an incentive for the customer to purchase work stations during the three-year period. After making this determination, the court concluded that the expected future benefit from the warrants falls within the incidental future benefit category of Indopco. The court noted that: (1) "the long-term benefits to [the taxpayer] from the relationship with [the customer] were softer and were speculative compared to the immediate benefits to [the taxpayer] of the anticipated sales to customer during the three-year period", and (2) that the customer "did not intend to purchase or hold the stock of [the taxpayer]."

In Sun Microsystems, the court realized that the factual situation possibly involved both present year and future year benefits. Nonetheless, the court found that costs associated with the warrants were currently deductible because the warrants were directed towards obtaining an immediate benefit and no anticipated future benefit from the warrants could clearly be associated with future years. The anticipated long-term benefits from the taxpayer's shareholder relationship with the customer were soft and speculative.

[e] RJR Nabisco, Inc. v. Commissioner

In RJR Nabisco, Inc. v. Commissioner, CCH Dec. 52,786 (July 8, 1998), the Tax Court held that expenses incurred for the graphic design (i.e., the verbal information, styles of print, pictures or drawings, shapes, patterns colors and spacing that make up an overall visual display) and package design (design of the physical construction of a package) for cigarette packages were deductible. The Tax Court first concluded that the graphic design expenses were indistinguishable from advertising expenses because the functions of the graphic design on the cigarette packages and advertising were similar. That is, "the graphic designs for a product serve to identify the product, convey information, attract attention at the point of sale when the retailer displays the pack and other purposes."
The Tax Court rejected the IRS argument that advertising expenses, such as the graphic design costs, had to be capitalized because they produced a future benefit in the form of goodwill or the "expectancy of continued patronage." The Tax Court stated that the deductibility of advertising expenses is long-standing and is unaffected by Indopco, even though such expenses produce a future benefit. The court specifically cited Rev. Rul. 92-80 in which the IRS held that Indopco did not affect the deductibility of advertising expenses directed toward obtaining future benefits traditionally associated with advertising. In this regard, the Tax Court reasoned:

Although Rev. Rul. 92-80 [may] raise some question of just what benefits are traditionally associated with ordinary product advertising . . . , there is no doubt that such traditional benefits include not only patronage, but also the expectancy of patronage (i.e., "goodwill"). Thus, even if advertising is directed solely at future patronage or goodwill, (i.e., ordinary business advertising), Rev. Rul. 92-80 . . . indicates that normally the costs are deductible.

The unusual treatment of expenditures for ordinary product advertising manifest in Rev. Rul. 92-80 . . . is long-standing. Its genesis is in efforts by taxpayers in the early years of income taxation to capitalize the costs of large-scale advertising campaigns and to amortize the capitalized amounts over a period of years, efforts that were consistently opposed by the Commissioner on the grounds that allocating advertising expenditures between current and capital outlays was not feasible. Although the courts did not entirely foreclose the propriety of capitalizing some advertising expenditures, taxpayers found it difficult to prove an appropriate allocation between current and long-term benefits.

The result, as a practical matter, is that, notwithstanding certain long-term benefits, expenditures for ordinary advertising are ordinary business expenses if the taxpayer can show a sufficient connection between the expenditure and the taxpayer's business.

[f]  Cellular Service Contracts

In the Proposed ISP Coordinated Issue Paper on Cellular Service Contracts, IRS examiners take the position that commissions paid to sales agents for selling to customers one year or shorter renewable service contracts must be capitalized under section 263. The paper asserts that the payments should be capitalized because (1) they create a separate and distinct asset, and (2) because of the possible long-term contractual relationship with a customer. However, the proposed ISP paper was never approved.

More recently, the IRS took a similar position in TAM 9813001 (December 3, 1997). In the TAM, the Service held that commissions paid by a cellular company to third-party distributors ("sales agents") for getting new customers to enter into cellular telephone service agreements ("subscription agreements") must be capitalized. The subscription agreements generally provided for an initial term of one month. However, an agreement would be automatically renewed on a monthly basis unless it were terminated by either the customer or Taxpayer. A customer could terminate an agreement without penalty by giving Taxpayer at least 7 days advance notice. Further, Taxpayer could adjust its rates at any time.
with 7 days advance notice. Once a customer was enrolled, a sales agent would not provide any additional services for Taxpayer with respect to such customer. If a customer terminated a subscription agreement within a specified period of time (ranging from 30 to 180 days) of such agreement, Taxpayer would take a credit against the commissions that had been paid to the sales agent who had enrolled that customer. In some cases, such as when a customer retained service for between 90 and 180 days, Taxpayer would take only a partial credit against the commissions that had been paid. The Service held that the commissions must be capitalized because (1) they resulted in the acquisition of a capital asset; (2) they conferred a significant long-term benefit; and (3) based on an analysis of the renewability rate of the subscription agreements, they conferred benefits extending substantially beyond the close of the taxable year.

It is important to note that the IRS has not conclusively resolved the issue on the proper treatment of cellular service contracts, and placed the issue on the IRS Priority Guidance Plan to be resolved in 1999 or 2000.

Both the proposed ISP paper and TAM appear to be inconsistent with the incidental future benefit language in Indopco. Although the Supreme Court in Indopco stated that the realization of a long-term future benefit is undeniably important in determining the existence of a capital asset, the court was equally clear that the mere presence of an "incidental future benefit -- some future aspect -- may not warrant capitalization." Indopco at 1044. When business expenditures may produce benefits both in the current year and future years, such expenditures must be capitalized only where a careful examination of all the facts indicates that the expenditures are directed at securing significant future benefits. Indopco does not require the capitalization of business expenses simply because they may have some future benefit. Just as in the case of advertising costs, arguably, any long-term customer relationship generated by the commissions would seem to be too soft and speculative to warrant capitalization. Sun Microsystems, supra, and RJR Nabisco, supra, would seem to support this analysis.

ISO Certification Costs

Finally, IRS agents have raised in a number of audits across the country whether costs incurred to obtain ISO certification should be capitalized. ISO certification was developed by the International Organization of Standards (ISO), a European Community body seeking to establish worldwide quality standards. ISO certification establishes that certain process quality standards are maintained by a particular provider of goods or services. More specifically, it certifies that a system of policies and procedures is in place to enable the manufacture or provider to deliver quality products or services. However, it does not guarantee that a company produces quality products or services. Therefore, a company can produce ISO 9000 certified products that no one wants or needs.

ISO 9000 has different levels of certification depending on the complexity of manufacturers' operations, which range from warehousing and distribution (for smaller manufacturers) to full product design, manufacturing, installation and service (for larger companies). No matter what certification level is sought by a manufacturer, ISO 9000 requires a heavy reliance on written policies, procedures, quality document and so on.
Companies begin the certification process by selecting the most appropriate ISO 9000 standard. ISO 9001 is the most comprehensive standard and is intended for use in companies that take products from the drawing board to the consumer. Companies that design and develop, produce, install and service their products should seek ISO 9001 certification. ISO 9002 certification covers a much narrower range and is suited for companies that only produce and install their products. Finally, ISO 9003 certification is most appropriate for companies that only inspect and test products.

IRS agents have tentatively taken the position that ISO 9000 certification costs should be capitalized because a taxpayer obtains the ability to compete for business in markets that would otherwise be unavailable absent the ISO 9000 certification. One agent's report states:

ISO 9000 certification yields four potential advantages. First, certification provides access to certain European markets that are available only to ISO 9000 certified suppliers. The European Union requires suppliers of certain regulation produces to have ISO 9000 certification. Regulated products are those that have important health, safety, or environmental implications, such as medical devices, construction products, or telecommunications equipment. Approximately one-half of the more than $100 billion in U.S. exports to the European Union are regulated products.

Second, ISO 9000 certification enables companies to compete for business from individual customers (both foreign and domestic) that contractually require their suppliers to be certified.... Third, ISO 9000 plays a role in marketing, with ISO 9000 certified companies seeking to distinguish themselves from non-certified competitors. Fourth, some companies use the certification process of creating, documenting, and establishing the controls for a quality system as a catalyst for improving the overall quality of their operations.

Section 263(a) requires capitalization of any expenditures that either create a separate and distinct asset or that result in a benefit lasting beyond the taxable year. The ability to compete for business in markets that would otherwise be unavailable absent the ISO 9000 certification confers upon the taxpayer a business advantage that is intended to last beyond the taxable year. In this respect, payments incurred in connection with obtaining access to such markets are analogous to the capital expenditures incurred in connection with obtaining a seat on a stock exchange, admission to the bar, or acquisition of hospital staff privileges.

However, ISO certification costs, arguably, are very similar to advertising costs in that ISO certification costs are designed to develop customer relationships and enhance the general goodwill of the company. Following this logic, such costs should be deductible.
Environmental Clean up Costs

The tax treatment of environmental clean up costs has been the subject of considerable controversy. The determination of whether these costs are currently deductible as ordinary and necessary business expenses under section 162 or capitalizable under section 263 has been controversial because of the subjectivity involved in distinguishing between a currently deductible repair and capitalizable improvement. Further complicating the issue is the extent to which the Supreme Court's holding in Indopco should affect the determination.

The IRS first addressed the deductibility of these expenditures in two published TAMs - one on soil remediation (TAM 9315004) and the other on asbestos (TAM 9240004). The TAMs held that the costs were "capital improvement or betterment" costs and generated numerous letters from Congress and taxpayers requesting that the IRS reconsider its positions. In response to those requests, the IRS set up a task force made up of IRS and Treasury personnel to consider the deductibility of environmental cleanup costs. The IRS later issued a second TAM on asbestos (TAM 9411002) holding that costs were capitalizable where asbestos was removed, but were deductible where asbestos was encapsulated. The IRS also issued Rev. Rul. 94-38 holding that certain soil and groundwater remediation costs may be deducted. While that revenue ruling has defused much of the controversy surrounding the soil remediation TAM, extensive controversy still exists with respect to whether asbestos removal costs are currently deductible and whether Indopco is irrelevant to this decision.

[a] Four/Three Prong Test

The IRS has suggested that there may be a four-prong test for determining whether remediation costs should be deducted or capitalized. That is,

*Increase in value.* The remediation costs must not materially add value to the property prior to the condition (e.g., discharge of hazardous waste) that triggered the expenditures. See Oberman Manufacturing Co. v. Comm'r., 47 T.C. 471 (1967); Plainfield-Union Water Co. v. Comm'r., 39 T.C. 333 (1962) and Rev. Rul. 94-38.


*New and different use.* The expenditures must not adapt the property to a new or different use. See Midland Empire Packing Co. v. Comm'r., 14 T.C. 635 (1950), acq., 1950-2 C.B. 3.

*Incidental cost.* The remediation costs must not be more than incidental. Treas. Reg. §1.162-4 provides that the cost of incidental repairs can be deducted. In TAM 9315004 (discussed below) the IRS viewed soil remediation costs as not "incidental" because the expenditures were for extensive replacements of significant sections of land. However, see Rev. Rul. 94-38 where this test was seemingly irrelevant.

[b] Indopco's Effect on the Four/Three Prong Test
Based on various IRS pronouncements, the "significant future benefits" test of Indopco is an additional factor or prong that may have to be overcome in order to deduct environmental remediation costs. The first Asbestos technical advice memorandum (TAM 9240004) seemingly relied in part on Indopco for its holding. However, certain IRS officials have stated that the Indopco decision has not altered the test for capitalization and that the reference to Indopco in the Asbestos TAM may be softened or eliminated upon reconsideration. Assistant Chief Counsel, Internal Revenue Service, Comments at Environmental Tax Committee Meeting at ABA Tax Section Mid-Year Meeting (February 6, 1993). Also, Revenue Ruling 94-38 cites Indopco but does not rely on Indopco for its conclusions. Moreover, recently issued Rev. Rul. 94-12 holds that Indopco does not affect the treatment of incidental repair costs as business expenses, which are generally deductible under section 162 of the Code. It states that "[a]mounts paid or incurred for incidental repairs are generally deductible as business expenses under that section even though they may have some future benefit." Thus, the IRS may well think that Indopco does not affect whether environmental clean up costs are "incidental repair" costs.

[c] Soil And Groundwater Remediation

Rev. Rul. 94-38. As noted earlier, Rev. Rul. 94-38, I.R.B. 1994-25, substantially clarifies the issue of whether remediation costs can be deducted.

Facts. X, an accrual basis corporation, owned and operated a manufacturing plant. X built the plant on land that it had purchased in 1970. The land was not contaminated by hazardous waste when it was purchased by X. X's manufacturing operations discharged hazardous waste. In the past, X buried this waste on portions of its land. In 1993, in order to comply with federal, state, and local environmental requirements, X decided to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation had removed all hazardous waste. Accordingly, X began excavating the contaminated soil, transporting it to appropriate waste disposal facilities, and backfilling the excavated areas with uncontaminated soil. These soil remediation activities started in 1993 and will be completed in 1995. X also began constructing groundwater treatment facilities which included wells, pipes, pumps, and other equipment to extract, treat, and monitor contaminated groundwater. Construction of these groundwater treatment facilities began in 1993, and the facilities will remain in operation on X's land until the year 2005. During this time, X will continue to monitor the groundwater to ensure that the soil remediation and groundwater treatment eliminate the hazardous waste to the extent necessary to bring X's land into compliance with environmental requirements. The effect of the soil remediation and groundwater treatment was to restore X's land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, X continued to use the land and operate the plant in the same manner as it did prior to the clean up except that X disposed of any hazardous waste in compliance with environmental requirements.

Holdings. Rev. Rul. 94-38 holds that both the soil-remediation and the groundwater-monitoring expenditures are currently deductible. The ruling notes that these expenditures will not add to the value of the company's property, substantially prolong its
useful life, or adapt the property to a new or different use. The ruling further indicates that in applying the increase-in-value test, the status of the asset before the condition arose that necessitated the expenditure must be compared with the status after the expenditure. Because the land was clean when acquired by company, the status did not change, i.e., clean to clean.

Rev. Rul. 94-38, holds, however, that the costs to acquire and construct the groundwater-treatment facilities are capitalizable under section 263 since they have a useful life substantially beyond the end of the year of construction. In addition, these costs are depreciable under section 168.

Note: Although the IRS did not specifically rely on Indopco for its conclusions, the IRS cited Indopco for the following two propositions: (1) the Internal Revenue Code, through provisions such as section 162, 263(a) and related sections, endeavors to match expenses with the revenues of the taxable period to which they relate, and (2) in determining whether an item should be capitalized, it is important to consider whether the expenditure would produce a significant long-term benefit. The IRS' mention of the first proposition clearly indicates that one of the IRS' primary concerns was to reach a conclusion that would achieve a clear reflection of income.

[ii] TAM 9315004. Rev. Rul. 94-38 reversed TAM 9315004, which held that soil remediation costs were required to be capitalized. In that TAM, the taxpayer operated a natural gas pipeline. It used chemicals containing PCBs as lubricants on some of the equipment. These chemicals were routinely permitted to drain into the surrounding soil prior to a determination that PCBs pose a health risk. The taxpayer entered into an agreement with the EPA to clean up soil affected by the PCB contamination at various sites. The taxpayer treated the clean up costs as current deductions except for the costs of equipment and facilities associated with the clean up activities. The IRS held that the soil remediation activities did not constitute a repair, but constituted a general restoration of the property which should be treated as a capital expenditure. Although the IRS cited Indopco for the proposition that the Code's capitalization provision envisions an inquiry into the duration and extent of the benefits realized by the taxpayer, the TAM did not directly rely on Indopco for its holding, even though the TAM had a future benefit tone to its analysis. Rather, the TAM primarily relied on the following line of analysis for its conclusion.

Mountain Fuel. The IRS relied heavily on Mountain Fuel Supply Co. v. United States, 449 F.2d 816 (10th Cir. 1971) (Taxpayer rehabilitated gas pipe lines and expensed the costs of digging, removing, repairing, and returning the pipes to the ground. The 10th Circuit found the expenses capital in nature due to the fact that the pipes could now withstand a higher throughput of gas, and that the repairs imparted a new useful life to the pipes, and that the repairs were done pursuant to a plan of rehabilitation). The IRS found that the taxpayer was rehabilitating the contaminated soil as well.

Wolfsen. The IRS also relied on Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1 (1979) (Taxpayer there sought to deduct the cost of irrigating canals on its ranch land, an expensive process that was necessary to restore the canals to their full function, and which could be as expensive as building a new canal. The Court disallowed the deduction because it would distort income to allow a deduction in the current year for cumulated maintenance costs that would produce a benefit for a number of years. The court
found that a cleaned or reworked asset has more value than one in need of repair.) The IRS similarly concluded that the remediation activities were part of a systematic plan that led to an increase in the property's value.

**Plainfield-Union.** In addition, the IRS disregarded *Plainfield-Union* (There taxpayer cleaned and lined lengths of pipe with cement. The expenses were deductible since there was no overall plan of rehabilitation, did not materially increase the useful life, value, or structural strength of the pipes as compared to their value prior to the condition causing the repair, or make the pipes suitable for any new or additional use.) The IRS claimed that the situation is governed by the more recent decision in *Wolfsen*, which did not apply the *Plainfield-Union* valuation technique for determining whether there is a material increase in value — *i.e.*, comparing the value of the asset before the condition arose necessitating the repair with the value of the property after the repair. The IRS distinguished *Plainfield-Union* as follows.

1. The decision in *Plainfield-Union* was based on the entire factual context.
2. The repair in *Plainfield-Union* involved a very minor part of the petitioner's operation and was not part of any general plan.
3. If the *Plainfield-Union* "increase in value" test were the only factor used in determining whether an expenditure is capital or deductible, then any replacement of a capital asset would be deductible. In light of *Wolfsen*, we do not believe that the Tax Court intended such a narrow application of the inquiry into value.

[iii] **TAM 9541005.** In a factual situation similar to Rev. Rule 94-38, the Service in a perplexing decision disallowed the deduction of costs related to a mandatory soil remediation study. The taxpayer purchased uncontaminated land and used the site to dispose of agricultural chemical wastes and coke oven by-products. The land was subsequently contributed to the county which planned to use the property as a recreational park. The county discovered the contamination and conveyed the land back to the taxpayer. An EPA test found severe chemical contamination and the land was designated as a Superfund site under CERCLA. The taxpayer entered into a consent order with the EPA to perform a formal study of the contamination and to perform all remediation recommended in the study. As a result of this consent order, the taxpayer incurred fees for the study itself, legal fees, and other environmental consulting fees related to the preparation of the study.

The Service argued that Rev. Rule 94-38 did not apply, since the taxpayer had not held the property continuously from the time of uncontamination to its current polluted state. Therefore, the Service held that Rev. Rule 94-38 did not allow the otherwise nondeductible costs associated with the soil remediation study to be expensed.

[iv] **Repeal of TAM 9541005.** A rare reversal, the Service issued TAM 9627002 and withdrew controversial TAM 9541005. The Service retreated from its position that a change of ownership for the taxpayer to the state and back would disallow the application of Rev. Rule 94-38. The Service went on to state that these cost associated with the preparation of
the environmental remediation study would be deductible under section 162, regardless of the application of Rev. Rule 94-38.

[d] **Asbestos Abatement Costs**

There are generally three accepted methods of asbestos abatement: (1) "encapsulation" (2) "removal," and (3) "enclosure." Encapsulation involves the coating and sealing of walls, ceilings, pipes, or other structures. Removal involves the elimination of asbestos from the property while enclosure involves the construction of a barrier between the asbestos and the environment. The former two situations have been addressed by the IRS — albeit informally — in two TAMs which predate Rev. Rul. 94-38. In the first technical advice memorandum (TAM 9240004), the IRS addressed removal costs, while in the second technical advice memorandum (TAM 9411002), the IRS addressed both removal and encapsulation costs.

Both times, the IRS held that the removal cost had to be capitalized. The conclusion in the two TAMs regarding asbestos removal arguably would have been different if the reasoning in Revenue Ruling 94-38 (i.e., the Plainfield-Union test) had been applied. The critical question to be decided by the IRS is whether the Plainfield Union test can be applied in an asbestos abatement context when technically there is no change in the property's condition requiring a repair. Some practitioners indicate that the condition requiring the repair is the determination that asbestos is a health hazard so that the comparison should be to the value of the equipment before asbestos was determined to be a health hazard. The two TAMs clearly reject this comparison and rely heavily on the future benefit that the taxpayer will receive from abating asbestos in determining whether the asbestos abatement costs must be capitalized.

More recently the issue of asbestos removal was before the Tax Court in *Norwest Corporation and Subsidiaries v. Commissioner*, 108 T.C. 358 (1997). In this case, the court held that the asbestos removal was part of a general plan of rehabilitation and did not address in isolation asbestos removal costs. This case is discussed in detail below.

[i] **TAM 9240004.** In the first of the two TAMs, the taxpayer operated a plant containing equipment insulated with asbestos. Taxpayer removed and replaced the insulation, and deducted these costs under section 162. The costs were minor in relation to the overall repair and maintenance costs of the facility, and in relation to the assessed value of the equipment for property tax purposes. The IRS, nevertheless, held that the costs incurred to remove and replace asbestos insulation were not incidental repairs, but rather improvements or betterments since the equipment "is inherently more valuable" after the asbestos removal. Rather, they were in the nature of a capital expenditure that increased the value of the equipment by reducing health risks, and made the equipment more marketable.

The IRS stated that the Plainfield-Union test was inapplicable for three reasons:

1. **Plainfield-Union** is relevant only in situations where repairs are necessary because the property has progressively deteriorated.

2. Since the asbestos was in the property when manufactured, it is impossible to value the asset prior to the existence of the asbestos.
The increase in the property's value following asbestos abatement is based on subjective factors (safer working conditions, improved marketability) that are not compatible with the objective measurement articulated in Plainfield-Union.

The TAM cites Indopco and states that the Supreme Court "noted that, in determining whether an expenditure is capital in nature, an important consideration is whether the taxpayer realizes benefits beyond the year in which the expenditure is incurred." According to the TAM, the asbestos removal creates "long-term future benefits" that:

are not merely incidental. In fact, they relate to the very reason for incurring the expense -- increased health and safety. As discussed above, these benefits include safer working conditions for employees, reduced risk of liability for owners and investors, and generally, increased marketability [of the equipment]. Accordingly, these asbestos removal costs must be characterized as capital expenditures.

(ii) TAM 9411002. In the second TAM, the taxpayer was engaged in the sale of rental warehouse space and related services. The taxpayer's facility consisted of a warehouse and a boiler house. The boiler house contained equipment that was originally used to heat the warehouse. However, this equipment had not been used by the taxpayer for several years. The boiler house (and its equipment) and warehouse were treated as one asset for purposes of depreciation. In order to secure a bank loan for expansion of its facility, the taxpayer was required by its lender to abate asbestos in its boiler house and warehouse.

Boiler House. The taxpayer removed all asbestos-containing materials from its boiler house. The taxpayer converted the boiler room into a two-truck garage and office space and rented the office space to a related freight company. The IRS held that the costs incurred by the taxpayer to remove asbestos-containing materials from its boiler house were capital expenditures under section 263 because these expenditures add to the value of the taxpayer's property and adapt such property to a new and different use. The IRS' technical analysis was that the taxpayer's expenditures to remove asbestos-containing materials from its boiler house were unlike the costs in Plainfield-Union. In the taxpayer's situation, the costs incurred to remove asbestos increased the value, use, and capacity of the taxpayer's property as compared to the status of its property in its original asbestos-containing condition. First, the taxpayer's expenditures permanently eliminated the health risks posed by the presence of asbestos in the boiler house. Second, the expenditures made the taxpayer's property significantly more attractive to potential buyers, investors, lenders, and customers. Third, the expenditures enhanced the usefulness and capacity of the taxpayer's property by enabling the taxpayer to provide office space and a garage in the space made available by the elimination of the asbestos hazard. In addition, the taxpayer's asbestos removal expenditures enabled the taxpayer to convert its boiler house into a garage and office space. By removing the asbestos, the taxpayer permanently eliminated the defect in its boiler house. It is unclear the extent to which Indopco was relevant to the holding. Although the TAM did not specifically rely on Indopco for its conclusion, it did cite Indopco for the proposition that deductions are exceptions to the norm of capitalization.

Warehouse. The taxpayer engaged an asbestos contractor to perform asbestos encapsulation activities in the warehouse area. The contractor rewrapped and
encapsulated the damaged or punctured areas of asbestos-containing pipe insulation and discarded insulation that was too damaged to be rewrapped. The pipes requiring encapsulation amounted to less than 25 percent of the total pipes in the warehouse. The IRS held that costs incurred by the taxpayer for encapsulation of asbestos-containing materials in its warehouse constitute incidental repair costs that neither materially add to the value of its property nor appreciably prolong its life. Therefore, such costs may be currently deducted as ordinary and necessary business expenses under section 162 of the Code. These expenditures were attributable to the rewrapping and encapsulation of damaged or punctured areas of asbestos-containing pipe insulation and related activities. Unlike the costs incurred for asbestos removal in the taxpayer's boiler house, the costs incurred by the taxpayer for encapsulation of damaged insulation in its warehouse neither appreciably increased the value of the taxpayer's property nor substantially prolonged its useful life beyond what it was before the asbestos became damaged. The application of a canvas or plastic wrapping over damaged pipe insulation reduced, but did not eliminate, the threat of exposure to airborne asbestos fibers. Moreover, because of the continued presence of asbestos, the expenditure did not enable the taxpayer to operate on a changed, more efficient, or larger scale.

[iii] **Norwest Corporation.** In this case, the taxpayer removed asbestos concurrently with the renovation and remodeling of one of its buildings. The taxpayer claimed an ordinary and necessary business deduction with respect to the asbestos removal expenditures on its tax return because: (1) The asbestos removal constitutes "repairs" within the meaning of Treas. Reg. §1.162-4, (2) the asbestos removal did not increase the value of the building when compared to its value before it was known to contain a hazardous substance, and (3) although performed concurrently, the asbestos removal and remodeling project were separate and distinct projects, conceived and undertaken for different reasons by different contractors. The IRS, on the other hand, contends that the costs of removing the asbestos must be capitalized because: (1) The removal was neither incidental nor a repair, (2) it was a permanent improvement that increased the value of the property, (3) improvements made a safer and more efficient business workplace, and (4) removal and remodeling was part of a single plan of rehabilitation. The Tax Court held that asbestos removal costs were truly intertwined with the remodeling project and therefore must be capitalized because they were part of a general plan of rehabilitation and renovation. While not dispositive in this case, the court did indicate that asbestos removal apart from a general plan of rehabilitation does not itself materially increase the value of the building so as to require capitalization as the IRS had suggested. Although the court's statement that the asbestos removal did not material increase the value of the building to require capitalization is *dicta,* it does indicate that if the removal had not been part of a remodeling plan the court apparently would have allowed the costs to be expensed.

[iv] **Demolition/Section 280B.** Section 280B requires the cost to demolish any structure to be capitalized to the land on which the building is located. The cost to demolish a building with asbestos will grossly exceed the costs of demolishing an asbestos-free building. There is an issue whether the additional cost to demolish an asbestos insulated building is required to be capitalized to the land, but the answer appears to be that section 280B applies.

[v] **Abnormal Retirement Loss.** It may be possible to take an abnormal retirement loss for the tax basis of a building discovered to have asbestos, even though the building may be subsequently demolished and regardless if the land is sold. A loss may be
taken for a building which is withdrawn from service when it has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence, even if the building is not disposed of. See Reg. §1.167(a)-8(a)(3) and De Cou v. Commissioner, 103 T.C. No. 6. In order to receive the loss, it is essential that the property be withdrawn from service in the year asbestos is discovered and the loss is recognized before demolition occurs. See Linden Gates et ux v. U.S., 81 AFTR ¶98-629 (3d Cir. 1998) (affirmed on appeal in an unpublished decision).

[e] **Storage Tank Removal and Replacement Costs**

As with the other areas of environmental related costs, the tax treatment of costs associated with removing, replacing, monitoring, and cleaning up after underground storage tanks (UST) has been unclear. While Rev. Rul. 94-38 does not address the tax treatment of costs to remove storage tanks, Rev. Rul. 98-25 and a Coordinated Issue Paper from the IRS to the Petroleum Industry has provided some insight.

[i] **Removal and Replacement of Refillable Storage Tanks.** As a general matter, the IRS would argue where removal is preparatory to the substitution of a new storage tank, removal costs should be capitalized to the new tank. The IRS might also argue that the cost to remediate any hazardous waste that leaked from the tank should also be capitalized into the new tank. See, e.g., Comm'r v. Appleby's Estate, 123 F.2d 700 (2d Cir. 1941). However, an argument can be made that such remediation cost is separate from the replacement and, thus, would be deductible if such costs would otherwise be deductible. See Treas. Reg. §§1.165-(2)(c) and 1.167(a)-(8) & (9).

The Coordinated Issue Paper on Petroleum Industry Replacement of USTs (1/9/1998) confirms that the IRS believes that costs incurred to remove and replace retail gasoline USTs should be capitalized into the new tank. The paper goes on to clarify that costs incurred to clean up the soil surrounding the gas station UST are deductible under section 162, where such costs are incurred by the taxpayer who contaminated the property. Presumably the rationale of these positions are equally applicable outside the petroleum industry.

[ii] **Removal and Replacement of Permanent Storage Tanks.** In Rev. Rul. 98-25, the Service ruled that all costs incurred to remove an old UST, replace the old UST with a new UST, and the costs to monitor the replacement permanent UST are deductible under section 162. This ruling, however, only applies to USTs that are not emptied and refilled. The Service reasoned that unlike USTs that are repeatedly refilled and emptied, USTs that are permanently filled once have no remaining useful life and therefore are not capital expenditures. The old UST has no value salvage value. While not specifically addressed in the Revenue Ruling, the same rationale used by the Service should extend to the costs to acquire and install new, nonreplacement USTs which would remain filled indefinitely.

[iii] **Removal Only.** Where no replacement will occur, it would seem that the costs to remove a tank and treat the soil should be deductible under section...
162 because these costs will not increase the value of the property or prolong its useful life. This position is consistent with the FASB Emerging Issue Task Force Issue No. 90-8. It states that such soil refining costs should be charged to expense unless the property is currently held for sale and the costs were incurred to prepare the property for sale. However, a taxpayer must be careful that removal does not adapt the property to a new use. If section 162 is not available, section 165 may be available to treat the removal costs as an abandonment loss.

The recent Coordinated Issue Paper for the Petroleum industry confirms that Service views costs incurred to remove retail underground gasoline storage tanks and remediate the soil, in cases where the tanks will not be replaced, as deductible when incurred by the same taxpayer who contaminated the property. This does not apply in cases where the costs are incurred to adapt the property to a new or different use.

Section 280B. Under Section 280B, any costs associated with a demolition must be capitalized into the land upon which the demolished structure was located. There had been some question that a storage tank may be considered a structure. Final Regulations issued on Dec. 29, 1997 clarify that storage tanks are not considered "structures" for purposes of this code section, but rather the term "structure" only includes buildings and their components.

Pre-Acquisition Contamination

As a general rule, payment of a fixed obligation — whether environmental or otherwise — of the seller of property by the purchaser is a capital expenditure which becomes part of the cost basis of the acquired property. Magruder v. Supplee, 316 U.S. 394 (1942). Consequently, expenditures incurred to satisfy a fixed environmental liability of the seller of property will be capitalized by the purchaser. This treatment is consistent with the tax treatment that would have occurred if the seller had cleaned up the property prior to the sale since the purchaser would have paid a higher price for the clean property.

Whether contingent liabilities — environmental or otherwise — of a predecessor go into the purchaser's cost basis when paid or may be deducted when paid by purchaser is not altogether clear. It should be noted at the outset that there is no precise definition of the term "contingent liability." The plain meaning of the term suggests that is an item for which the fact of liability has not been established, such as in the case of a pending legal action.

Field Service Advice 199942025, however, has recently provided some insight into the IRS's current thinking on how to treat the payment of contingent environmental liabilities by a corporation purchased in a stock acquisition. In this FSA, the seller agreed to indemnify the buyer and its subsidiaries for environmental liabilities associated with property held by the acquired corporation. The acquired corporation later incurred clean-up costs associated with the property. After filing suit against the seller, the acquired corporation obtained reimbursement for these costs. The IRS agent auditing the acquired corporation sought to require capitalization under the principle of Arrowsmith v. Commissioner, 344 U.S. 6
(1952), arguing that the costs related back to the stock acquisition. The agent also argued that the costs were not deductible because they were subject to reimbursement. The IRS National Office disagreed with the agent's conclusions. The National Office stated that the relation-back principle of Arrowsmith would not prohibit the deduction. Rather, the reimbursements represented a contribution to capital by the former owners of the acquired corporation and did not affect the acquired corporation's ability to deduct the expense. To support this conclusion, the National Office cited VCA Corp. v. U.S., 566 F.2d 1192 (Ct. Cl. 1977) and Rev. Rul. 83-73, both of which applied the Arrowsmith relation-back principle to an indemnification payment and both of which allowed a deduction for the underlying expense. The National Office also stated that the tax benefit rule should not be applied to the indemnity payment and the corresponding deduction.

Contract Termination Payments

[a] Lease and Supply Contracts

Taxpayers often incur costs to cancel contracts with unfavorable terms. In PLR 9240005, the Service concluded that a payment made by a utility to terminate a burdensome coal supply contract is deductible under section 162, and is not required to be capitalized under section 263(a). The payment was made to reduce the taxpayer's future expenses, and the taxpayer did not intend to enter into another supply contract with the same supplier.

In PLR 9334005, however, a similar type of payment was required to be capitalized. In that situation, the taxpayer secured a more favorable contract with the same supplier that it had the previous contract with. The Service concluded that capitalization was necessary because the taxpayer gained substantial new contractual rights and benefits as a result of the termination of the old contract. The new contract was for 10 years.

In PLR 9607016, the Service held that a tax-exempt organization must capitalize a lease termination payment. In that situation, the organization planned to move to a new building that was to be constructed on newly purchased land (which was purchased from an unrelated party). However, the taxpayer requested a ruling that the lease termination payments be capitalized because it was planning on converting from a tax-exempt organization to a for profit corporation and did not want a large deduction that it could not use.

Based on the above three letter rulings, the Service is more likely to require capitalization when a separate and distinct asset is created. However, the language in the other IRS releases indicate that finding a long-term benefit alone is enough. See ISP Coordinated Issue Paper on RIC Management Contracts. In the ISP Coordinated Issue Paper, the IRS stated that even if a separate and distinct asset lasting for more than a year was found not to exist, the investment advisor's expected long-term benefit from future contractual relationships with the mutual fund was enough to require the capitalization of the investment advisor's cost to develop the RIC.

Another fact scenario dealing with the treatment of contract termination payments is when the taxpayer simultaneously acquires a new asset from its counterparty. The ability to deduct a portion of these costs has been addressed by two key court cases, Cleveland
Both cases involved cancellation of long term leases on real property. However, the IRS has issued recent guidance which indicates their position on the issue left unresolved after the Millinery decision.

In Cleveland Allerton Hotel, the taxpayer owned and operated a hotel on leased land. The taxpayer determined that the rent was excessive. It then purchased the land for $441,250, but established that the value of the land did not exceed $200,000. The taxpayer tried to deducted the difference between the value of the land and the price paid and argued that the excess was paid to be relieved of an unprofitable contract. The Sixth Circuit agreed with the taxpayer.

In Millinery Center, the taxpayer also entered into a long-term lease. The taxpayer, at its own cost, constructed a building on the property, but at the termination of the lease the title of the building would vest in the land owner/lessor. Subsequently, the taxpayer decided to purchase the land so as to be released from the lease. The price paid was $2,100,000. The Tax Court found that the value of the unimproved land was $660,000. Accordingly, the taxpayer contended that the additional $1,440,000 was paid to secure relief from the lease and was deductible as an ordinary and necessary business expense. The taxpayer argued that because it already owned the building any amounts paid to the owner/lessor in excess of the value of the land had to have been paid to avoid excessive rental payments, relying on Cleveland Allerton Hotel.

The Tax Court disagreed and expressly declined to follow Cleveland Allerton Hotel. The court concluded that a taxpayer that purchases a capital asset should not be allowed a business expense deduction for that part of the payment allocable to the cancellation of a burdensome lease. The Second Circuit, on appeal, agreed with this aspect of the case. The Second Circuit indicated that the bundle of rights that were purchased were more appropriately characterized as a capital asset than as an ordinary business expense. Plus, the Second Circuit noted that the Tax Court had not found that the lease was in fact onerous to the taxpayer. Thus, the court concluded that while the obligations under the lease may have motivated the purchase of the property, they could not change its fundamental nature from the acquisition of a capital asset to mere removal of a burden.

Because of the conflict between the two circuit courts, the Supreme Court granted certiorari. The Supreme Court affirmed the Second Circuit, rejecting the taxpayer’s premise that it owned the building prior to its purchase of the land. The Supreme Court determined that the only way the taxpayer could continue to enjoy the use of the building after termination of the first lease term was by renewing the lease and paying the stated rent and was not persuaded that the lease payments were excessive, or that any part of the purchase price was paid to secure release from an unprofitable contract. Therefore, the Supreme Court held that the amount paid represented the cost of acquiring the complete fee to the building and the land and no portion could be deducted as an ordinary and necessary business expense was unwarranted.

Despite the Supreme Court decision in Millinery Center, it remains unclear whether the Court rejected in its entirety the Sixth Circuit’s approach in allocating a portion of
the payment to the termination of the lease, or whether it simply concluded that the facts of the case did not warrant the conclusion that the difference between the value of the land and the amount paid was a proper measure of the cost of terminating the lease. However, recent guidance from the IRS has clarified their position on this issue.

In PLR 9842006 (June 22, 1998), the taxpayer, a utility company, paid to terminate uneconomic power purchase agreements, but the supplier also made the taxpayer purchase the electric generating facility associated with those power purchase agreements at the same time that it paid to terminate the agreements. The IRS ruled that the taxpayer could deduct the portion of the payment allocable to termination of the power purchase agreements as an ordinary and necessary business expense. The IRS stated that:

The approach of the court in Millinery Center is consistent with the analysis in Cleveland Allerton Hotel v. Commissioner (citations omitted), and other earlier cases that dealt with a lump sum payment to terminate a burdensome contract and purchase the asset associated with the burdensome contract.

The PLR later adds:

Although it might be argued that Millinery Center does not permit an allocation of a portion of Taxpayer's payment to a deductible contract termination payment . . . the [analysis set forth by the IRS] demonstrates not only that such an allocation is permissible but that it is consistent with [Cleveland Allerton Hotel, and other earlier cases].

IRS made the same determination in an FSA substantially similar to PLR 9842006. In FSA 199918022 (Jan. 25, 1999), the taxpayer was also a utility and was required to enter into long-term power purchase agreements with alternative suppliers. Many of the taxpayer's contracts became burdensome when market rates did not rise as much as anticipated. To terminate one burdensome contract, the taxpayer entered into an agreement to buy the supplier's plant. The taxpayer allocated part of the consideration to the facility and the rest to the price of terminating the contract. IRS agreed that the taxpayer could obtain a current deduction for a termination payment, although it ruled that the taxpayer had overstated the amount properly allocable to the termination payment and that the taxpayer had to establish the amount paid exclusively for the purpose of terminating the burdensome contract. The FSA indicated that it was restating the position IRS took in PLR 9842006 that an allocation of a termination payment may be appropriate in certain circumstances. In order for this reasoning to apply, the FSA stated that it must be clear that a portion of the payment was for the purpose of terminating an unprofitable contract and that the amount paid for this purpose must be ascertainable.

In addition to reconciling Millinery Center with Cleveland Allerton Hotel, the FSA took care to reconcile its reasoning with a recent tax court case, U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998) and several other cases that required capitalization. In U.S. Bancorp, the taxpayer leased a computer for a five-year term under a noncancellable agreement. Shortly thereafter, the taxpayer determined that the computer was inadequate. The taxpayer entered into a rollover agreement with the lessor to lease a suitable replacement machine. The total
cost included a rollover charge in the amount of $2.5 million to terminate the old lease. The rollover agreement specified that the termination charge was immediately due and payable. The taxpayer claimed a deduction for the entire $2.5 million in the year the agreement was executed and argued that the charge was paid to terminate the first lease. The IRS disallowed the deduction arguing that the rollover charge was a capital expense because it secured significant future benefits under the second lease.

The Tax Court agreed with the IRS and did not view the termination of the first lease and the initiation of the second lease as isolated events. Rather, the court found the two events to be “inextricably integrated” and that the charge was, therefore, capital in nature. As in Millinery Center, the court concluded that there was no ground for making an allocation of a portion of the payment as attributable to the termination of the first lease, but did not elaborate on this conclusion.

In the FSA, the IRS stated that position set forth in PLR 9842006 is not inconsistent with the Tax Court’s conclusion in U.S. Bancorp because the court did not foreclose the possibility of an allocation under any factual circumstances. While noting that taxpayer in the FSA essentially entered into two agreements which were closely related, the FSA treated the taxpayer’s transaction as two separate agreements—an agreement to purchase the facility and an agreement to terminate the purchase contract. The two agreements were not so “inextricably related” that all of the payment should be capitalized as a cost of acquiring the facility.

[b] Capital Asset Purchase Contracts

An issue arises on the treatment of a termination payment when an acquiring company has a contract to buy a target company’s stock and the acquiring company must pay a fee to the target company if it terminates the contract. Prior to the recent 1997 modification to Section 1234A, an acquiring could claim an ordinary abandonment loss under §165. See, e.g., U.S. Freight Co. v. United States, 422 F.2d 887 (Ct. Cl. 1970). Now, Section 1234A, states that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to “property” which is (or on acquisition would be) a capital asset in the hands of the taxpayer. The provision had previously only applied to “personal property” which is (or an acquisition would be) a capital asset in the hands of the taxpayer.

This section clarifies that the termination of a contract to acquire a company will be treated as a sale or exchange of a capital asset. For example, suppose an acquiring company enters into a contract to purchase a target companies stock for a set price with a termination fee if the acquiror breaches the contract. If the stock of the target tanks and the acquiror decides to pay the termination fee rather than acquire the target, the acquiror will be required to recognize a capital loss on the payment. If the target is the party in breach, the termination fee paid to the acquiror should be characterized as an ordinary loss.

[10] Miscellaneous Cases and Rulings Since Indopco
Energy Conservation Expenses

In Rev. Rul. 95-32, the Service held that expenses incurred by a utility to install energy saving devices in customers homes were currently deductible. It noted that the expenditures were aimed at reducing electrical costs for the customers, as well as addressing environmental and societal concerns. It further recognized that the "programs may also enable X to reduce its future operating and capital costs." These costs were capitalized for financial statement purposes. The ruling held that the expenditures were not capital within the meaning of section 263(a) because no asset was created. Although the expenditures reduce future operating costs, "these kinds of benefits, without more, do not require capitalization."

See and compare T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581 (1993), where the Tax Court held that amounts paid by a management company to a shareholder so that the shareholder would refrain from causing the company's royalty expense from increasing is deductible. There the company was a franchisee in several H&R Block franchises. Under some of the franchise agreements, the company was required to pay a 5 percent royalty. However, if the shareholder transferred a majority interest in the company stock, the royalty would increase to 10 percent. The shareholder sold a minority interest and turned over the management of the company to T. T and the shareholder entered into an agreement whereby the company made monthly payments to the shareholder to induce her from taking any action that would cause the royalty to increase to 10 percent. The court concluded that the company could deduct the payments because its purpose was to avoid increasing the company's operating expenses, and did not result in a significant future long-term benefit.

Reengineering Costs

In TAM 9544001, the taxpayer incurred these costs in an effort to improve its manufacturing processes. The taxpayer converted from batch processing to Just-In-Time manufacturing. Batch processing is completed using an assembly line technique whereby each employee fills a single function or completes one step of the manufacturing process. Under Just-In-Time, each employee works as part of a multi-skilled team in a production cell that completes an entire manufacturing process. Just-In-Time emphasizes a work flow whereby members of each team perform all of the steps in the manufacturing process. This process may require that a taxpayer's plant be reconfigured and workers cross-trained so that workers can perform multiple tasks with groupings of machinery as opposed to performing a single task in an assembly line. The processes within the plant are different after implementation of the Just-In-Time process, but the business and the products of the company are the same.

In connection with converting to Just-In-Time, the taxpayer incurred costs to relocate and reconfigure existing equipment to set up new processes, to repaint the plant to delineate specific areas, to perform other plant modifications, to acquire materials and supplies, to provide training and for related consulting. The IRS ruled that the costs incurred to initially adopt and implement the Just-In-Time manufacturing process were not deductible under section 162, but were required to be capitalized under section 263. After analyzing the case law relevant to the specific types of costs incurred in adopting Just-In-Time, the TAM based its conclusion that the costs must be capitalized on two theories: (1) that the implementation of Just-In-Time produced a significant future benefit; and (2) that it was tantamount to engaging in a new trade or business.
[c] Employee Training Costs

In Rev. Rul. 96-62, the IRS held that Indopco does not affect the deductibility of employee training costs under Sec. 162.

[d] Vacation Pay

In TAM 9716001, the Service ruled that a newly formed corporation that assumed vacation pay liabilities in a tax free section 351 transfer exchange may deduct the payments it makes in satisfaction of such liabilities. In the TAM, a transferor corporation transferred retail stores to the new transferee corporation. As part of the transaction, the transferee assumed the transferor's liability for its vacation pay plan. Citing Rev. Ruls. 80-198 and 95-74, the Service adopted somewhat of a "step into the shoes" approach, finding that since the vacation pay would have been deductible by the transferor it should also be deductible by the transferee. The Service noted that the liability was transferred for a valid business purpose (maintain employee morale) and not tax avoidance.

[e] Loan Origination Expenses

In PNC Bancorp, Inc. v. Commissioner, CCH Dec. 52,729 (June 8, 1998), the Tax Court held that origination expenses incurred in the creation of loans, including costs of obtaining credit reports, appraisals and similar information, must be capitalized. Importantly, the taxpayer did not argue that the loan origination costs were deductible because the loans were not separate and distinct capital assets. In fact, it was not disputed that the loans were separate and distinct capital assets. Rather, the taxpayer argued that the loan origination costs were deductible because they were "every-day, recurring costs" and produced only a short-term benefit.

The Tax Court rejected the taxpayer's argument, holding that because the loans were separate and distinct assets that generated revenue over a period extending beyond the current year, the loan origination costs must be capitalized. Specifically, in response to the taxpayer's recurring expense argument, the Tax Court stated:

Petitioner failed to cite, nor do we find, any authority which stands for the proposition that expenses incurred in the creation of a separate and distinct assets are currently deductible if such expenses are incurred regularly. Accordingly, the fact that the banks incurred expenditures on a recurring basis does not ensure their characterization as "ordinary" if they are incurred in the creation of a separate and distinct asset.

Similarly, in rejecting the taxpayer's argument that the expenses at issue produced only a short-term benefit, the Tax Court stated:

Credit reports, appraisals, and similar information about prospective borrowers are critical in deciding whether to make a loan. It is the basis
on which banks make their credit risk management. While the specific information available when a loan is made may become outdated in a relatively short period of time, the quality of the decision to make the loan (and thereby acquire an asset) is predicated on such information. The soundness of the decision to make a loan is assimilated into the quality and value of the loan. Thus, direct costs of the decision-making process should be assimilated into the asset that was acquired. . . . Costs associated with the origination of the loans contribute to the generation of interest income and provide a long-term benefit that the banks realize over the lives of the underlying loans. The resulting stream of income extends well beyond the year in which the costs was incurred. In was this income benefit that was the primary purpose for incurring these expenditures. While the useful life of a credit report and other financial data may be of short duration, the useful life of the asset they serve is not. Therefore, like the appraisal costs in *Woodward v. Commissioner*, *supra*, and *United States v. Hilton Hotels*, *supra*, the construction-related costs in *Commissioner v. Idaho Power Co.*, and the lease acquisition costs in *Strouth v. Commissioner*, *supra*, the loan origination costs herein must be assimilated into the cost of the asset created.

It is clear from the foregoing, that the Tax Court's decision in PNC was based entirely on the fact that the loans at issue were separate and distinct multi-year assets.

[f] **Insurance Premiums**

In *Black Hills Power and Light Company v. Comm.*, 102 T.C. No. 18 (1994), the Tax Court ruled that the taxpayer could not deduct premium payments to purchase black lung insurance because the payments created a long-term benefit. The insurance premiums covered claims made during the policy year and several years after termination. Also, the taxpayer was able to obtain a refund of the premiums it had paid if it canceled the policy. The court concluded that the taxpayer received a significant future benefit because most of premium amounts paid in the years at issue were prepayments of the premiums relating to the post-closure years. The court specifically relied on *Indopco* for its conclusion.

[g] **Exit and Entrance Fees for Depository Insurance Funds**

In TAM 9402006, the IRS ruled that a bank was required to capitalize exit and entrance fees paid to transfer insured deposits from one depository insurance fund to another depository insurance fund - - *i.e.*, from SAIF to BIF. The IRS concluded that the costs were similar to costs incurred by a lessor to cancel an old lease and enter into a new lease. The exit and entrance fees enabled the taxpayer to obtain the benefits of membership in the fund for future years. Citing *Indopco*, the IRS noted that capitalization of a cost is required when significant benefits extending beyond the taxable year will be derived from an expenditure. This point is particularly obvious when the cost leads directly to the creation of a separate and identifiable asset. The IRS also concluded that depreciation of the payments is not permitted because there was no ascertainable useful life.
Legal Settlement Payments

In a TAM 9427002, the IRS considered whether a railroad company properly deducted amounts paid under a settlement agreement with a pipeline company to settle an antitrust suit. The pipeline company alleged that taxpayer had engaged in acts with other railroad companies to unlawfully monopolize the interstate transportation of coal, which included refusing to grant the pipeline company permits to cross railroad right of ways and causing other land owners to refuse to grant right of ways. According to the field office, the amounts paid to settle the suit should be capitalized because the settlement provided a long-term benefit under Indopco. That is, the expenditures related to behavior that eliminated competition. The field office relied, among other cases, on KWTX Broadcasting Company v. Commissioner, 31 T.C. 952 (1959), where the court addressed the deductibility of a $45,000 payment to a competitor inducing the withdrawal of its application to operate the same television channel that the taxpayer was applying to operate. The court stated that the expense was not ordinary and necessary but was a capital expenditure paid in connection with obtaining the operating permit. See Woodward v. Commissioner, 397 U.S. 572 (1970). The IRS National Office, however, rejected this position and found that the settlement related to the railroad's day-to-day business and provided only an incidental long-term benefit.

A key factor in this ruling appears to be the structure of the settlement agreement. Arguably, if the settlement had prevented the pipeline company from ever again competing with the railroad, IRS could have found a long-term benefit. In looking at whether costs should be capitalized, IRS pays close attention to the contract in determining whether there is any long-term benefit.

One-Year Rule

The most recent case addressing the future benefits issue is US Freightways Corporation v. Commissioner, 113 T.C. No. 23 (1999) which dealt with the "One-Year Rule." The so-called "One-Year Rule" states generally that no deduction shall be allowed for any amount paid which provides an extended benefit substantially beyond the taxable year. See Treas. Reg. §1.263(a)-1, -2. In US Freightways, the taxpayer, an accrual method trucking company, took a current deduction on its 1993 tax return for license, insurance, and other similar fees which had an effective period extending into 1994. The taxpayer attempted to argue that the "substantially beyond" language of the one-year rule should be interpreted to mean that an item of expense is deductible if its benefit extends less than 12 months into the subsequent taxable year. Judge Nims disagreed with the taxpayer's argument finding that the proper interpretation of current case law is not whether the benefit endures beyond one 12 month period, but rather whether the life of the benefit exceeds the tax year in which it is incurred. Judge Nims also noted that even if the taxpayer's construction of the one-year rule was recognized, it would be inapplicable to an accrual method taxpayer since the expense would have to be prorated between tax years.

US Freightways appears to narrow the availability of the one-year rule. However, it appears distinguishable from the payments in the proposed ISP paper. The payments in the proposed ISP paper are analogous to advertising costs. Therefore, it appears more appropriate to analyze these costs under guidance on that subject.
Priority Guidance

The IRS business plan for 1999 and 2000 includes several Indopco related issues, some of which have been previously noted above.

1. ISO 9000 costs. Whether ISO 9000 costs should be capitalized.

2. Removal costs. Whether the costs of removing property that is replaced with other property should be capitalized.

3. Cyclical maintenance costs. Whether cyclical maintenance costs should be capitalized.

4. Sales commission paid to obtain new customers. Whether sales commissions paid to obtain new customers, particularly in connection with cellular service contracts, should be capitalized.

5. Mutual fund launch costs. Whether costs to launch new mutual funds should be capitalized.

6. Contract termination payments. Whether contract termination payments should be capitalized.

§1.04 CONCLUSION

It goes without saying that the Indopco decision has provided very little guidance for solving the capitalization riddle. In fact, the decision may have brought more confusion to the area. Based on its pronouncements since Indopco, the IRS may be exploring what effect the long-term benefit notion in Indopco should have on capitalization. Because the IRS continues to approach capitalization issues on a case-by-case basis and probably will not set out any general capitalization guidance for taxpayers to follow, Indopco's effect on capitalization may well not become settled until a number of cases work their way through the system. Ultimately, legislation may be the only answer.