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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL
CC:FIP

SUBJECT:

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LEGEND

Docket 1 =

Docket 2 =

Docket 3 =

Area 1 =
Date 1 =
Date 2 =
Date 3 =
Corporation A =
Firm 1 =
Year 1 =
Year 2 =
$a =
$b =
$c =
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ISSUES

1) Whether expenditures incurred by Corporation A for acquiring loans should be capitalized rather than deducted in the year incurred?

In connection with the above issue, the Court requested respondent to address collateral issues. These issues are summarized as follows:

a) Is respondent's position in this case inconsistent with the Third Circuit's opinion in PNC Bancorp?

b) Is respondent's position in this case inconsistent with the government's appellate brief filed in Wells Fargo?

c) Is respondent's position in this case inconsistent with Rev. Rul. 99-23, 1999-20 I.R.B. 3?

2) Whether expenditures incurred by Corporation A for commissions and offering expenses should be capitalized rather than deducted in the year incurred?

CONCLUSIONS

1) Expenditures incurred by Corporation A to acquire loans should be capitalized rather than deducted in the year incurred.

a) Respondent need not modify its litigating position with respect to the capitalization of "loan origination costs" in light of the Third Circuit's opinion in PNC Bancorp.

b) The government's position, as framed on brief in Wells Fargo (relating to certain investigatory costs incurred in connection with the expansion of an ongoing business), is not inconsistent with respondent's position in the case at bar.

c) Respondent's position in this case is not inconsistent with Rev. Rul. 99-23.

2) Expenditures incurred by Corporation A for commissions and offering expenses should be capitalized rather than deducted in the year incurred.

FACTS

Dockets 1, 2 and 3 are consolidated Tax Court cases. The trial was held in Area 1 on Date 1. Briefs are due with the Tax Court as follows: Respondent's

Special Brief (to address objections to petitioners' proposed findings of fact) by Date 2; and Respondent's Answering Brief, by Date 3. The Court also specifically requested the parties to address the impact of certain rulings and pleadings on brief.

The facts for Issues 1 and 2 are taken directly from the summary in your incoming request for advice and, therefore, they may not reflect nuances contained in the factual record.[1] Consequently, you may need to tailor the advice given here to the facts as more fully developed in the record rather than simply lifting language verbatim from this FSA for incorporation in arguments to be made on brief. We recommend, therefore, that both requested findings of fact and arguments based on such requested findings be tied as closely as possible to the evidentiary record.

Issue 1

Corporation A acquires installment sales contracts containing embedded promissory notes (hereinafter, the "loans") from automobile dealers ("dealers") in connection with used car sales. Generally, the loans relate to bad or marginal credit risk automobile customers ("customers") who typically have difficulty obtaining financing.

With respect to each sales transaction, a contractual arrangement is entered into concurrently and simultaneously between the dealer, the customer and Corporation A. Corporation A performs a credit analysis to determine the prospective customer's financial situation. Corporation A then determines whether it will provide funding with respect to a particular prospective customer. If Corporation A decides to provide funding, the dealer and the customer enter into the installment sales contract, which contains the embedded promissory note. The dealer assigns the note to Corporation A as part of this sales transaction. There is no pre-existing loan between the dealer and the customer.[2] On average, the dealer is paid m% of the note with the remaining n% representing income to Corporation

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[1] One of these factual nuances concerns characterization of the costs at issue as either loan acquisition or loan origination costs. We believe that the factual record provides stronger support for the argument that Corporation A acquired installment contracts containing embedded installment notes as a purchaser rather than as an originator. Although we think that the costs at issue are better characterized as acquisition costs, this is not entirely free from doubt, especially given the inconsistent characterizations accorded to these arrangements by petitioners.

[2] We assume by this statement you mean that there is no loan in existence prior to the execution of the installment sale contract by the dealer and the customer.

A. Corporation A incurs various expenditures in connection with the origination/acquisition of these loans.

The average maturity of the loans (based on the notes' stated terms) were AVG 1 and AVG 2 for Year 1 and Year 2, respectively. Corporation A never sold the loans it acquired; Corporation A held the loans for average time periods of AVG 3 and AVG 4 for Year 1 and Year 2, respectively. Corporation A separately listed the loans as assets on its balance sheet.

For Year 1, the total costs related to the acquisition of the loans were $a. These costs were comprised of personnel expenses plus a prorated share of overhead expenses. Corporation A deducted the total amount of these costs on its federal income tax return for Year 1.

For Year 2, the total costs related to the acquisition of the loans were $b. These costs were comprised of personnel expenses plus a prorated share of overhead expenses. Corporation A deducted only $c of these expenses on its federal income tax return for Year 2 and now seeks an additional deduction of the remaining $d.

For financial accounting purposes, Corporation A did not currently deduct these costs, but instead recovered the costs over the expected life of the subject loans in a manner consistent with the Statement of Financial Accounting Standards No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" (SFAS 91). Corporation A did not track specific costs associated with each loan application.

To comply with SFAS 91, Corporation A established a separate ledger account to record fees and costs subject to deferral. For Year 1, Corporation A currently deducted, for federal income tax purposes, the costs identified by the petitioners as direct loan origination costs described in SFAS 91. Respondent determined these costs were not deductible as ordinary and necessary business expenses under I.R.C. § 162, because they were incurred in connection with Corporation A's acquisition of separate and distinct assets (i.e., the loans) that had useful lives extending beyond the taxable year in which such loans were acquired.

Respondent disallowed the deductions claimed by Corporation A for certain costs incurred in connection with acquisition of the loans. The disallowed deductions pertained exclusively to those costs that Corporation A had identified on its books and records as direct "loan origination costs." Respondent further determined that these costs should be capitalized under I.R.C. § 263 and recovered over the lives of the loans through amortization deductions. Accordingly, respondent disallowed Corporation A's claimed deductions for loan origination costs in the amount of $e for Year 1.

Respondent's adjustment for Year 1 was based on the balances in Corporation A’s ledger accounts and took into account any amortization or yield adjustment reflected in such accounts. A portion of the expenses included in respondent's adjustment are attributable to loans that were ultimately not acquired by Corporation A. Respondent does not dispute the current deductibility of the expenses associated with Corporation A’s unsuccessful loans.[3] There is a dispute, however, with respect to the specific amount attributable to these unsuccessful loans.

Petitioners asserted on brief that the costs at issue were incurred by Corporation A in connection with the acquisition (by purchase) of retail installment contracts from automobile dealers. Petitioners contend that under Michigan law, Corporation A is prohibited from "originating" loans. Petitioners, however, introduced testimony that there are no pre-existing loans prior to the acquisition of the sales installment contracts by Corporation A. Corporation A's audited financial statements for Year 1 and Year 2 specifically refer to "loan origination costs" in calculating revenue. At trial, the Court recognized that the costs incurred by Corporation A were in the general nature of loan origination costs.

In connection with the appeal in Wells Fargo,[4] the government conceded that certain costs incurred in investigating the creation or acquisition of a business by a taxpayer already engaged in the active conduct of a trade or business in the same field are currently deductible. The concession was based on Rev. Rul. 99-23 which set forth, inter alia, the proper treatment of investigatory costs incurred by a taxpayer already engaged in an existing trade or business in the same field as the trade or business with respect to which the investigatory costs are incurred.

At the Date 1 trial in these three consolidated dockets, the Court expressed its concern with the respondent’s litigating position in this case, in light of the government’s concession on appeal in Wells Fargo, as follows:

> The Court: I think there’s an issue here, and I think both parties need to examine very carefully before you prepare your briefs.

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[3] Although respondent would not contest the current deductibility of Corporation A’s costs attributable to the unsuccessful loans, we believe the deduction is authorized under I.R.C. § 165 of the Code, not I.R.C. § 162.

[4] Norwest v. Commissioner, 112 T.C. 89 (1999), appeal docketed sub nom Wells Fargo & Company and Subsidiaries v. Commissioner, No. 99-307 (8th Cir. July 8, 1999).

> And it's my impression, but I have to say I don't have Norwest in front of me. But it is my impression that the Government argued at the Tax Court that the pre-decisional expenses should be capitalized, and yet conceded that issue on appeal -- on the appeal of Norwest. If so, that's disturbing to this Court, and it would be further disturbing if the Government in this case were to take a position that is inconsistent with its own appeal position.

Tr. 146, line 21 through 147, line 7. Respondent stated at trial in this case that Corporation A's loan costs were "pre-decisional," rather than "post-decisional," in nature. Tr. 145, lines 4-8. However, respondent did not concede that the concession in Wells Fargo and Rev. Rul. 99-23 controlled the proper tax treatment of the costs at issue in the case at bar. Tr. 145-146.

Issue 2

Pursuant to a private placement memorandum, Corporation A in Year 1 offered $f of o% subordinated asset-backed cc year notes (the "securities"), redeemable by holders dd and ee months after date of issue. To effectuate the offering of these securities, Firm 1, a brokerage firm, sold the securities on Corporation A's behalf. Corporation A paid Firm 1 a sales commission equal to p% of the principal amount of the securities sold, plus q% if the holder did not redeem on the first redemption date, plus an additional q% if the holder did not redeem on the second redemption date. A due diligence fee of q% was included in the sales commission paid to Firm 1.

LAW AND ANALYSIS

Issue 1: Whether expenditures incurred by Corporation A for acquiring loans should be capitalized rather than deducted in the year incurred?

Section 162(a) allows a current deduction for an item that is (1) "ordinary," (2) "necessary," (3) an "expense," (4) "paid or incurred during the taxable year," and (5) made for "carrying on any trade or business."

Costs that are capital expenditures under I.R.C. § 263(a) are not currently deductible. Section 263(a)(1) provides the general rule that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Capital expenditures are generally amortized or depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, deducted upon dissolution of the enterprise.

Capitalization takes precedence over the allowance of deductions. See I.R.C. §§ 161 and 261. Deductions, as exceptions to the norm of capitalization, are strictly construed and allowed only "when there is a clear provision therefor." INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 85 (1992), quoting Deputy v. DuPont, 308 U.S. 488, 493 (1940).

The Supreme Court in Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) noted that an expenditure that otherwise might qualify as a currently deductible expense must nevertheless be capitalized if it is incurred in acquiring a capital asset. 418 U.S. at 11 (depreciation of equipment used by a public utility to construct electrical transmission and distribution facilities, otherwise deductible under I.R.C. § 167, required to be capitalized and added to the utility's adjusted basis in the facilities). See also Helvering v. Winmill, 305 U.S. 79 (1938) (regular and recurring expenses incurred by a taxpayer in the business of acquiring securities required to be capitalized as part of the cost of the securities acquired).

Petitioners bear the burden of showing that the costs at issue are not required to be capitalized under I.R.C. § 263(a), but rather are currently deductible under I.R.C. § 162. See INDOPCO, 503 U.S. at 85; T.C. Rule 142(a).

Corporation A's loan costs are required to be capitalized and are not currently deductible regardless of whether such costs are characterized as loan origination costs or loan acquisition costs.

Between their financial books and records and filings with the Tax Court, the petitioners have alternately described the costs at issue both as loan origination costs and as loan acquisition costs. The question in this regard is whether, for Federal income tax purposes, Corporation A in substance originated loans to the customers using the dealers as intermediaries, or whether Corporation A instead acquired loans originated by the dealers to their customers.[5] Although the answer

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[5] A fact pattern similar to the situation in the present case was considered in Hansen v. Commissioner, 360 U.S. 446 (1959), rev'g, 258 F.2d 585 (9th Cir., 1958), aff'g in part and rev'g in part, T.C. Memo. 1957-113. Although Hansen addressed the consequences to the dealer of whether, as the seller of the installment contract, it was required to include amounts retained from the purchase price paid by GMAC to establish a dealer's reserve, the appellate court described the substance of the original installment sale and assignment as follows:

> [w]hen we get down to what actually happens, ... we find one transaction -- a three-cornered agreement with interrelated obligations of dealer, purchaser, and finance company. Instead of being out of the first step of the transaction (the trailer sale to the purchaser), the finance company dictates the terms of the sale,

to this question is not free from doubt, we believe that these costs are more accurately described as loan *acquisition* costs, because Corporation A's rights against the automobile borrower arose out of the contractual rights that it purchased from the automobile dealer. However, *regardless* of whether the costs at issue are characterized as loan acquisition costs or loan origination costs, such costs are required to be capitalized under I.R.C. § 263(a) because such costs either were incurred in connection with the acquisition of a separate and distinct identifiable asset, or served to create or enhance a separate and distinct identifiable asset. In addition, the costs are required to be capitalized because the costs provide significant future benefits beyond the taxable year in which they were incurred.

A) The installment notes acquired by Corporation A are separate and distinct identifiable assets.

The relevant facts and circumstances in this case indicate that the loans acquired by Corporation A are distinct and recognized property interests that are generally transferable as evidenced by the dealers' transfer of them to Corporation A. The loans were separately listed on Corporation A's balance sheet as assets.[6] The loans also generate income, generally in the form of interest over their terms. These factors indicate that Corporation A's loans are separate and distinct assets. Cf., Commissioner v. Seaboard Finance Company, et. al., 367 F.2d 646 (8th Cir., 1966) (part of premium paid for small loan company was allocable to individual loan assets). Because Corporation A's loan costs either are incurred in connection with the acquisition of, or serve to create or enhance, these separate and distinct assets, such costs must be capitalized. See, Idaho Power, supra; Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345 (1971).

B) The installment notes acquired by Corporation A are capital assets.

> has obligations running to it in the sales contract, has a fixed percentage for its finance charges worked into the sales price, and is as much a part of the substance of the business transaction as the dealer -- whether or not it is the dealer who transfers the title formally to the purchaser, apparently for one hundred percent of the purchase price.

Hansen, 258 F.2d at 587, quoting Texas Trailercoach v. Commissioner, 251 F.2d 395, 397 (5th Cir., 1958).

[6] A well-established secondary market exists for automobile loans, indicating that such loans are marketable assets with extrinsic value.

As indicated above, expenditures which otherwise might qualify as currently deductible must be capitalized if they are incurred "in connection with" the acquisition of a capital asset. Idaho Power 418 U.S. at 13. In American Stores Company and Subsidiaries v. Commissioner, 114 T.C. No. 27, (May 26, 2000), the Tax Court quoted from Ellis Banking Corp. v. Commissioner, T.C. Memo. 1981-123 (41 T.C.M. (CCH) 1107), aff'd in part and remanded in part on another issue, 688 F.2d 1376 (11th Cir. 1982), cert denied, 463 U.S. 1207 (1983), to describe the meaning of the term "capital asset" in this context:

> ...Thus an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset.(n6) ...
>
> n6 *We do not use the term "capital asset" in the restricted sense of I.R.C. § 1221. Instead, we use the term in the accounting sense, to refer to any asset with a useful life extending beyond one year.* (Emphasis added).

American Stores, supra, at 19-20, quoting Ellis Banking, 688 F.2d at 1379 and n.6 (11th Cir. 1982).

The average maturity (term) of the loans acquired by Corporation A were AVG 1 and AVG 2 for Year 1 and Year 2, respectively. Because the loans acquired by Corporation A are clearly capital assets within the meaning of Idaho Power and its progeny (including American Stores), the costs incurred in connection with their acquisition are required to be capitalized under I.R.C. § 263(a). The petitioners implicitly concede that these notes are capital assets in its brief at page 59, where petitioners state that the purchase price of the installment note is a cost that is required to be, and was, capitalized.

C) Corporation A's loan costs are required to be capitalized if characterized as loan acquisition costs.

A long line of Supreme Court opinions holds that expenses incurred in connection with the acquisition of a capital asset must be capitalized. The Supreme Court in Idaho Power stated that an expenditure that otherwise might qualify as a currently deductible expense must nevertheless be capitalized if it is incurred in acquiring a capital asset. 418 U.S. at 11 (depreciation of equipment used by a public utility to construct electrical transmission and distribution facilities, otherwise deductible under I.R.C. § 167, required to be capitalized and added to the utility's adjusted basis in the facilities). See also Winmill, supra (regular and recurring expenses incurred by a taxpayer in the business of acquiring securities

required to be capitalized as part of the cost of the securities acquired). The requirement that costs be capitalized extends beyond the price payable to the seller to include any costs incurred by the buyer in connection with the purchase, such as appraisals of the property or the costs of meeting any conditions of the sale. See, e.g., Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970).

The Internal Revenue Service has long taken the position that costs incurred in connection with the acquisition of a capital asset must be capitalized. In Rev. Rul. 57-400, 1957-2 C.B. 520, the Service held that finders' fees paid in the form of buying commissions by a bank to brokers and other third parties for their introduction of acceptable applicants for mortgage loans must be capitalized because the commissions are a part of the acquisition cost of the loans. See also, Rev. Rul. 73-580, 1973-2 C.B. 86; Rev. Rul. 69-331, 1969-1 C.B. 87.

Petitioners have stated that a majority of the costs at issue were incurred in connection with the acquisition of the installment notes. See Petitioners' proposed findings of fact, nos. 73 and 76. Because the costs at issue were incurred in connection with the acquisition of installment notes that are separate and distinct capital assets, such costs are required to be capitalized under I.R.C. § 263(a).[7]

D) Corporation A's loan costs are required to be capitalized if characterized as loan origination costs.

If the costs at issue are properly characterized as loan origination costs rather than as loan acquisition costs, such costs nevertheless are required to be capitalized under I.R.C. § 263 because they serve to create or enhance separate and distinct capital assets. In Lincoln Savings, supra, the Court concluded that payments made by the taxpayer into a "Secondary Reserve" fund at the Federal Savings and Loan Insurance Corporation (FSLIC) were not currently deductible as ordinary business expenditures. Following an extensive analysis of the nature of the Secondary Reserve fund and the premium payments made into it by Lincoln Savings and other similarly situated FSLIC-insured institutions, the Court stated:

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[7] The regulations under I.R.C. § 263 also support capitalization of the costs at issue. Section 1.263(a)-2(e) of the regulations provides commissions paid in purchasing securities as an example of capital expenditures. Although petitioner cited this regulation in its brief for the proposition that dealers in securities are permitted to deduct these commissions as ordinary and necessary business expenses (see petitioner's brief at p. 52), the regulation provides only that commissions paid by a dealer in *selling* securities may be so deducted.

> What is important and controlling, we feel, is that the [Secondary Reserve] payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) in the absence of other factors not established here.

403 U.S. at 354.

If the court finds that Corporation A originated the loans, the costs at issue clearly served to create or enhance such notes, and therefore such costs are required to be capitalized under I.R.C. § 263(a). Petitioners have stated that Corporation A would not fund a transaction unless and until it had reviewed the prospective customer's credit application, reviewed credit reports, and performed credit evaluations of the customer's payment history and creditworthiness. See Petitioners' proposed findings of fact, nos. 68 and 78. Thus, but for incurring these costs, Corporation A would not have funded these loans. The courts have required that similar costs, such as appraisals and investigation expenditures, be capitalized into the capital asset to which the cost relates. See, e.g., Woodward, supra, (ancillary legal, accounting, and appraisal costs incurred in acquiring an asset required to be capitalized); Hilton Hotels Corp., supra, (fees incurred in connection with an appraisal proceeding to value shares of dissenting shareholders in merged corporation required to be capitalized); Ellis Banking, supra, (investigation expenditures directly related to examination of stock acquired capitalized as part of the cost of the stock); and Strouth v. Commissioner, T.C. Memo. 1987-552, (costs of securing potential leases, including checking the lessee's credit, reviewing the lease application, and drafting the lease documents required to be capitalized).

E) Whether characterized as loan acquisition costs or loan origination costs, the costs at issue here are required to be capitalized because they provide significant future benefits beyond the taxable year in which they are incurred.

In INDOPCO, the Supreme Court reaffirmed and expanded upon the separate and distinct asset test applied in Lincoln Savings. INDOPCO addressed whether investment banking and legal fees incurred by a target corporation in support of a friendly takeover were currently deductible. The Court held these expenditures were required to be capitalized even though the costs did not serve to create or enhance a separate and distinct asset.

The Court clarified that the separate and distinct asset test applied in Lincoln Savings was not the sole measure for determining whether an expenditure is required to be capitalized, stating:

> Lincoln Savings stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance . . . a separate and distinct" asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. We had no occasion in Lincoln Savings to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, Lincoln Savings holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure.

503 U.S. at 86-87.

The Court noted that through specific provisions such as I.R.C. §§ 162(a) and 263, the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. The Court stated that although the mere presence of some future benefit may not warrant capitalization, a taxpayer's realization of future benefits is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. 503 U.S. at 87.

In the instant case, the costs were incurred to acquire, create, or enhance loans, which generated interest income for the Corporation A well beyond the close of the taxable year. The future stream of income produced by the loans constitutes the very kind of long-term benefit that the Supreme Court in INDOPCO held to be indicative of capital expenditures. See also Colonial American Life Ins. Co. v. Commissioner, 491 U.S. 244, 251 n.5 (1989) ("the important point is . . . whether the taxpayer is investing in an asset or economic interest with an income-producing life that extends substantially beyond the taxable year"). Because the costs at issue contribute to the generation of interest income and provide a long-term benefit that Corporation A expects to realize well beyond the taxable year of the expenditure, such costs, like the costs at issue in Idaho Power, Woodward, Hilton Hotels Corp., Ellis Banking, and Strouth, are required to be capitalized.

Subissue a: Is respondent's position in this case inconsistent with the Third Circuit's opinion in PNC Bancorp?

No. As an initial proposition, the Third Circuit's decision in PNC Bancorp Inc., et. al. v. Commissioner, 212 F.3d 822 (3d Cir. 2000), rev'g 110 T.C. 349 (1998), does not control respondent's position in this case because it is factually

distinguishable from the present case. Even if the Court finds that the facts of PNC Bancorp are not factually distinguishable from the present case, we believe that PNC Bancorp was wrongly decided by the Third Circuit and should not be followed in this case. Furthermore, because this case would be appealable to the Sixth Circuit, the Tax Court is free here to disregard the Third Circuit's opinion. Cf., Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

Background on PNC Bancorp

PNC incurred costs directly related to the origination of loans, including external costs paid to third parties and internal costs paid by the taxpayer to its employees, for the following activities: processing a prospective borrower's loan application; evaluating a prospective borrower's financial condition; negotiating loan terms; obtaining or creating credit reports and property reports; preparing and processing documents; appraising property; searching title; evaluating and recording loan guarantees, collateral and security arrangements; recording security interests; and closing the loan. The taxpayer capitalized and amortized these costs for financial accounting and reporting purposes but currently deducted the costs for tax purposes.

The taxpayer argued that its costs were currently deductible as ordinary and necessary expenses under I.R.C. § 162(a) because the costs 1) were recurring expenses in the banking business, 2) were integral to taxpayer's day-to-day banking operations, and 3) provided only short-term benefits. The taxpayer did not dispute that its loans were separate and distinct assets.

The Tax Court, following Lincoln Savings and INDOPCO, held that the taxpayer's loan origination costs were incurred to create separate and distinct assets, i.e., loans. The court also stated that the costs provided long-term benefits, in the form of interest income, realized by the taxpayer over the lives of the loans. The court required the taxpayer to capitalize and amortize the costs over the lives of the loans in order to accurately measure the taxpayer's income.

On appeal, the Third Circuit saw no reasonable distinction between the loan origination costs at issue and other costs the taxpayer incurred as "ordinary expenses," and held the costs were deductible as ordinary and necessary business expenses under I.R.C. § 162(a). 212 F.3d at 835. The court noted that in determining what expenditures qualify as "ordinary," the court should refer to the common meaning of the term. The court found that the costs incurred were normal and routine "in the particular business" of banking. Id., at 829, quoting Deputy v. du Pont, supra at 496. Furthermore, because of the regularity of the expenses, the court concluded that currently deducting the costs would not distort PNC's income.

The Third Circuit reasoned that PNC's costs did not create separate and distinct assets within the meaning of Lincoln Savings because the asset created in Lincoln Savings existed apart from the taxpayer's day-to-day business. The Third Circuit further reasoned that unlike the payments in Lincoln Savings that actually formed the corpus of the asset, PNC's loan origination costs were not part of the principal amounts loaned, and, therefore, did not "create" or become a part of the loans. The court stated that the Service's expansive reading of Lincoln Savings would require capitalization of costs incurred "in connection with" or "with respect to" the acquisition of an asset. 212 F.3d at 830. The Third Circuit cited Iowa-Des Moines National Bank v. Commissioner, 68 T.C. 872 (1977), aff'd, 592 F.2d 433 (8th Cir. 1979); Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir. 1974); and First National Bank of South Carolina v. United States, 558 F.2d 721 (4th Cir. 1977) (together, the "credit card" cases), to support its findings that PNC's costs did not create anything and that such costs were "ordinary" expenses under I.R.C. § 162. 212 F. 3d at 830-31. Finally, citing language in the credit card cases, the court concluded that the costs were not required to be capitalized under INDOPCO because the costs themselves provided no significant future benefits. 212 F. 3d at 831.

A) The Third Circuit's opinion in PNC Bancorp does not control respondent's position in this case because it is factually distinguishable from the present case.

The Third Circuit's holding in PNC Bancorp that the loan costs at issue were not required to be capitalized hinged on that court's finding that such costs did not *create* capital assets, i.e., the originated loans. In the present case, the petitioners contend that the costs at issue were incurred in connection with *acquiring* loans. As discussed above, costs incurred in connection with the acquisition of a capital asset are clearly required to be capitalized, and therefore are not currently deductible. Because petitioners maintain that Corporation A acquired the loans in this case, it is not necessary for respondent to show that the costs *created or enhanced* the loans, and the Third Circuit's interpretation of the requirements under I.R.C. § 263(a) and Lincoln Savings in PNC Bancorp does not apply in this case.

B) The Third Circuit's decision in PNC Bancorp was wrongly decided and should not be followed.

Assuming the Court finds that the facts of PNC Bancorp are indistinguishable from the facts of the present case, the costs at issue are nevertheless required to be capitalized. We believe that PNC Bancorp was wrongly decided by the Third Circuit. To arrive at its holding that the costs at issue are currently deductible and are not required to be capitalized, the Third Circuit court narrowly construed the term "create" in direct conflict with a number of Supreme

Court cases, misinterpreted the term "ordinary," and instead improperly focused on the "regular and recurring" nature of the costs.

As stated above, a long series of Supreme Court opinions hold that expenses incurred in connection with the creation or acquisition of a capital asset must be capitalized. See, e.g., Idaho Power, supra; Winmill, supra. Unlike the Third Circuit's opinion in PNC Bancorp, none of these Supreme Court cases requires as a condition for capitalization under I.R.C. § 263, that a cost create an asset separate from the taxpayer's day-to-day business, or become an actual part of the asset created or enhanced. Moreover, if an expense that regularly recurs in a taxpayer's business creates or enhances a separate and distinct asset or provides the taxpayer with a significant future benefit, that expense is required to be capitalized under I.R.C. § 263. See, e.g., I.R.C. § 263A; Idaho Power, supra; Winmill, supra; and INDOPCO, supra. Consequently, the Third Circuit's opinion violates the fundamental principle set forth by the Supreme Court in INDOPCO that deductions, as exceptions to the norm of capitalization, are strictly construed and allowed only "when there is a clear provision therefor." 503 U.S. at 85, quoting Deputy v. du Pont, supra, at 493.

i) *The Third Circuit's interpretation of "ordinary" under I.R.C. § 162 was improper and conflicts with Supreme Court precedent.*

By focusing on the common meaning of "ordinary," the Third Circuit failed to acknowledge that for federal income tax purposes "[t]he principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures." Commissioner v. Tellier, 383 U.S. 687, 689 (1966). In American Stores Co., the Tax Court observed that:

> A particular cost, no matter what its type, may be deductible in one context but may be required to be capitalized in another context. Simply because other cases have allowed a current deduction for similar expenses in different contexts does not require the same result here.

Id., slip op. at 18. The fact that a taxpayer "incurs expenditures ... on a recurring basis does not ensure their characterization as 'ordinary' if they are incurred in the acquisition of a capital asset." Ellis Banking v. Commissioner, supra, 41 T.C.M. (CCH) at 1113 (citing Woodward, supra). See also Winmill, supra. In discussing the specific costs at issue in Ellis Banking, the Tax Court further noted that "the fact that petitioners were engaged in the business of acquiring bank stock [would not] entitle it to deduct such expenditures if the bank stock was a capital asset and the expenditures were incurred in the acquisition thereof." Ellis, supra, 41 T.C.M. at

1113. The fact that the costs at issue in PNC Bancorp served to create new loans makes the fact that they were "recurring" irrelevant.[8]

ii) *The Third Circuit improperly read I.R.C. § 263 to require the capitalization of a cost only when that cost creates or enhances an asset that exists apart from the taxpayer's day-to-day business.*

The Third Circuit distinguished Lincoln Savings on the grounds that the asset in that case, the Secondary Reserve fund, existed apart from the bank's day-to-day operations and was distinctly marked as the bank's property. Section 263, however, does not restrict deductions only for amounts paid that increase the value of property *separate from the taxpayer's day-to-day business*. Section 263(a)(1) provides that no deduction shall be allowed for *any amount paid* out for new buildings or for permanent improvements or betterments made *to increase the value of any property or estate*. (Emphasis added). Treas. Reg. § 1.263(a)-2(a) provides as examples of capital expenditures the cost of acquisition, construction, or erection of *buildings, machinery and equipment, furniture and fixtures, and similar property* having a useful life substantially beyond the taxable year. (Emphasis added). Furthermore, the Supreme Court has never interpreted I.R.C. § 263 to require capitalization only of costs that create or enhance an asset apart from the taxpayer's day-to-day business. For example, in Winmill, the Court held that the taxpayer, who was in the business of acquiring securities, was required to capitalize regular and recurring expenses incurred to acquire these securities. 305 U.S. at 84. Under the Third Circuit's reasoning, expenditures incurred to acquire manufacturing machinery or equipment would arguably be currently deductible because the assets are integral to the manufacturer's daily business operations. The regulations under I.R.C. § 263, however, list these costs as examples of capital expenditures, and thus, they must be taken into account through inclusion in inventory costs or a charge to a capital account, and are, therefore, not currently deductible. See Treas. Reg. §§ 1.263(a)-1(b) and -2(a).

iii) *The Third Circuit improperly read I.R.C. § 263 to require the capitalization of a cost only when that cost becomes an actual part of the asset created or enhanced.*

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[8] There are numerous instances where recurring expenditures incurred in a business context are not immediately deductible. For example, wages paid to an assembly line worker at an auto plant, clearly recurring and integral to the primary business activity of the auto maker, must be capitalized and allocated to the cost of the auto maker's inventory. See Treas. Reg. § 1.471-3(c).

The Third Circuit also reasoned that unlike the payments in Lincoln Savings that actually formed the corpus of the asset, PNC's loan origination costs were not part of the principal amounts loaned, and, therefore, did not "create" or become a part of the loans. This narrow interpretation of the term "create" utilized by the Third Circuit is clearly inconsistent with established precedent and at odds with the plain meaning of "create." A cost need not become a part of the asset acquired or created in order to be capitalized. If this was the case, the depreciation of equipment used to construct the electrical transmission and distribution facilities in Idaho Power would not have been required to be capitalized because that expense does not constitute an actual part of the facilities constructed. The Third Circuit's application of Lincoln Savings also ignores the broader language in that case that requires the capitalization of any expenditure that serves to create *or enhance* an asset.

iv) *The Third Circuit improperly rejected a test for capitalization adopted by the Supreme Court in Idaho Power.*

The Third Circuit reasoned that the Tax Court's interpretation of the "separate and distinct asset test" of Lincoln Savings was inappropriately expansive because it would require capitalization of costs incurred "in connection with" or "with respect to" the acquisition of an asset. PNC. Bancorp, 212 F.3d at 830. This reasoning appears to conflict not only with the Supreme Court's reasoning in Idaho Power that when amounts "are paid in connection with the construction or acquisition of a capital asset, they must be capitalized," but also with the reasoning of other circuit courts that have required capitalization of amounts incurred "in connection with" the acquisition or creation of assets. Idaho Power, supra, at 13; Nickell v. Commissioner, 831 F.2d 1265 (6th Cir. 1987); Johnsen v. Commissioner, 794 F.2d 1157 (6th Cir. 1986); Honodel v. Commissioner, 722 F.2d 1462 (9th Cir. 1984); Ellis Banking Corp., supra; Union Mutual Life Ins. Co. v. United States, 570 F.2d 382 (1st Cir. 1978); Estate of Meade v. Commissioner, 489 F.2d 161 (5th Cir. 1974). See also A.E. Staley Manufacturing v. Commissioner, 119 F.3d 482 (7th Cir. 1997) (costs "associated with" facilitating a capital transaction required to be capitalized).

v) *The credit card cases that the Third Circuit relied on were inapplicable to the costs at issue in PNC Bancorp because the costs in the credit card cases did not create or enhance separate and distinct assets.*

While the costs at issue in the credit card cases were similar to the costs incurred by PNC, these cases are factually distinguishable. The costs held to be currently deductible in the credit card cases were all incurred in the start-up phase of new credit card businesses, and did not produce clear and identifiable separate assets with determinable useful lives. For example, in Colorado Springs National

Bank, the Tenth Circuit noted that "[t]he start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable." 505 F.2d at 1191. See also Iowa-Des Moines National Bank, 68 T.C. at 879, in which the court held that the costs "did not create or enhance a separate and distinct asset or property interest." [9] In PNC Bancorp, on the other hand, the taxpayer incurred substantially similar types of costs to create clearly identifiable separate and distinct assets in the form of new loans with determinable useful lives.

The Third Circuit's reliance on the credit card cases ignores the premise that a particular cost, no matter what its type, may be deductible in one context but may be required to be capitalized in another context. In recognition of this principle, the Supreme Court in Idaho Power noted the following regarding wages paid by a taxpayer in its trade or business:

> There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1) of the 1954 Code, 26 U.S.C. § 162(a)(1). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired.

418 U.S. at 13.

vi) *The Third Circuit misapplied the standard for capitalization set forth in INDOPCO.*

Under the Third Circuit's interpretation of INDOPCO, if a taxpayer can somehow link an expenditure to the "needs of current income production," that expenditure should qualify for current deduction. PNC Bancorp, 212 F.3d at 833-834 (citing National Starch & Chem. Corp. v. Commissioner, 918 F.2d 226, 433 (3rd Cir. 1990), aff'd sub nom. INDOPCO, supra). In the instant case, the costs were

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[9] Except in the case of First National Bank of South Carolina, the courts in each of the credit card cases held that an initial fee paid by the subject banks for joining the credit card system was required to be capitalized since the fee served to create a separate and distinct asset. In First National Bank of South Carolina, the court determined as a matter of fact that "[membership in ASBA [(a bank association facilitating the processing of credit card transactions)] [was] not a separate and distinct additional asset created or enhanced" by the subject banks' payment of an ASBA assessment. The court further found that the assessment in issue in that case was made "solely to meet pre-operational expenses." 558 F. 2d. at 1111.

incurred to create or enhance loans, which generated interest income for the taxpayer beyond the close of the taxable year. The future stream of income produced by the loans constitutes the very kind of long-term benefit that the Supreme Court in INDOPCO held to be indicative of capital expenditures. See also Colonial American Life Ins. Co., supra. The Third Circuit concluded that “there need be no concern about a distortion of [PNC’s] income because of the regularity of these expenses.” 212 F.3d at 835. Currently deducting these expenses, however, would not match the costs with the interest income to which they relate, resulting in a distortion of the taxpayer’s income. As the Supreme Court stated in INDOPCO, "[t]he [Internal Revenue 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 taxable income." INDOPCO, 501 U.S. at 84.

In this regard, the Tax Court astutely observed that if a taxpayer were permitted to currently deduct a capital expenditure, the taxpayer’s taxable income would be seriously understated in a year when the amount of the costs at issue were increasing and just as seriously overstated in a year when the amount of those costs were decreasing, “with the result of making the corporation’s financial fortunes appear to be sinking when in fact it was enjoying great success, and rising when in fact its business was seriously diminished.” PNC Bancorp, Inc. v. Commissioner, 110 T.C. at 373, quoting Electric & Neon, Inc v. Commissioner, 56 T.C. 1324, 1333 (1971), aff’d without published opinion, 496 F.2d 876 (5th Cir. 1974) (taxpayer erroneously treated the entire cost of constructing signs it subsequently leased as a current expense, notwithstanding that the original term of the lease for these signs was usually five years). Therefore, the Third Circuit’s assumption that the regular and recurring nature of the expenses ensures that income is clearly reflected was erroneous.

Subissue b: Is respondent’s position in this case inconsistent with the government's appellate brief filed in Wells Fargo?

No. Wells Fargo, supra, involved the deductibility under § 195 of a target’s investigatory costs incurred in connection with a corporate consolidation. Norwest initially contacted Davenport about combining their banking businesses through a reorganization. Davenport hired a law firm to investigate the products, services, and reputation of Norwest, to ascertain whether Norwest would be a good business fit for Davenport, and to ascertain whether the proposed transaction with Norwest would be good for the Davenport community. Ultimately, it was agreed that Davenport and Bettendorf Bank (a member of the Norwest consolidated return group) would join to form a national bank (new Davenport) which would be wholly owned by Norwest.

The Tax Court held that the investigatory costs incurred by Davenport were required to be capitalized in accordance with INDOPCO, even though they were incurred before the decision to consolidate was made, because they were sufficiently related and connected to an event (the transaction) that produced a significant long-term benefit. The taxpayer appealed.

Section 195 provides that "start-up expenditures" may not be deducted, but taxpayers can elect to amortize them over a period of at least five years. A two-part definition of a start-up expenditure is provided in §§ 195(c)(1)(A) and (B). Those sections provide that a start-up expenditure is any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business; and (B) which, if paid or incurred in connection with the operation of an existing active trade or business, would be allowable as a deduction for the taxable year in which paid or incurred.

Under § 162, a deduction is allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In describing the law prior to § 195 (enacted in 1980), Congress explained that "investigatory expenses," which were "costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business," normally were not deductible because they were not incurred in carrying on a trade or business. See H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9 (1980) (House Report); S. Rep. No. 1036, 96th Cong., 2d Sess. 10 (1980) (Senate Report). Investigatory expenses incurred in searching for a new business could be deducted, however, if a taxpayer could show the search was related to an already existing business. Id. The disparity in the tax treatment of investigatory expenses resulting from the "carrying on a trade or business" requirement discouraged taxpayers from investigating the creation or acquisition of new trades or businesses. Section 195 was enacted, in part, to minimize this disparity and to encourage formation of new businesses by providing an amortization deduction for eligible investigatory expenses.

Prior to § 195, no deduction was allowed for investigatory expenditures if they were not incurred in connection with the operation or expansion of an existing business. Taxpayers were successful in obtaining a current deduction in cases where a trade or business was already in existence and courts concluded that the investigatory expenditures did not create or enhance separate and distinct additional assets. See NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973). Whether a taxpayer was expanding an existing business or creating or acquiring a new trade or business became a controversial issue between the Service and taxpayers.

After enactment of § 195 and prior to issuance of Rev. Rul. 99-23, the law regarding the proper tax treatment of costs incurred to investigate the expansion of

an existing business or the creation or acquisition of a new trade or business remained uncertain. As explained in the government's brief on appeal in Wells Fargo:

> Prior to the issuance of Rev. Rul. 99-23, supra, the proper tax treatment of costs incurred by a taxpayer in investigating the possible expansion or acquisition of a business was subject to uncertainty. Compare NCNB Corp. v. United States, [supra], in which the court held that costs incurred in conducting various market and feasibility studies in the process of opening new branch banks were deductible, with Central Texas Saving & Loan Assoc. v. United States, 731 F.2d 1181 (5th Cir. 1984), in which the court disagreed with NCNB and held that costs incurred in investigating whether to establish new branches of a savings and loans association were capital expenditures. Further, cases involving the deductibility of investigatory costs were often heavily influenced by the now-discredited view that an expenditure need not be capitalized unless the expenditure results in the creation of a separate and additional asset. See NCNB Corp., [supra, at 288-290]; Central Texas Savings & Loan Assoc., [supra, at 1184-1185]; see also Briarcliff Candy v. Commissioner, [supra, at 785-786]. In INDOPCO, the Supreme Court rejected the contention that expenditures were not subject to capitalization unless the expenditures resulted in the creation of a separate and additional asset.

Wells Fargo, supra, Government's Brief on Appeal, at p. 21.

The Service issued Rev. Rul. 99-23 during the pendency of the taxpayer's appeal. The government, in its brief in Wells Fargo, conceded that Davenport's investigatory costs were deductible under § 162 in light of the analysis provided in Rev. Rul. 99-23. The concession was explained on brief as follows:

> The ruling's conclusions concerning the types of expenditures that qualify as "investigatory" costs that may be amortized under Section 195 also demonstrates the IRS's current view concerning what types of investigatory costs may be deducted when incurred in investigating the creation or acquisition of a business by a taxpayer already engaged in the active conduct of a trade or business in the same field. One of the requirements that must be satisfied in order for an expense to be treated as a "start-up" cost is that the expense be one that would be deductible if incurred in an existing, active trade or business in the same field. ... Consequently, expenditures treated by Rev.

> Rul. 99-23 as investigatory costs that may be amortized under Section 195 are expenditures of a type that are deductible (not merely amortizable) when incurred by a taxpayer that is actively engaged in conducting an existing trade or business in the same field.

Wells Fargo, supra, Government's Brief on Appeal, at p.21.

Section 195 was enacted, however, to encourage the formation of new businesses by providing previously unavailable tax relief to a taxpayer investigating the creation or acquisition of a new trade or business. The Tax Court found that the investigatory expenditures at issue in the Wells Fargo case had to be capitalized in accordance with INDOPCO because they were sufficiently related to an event (the corporate acquisition) that produced a significant long-term benefit. Although the government conceded on appeal that Davenport's investigatory costs were deductible in light of Rev. Rul. 99-23, this concession is limited to situations where a taxpayer incurs investigatory expenditures in determining whether to expand its current business through an acquisition (either as the acquiring or the acquired).

Neither § 195 nor Rev. Rul. 99-23 were directed at changing the relevant capitalization principles regarding the acquisition of a specific capital asset. The following passage from the legislative history of §195 illustrates that the relief Congress sought to provide in § 195 is specifically directed to the type of expenditures typically incurred in investigating whether to acquire a business and which business to acquire:

> [E]ligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. Eligible expenses also include start-up costs which are incurred subsequent to a decision to establish a particular business and prior to the time when the business begins. For example, start-up costs 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.
>
> Start-up expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowed to an existing trade or business for the taxable year in which the expenditure was paid or incurred. . . . In addition, the amortization election for start-up

> expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, start-up expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life.

House Report at pp.10-11; Senate Report at pp.11-12.

Additional evidence that Congress was not attempting to address the capitalization rules outside the context of a search for a business is found in its discussion of investigatory expenses attributable to the acquisition of corporate stock:

> In addition to the active business requirement applicable to the entity, in the case of investigatory expenditures incurred by a taxpayer with respect to the acquisition of an existing trade or business, the taxpayer will be considered to have entered into a trade or business only if the taxpayer has an equity interest in, and actively participates in the management of, the trade or business. . . . In the case of a taxpayer incurring investigatory expenses with respect to the acquisition of common stock, a taxpayer would usually be considered to have acquired an investment interest rather than a qualifying trade or business interest. Thus, investigatory expenses attributable to the acquisition of corporate stock generally will not be eligible for amortization. . . . However, if in substance, a transaction is the acquisition of the assets of a trade or business, the investigatory expenses are eligible for amortization even though one of the steps of the transaction involved the acquisition of stock, e.g., the acquisition of a corporation which is then liquidated.

Id.

It is well-settled that income tax deductions are a matter of legislative grace and the burden of showing the right to a deduction is on the taxpayer. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); Deputy v. Du Pont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Deductions are exceptions to the norm of capitalization. See §§ 161 and 261. Congress has expressed an intent, through § 195, to allow for amortization of certain investigatory expenditures incurred in connection with the acquisition of a new trade or business. Congress did not express an intent, however, for that analysis to extend to the investigation of the acquisition of a specific capital asset.

Thus, where a taxpayer is already operating an existing trade or business and incurs costs in investigating the acquisition of a specific capital asset, the law is clear that those costs are capital acquisition costs. The government's concession in Wells Fargo, therefore, should not affect the disposition of this case. Because Corporation A is investigating the potential acquisition of a specific capital asset, not the formation of a new business, respondent's litigating position is consistent with the government's concession on appeal in Wells Fargo.

Subissue c: Is respondent's position in this case inconsistent with Rev. Rul. 99-23, 1999-20 I.R.B. 3?

No. Rev. Rul. 99-23 provides guidance concerning which investigatory costs incurred in connection with the acquisition of a new trade or business are eligible for amortization as start-up expenditures under § 195. In the ruling, the Service explained that under § 195(c)(1)(B), expenditures described in § 195(c)(1)(A) that are incurred before the establishment of an active business are deemed to be paid or incurred in the operation of an existing active trade or business (provided that such existing trade or business is in the same field as the business the taxpayer is investigating whether to create or acquire). Thus, such costs are deemed to satisfy the carrying on a trade or business requirement, clearly requiring that the § 162 threshold be met. The ruling also explains that because § 195(c)(1)(B) requires that an expenditure described in § 195(c)(1)(A) be allowable as a deduction for the

taxable year in which paid or incurred, the expenditure must still meet all of the other requirements of § 162. Accordingly, the expenditure must be an ordinary expense qualifying under § 162 and not a capital expenditure in order to be a start-up expenditure under § 195.

Rev. Rul. 99-23 holds that expenditures incurred in the course of a general search for, or investigation of, an active trade or business 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) qualify as investigatory costs that are eligible for amortization as start-up expenditures. Expenditures that are incurred, however, in connection with the attempt to acquire a specific business do not qualify as start-up expenditures because they are acquisition costs under § 263.

The holding of Rev. Rul. 99-23 evolves from the capitalization line drawn in Rev. Rul. 77-254, 1977-2 C.B. 63, which was specifically referenced to in the legislative history of § 195. Rev. Rul. 77-254 considers which costs incurred in the potential acquisition of a new business are capital acquisition costs for purposes of §§ 165 and 263. In that ruling, the taxpayer placed advertisements in several newspapers, traveled to various locations to investigate businesses that were for sale, and commissioned audits to evaluate the potential of several of these businesses. Eventually, the taxpayer decided to purchase a specific business and retained a law firm to draft the necessary purchase documents. The taxpayer ultimately abandoned all attempts to acquire the business and reported a loss under § 165(c)(2). Rev. Rul. 77-254 concluded that the expenses for advertisements, travel to search for a new business, and the cost of audits designed to help the taxpayer decide whether to attempt an acquisition were investigatory expenses that were not deductible under § 165(c)(2). The expenses of retaining a law firm to draft the purchase documents and other expenses incurred in the attempt to complete the purchase of a specific business were capital in nature, and thus were deductible upon the abandonment under § 165(c)(2).

The Tax Court has also recognized that there is a distinction between investigatory expenditures incurred to expand an existing business and costs incurred to acquire a separate and distinct capital asset. In Ellis Banking Corp. v. Commissioner, supra, the taxpayer incurred expenses for office supplies, filing fees, travel, and accounting services in connection with its examination of a target bank's books and records. The examination was performed pursuant to an acquisition agreement for the purchase of target's stock that was contingent upon several terms and conditions. The taxpayer argued that the expenses at issue were not acquisition costs because they were made without a firm commitment to purchase the target's stock, and because they were made to "investigate" the financial condition of a potential acquisition. The Tax Court concluded that these expenses were nondeductible capital expenditures incurred in the acquisition of a capital

asset. The court determined that this would be the result even if the taxpayer had been in the business of acquiring banks or even if the expenditures were incurred on a recurring basis.

The Court of Appeals agreed with the taxpayer's assertion that "the expenditures were made in the investigation" of the target, and without a firm commitment to buy. Nonetheless, the Court of Appeals concluded that "the expenses of investigating a capital investment are properly allocable to that investment and must therefore be capitalized." Id., 688 F.2d at 1382. In rejecting the taxpayer's argument that York v. Commissioner, 261 F.2d 421 (4th Cir. 1958), rev'g. 29 T.C. 520 (1957), permitted the deduction for investigatory costs, the Court of Appeals noted that the appellate court in York "never considered the possibility that the expenditures might be capital in nature, [instead] focusing solely on the requirement of section 162 that the taxpayer be in the trade or business." Ellis Banking, 688 F.2d at 1380, n. 9. In sustaining the government's position, the Court of Appeals further noted that "the *great weight of authority* ... and [its own] examination of the relationship of sections 162 and 263 establish that the cost of investigating an investment is part of the cost of the investment even if the taxpayer is not entering a new business." (Emphasis added.) Id.

The Service has also separately considered the deductibility of investigatory expenditures incurred to acquire capital assets. In Rev. Rul. 74-104, 1974-1 C.B. 70, the Service considered the deductibility of "evaluation" expenditures incurred by a corporation in the business of acquiring existing residential property to renovate and subsequently sell to the general public. Prior to acquiring property for renovation, the taxpayer incurred expenditures in evaluating a potential locality to determine the feasibility of selling such property in the locality. The expenditures included the cost of securing an initial report from an independent agent, and salaries, travel, and other related costs incurred by the taxpayer in evaluating the agent's report and the locality involved. The ruling holds that because the expenditures are incurred by the taxpayer in connection with acquiring existing residential property and provide benefits beyond the current taxable year through the sale of the renovated property, such expenditures are capital expenditures that must be taken into account as part of the cost of acquiring the property. However, if the expenditures do not result in the acquisition of property, they are deductible under § 165.

Although Rev. Rul. 99-23 clarifies that "whether and which" investigatory expenditures are deductible if they are incurred in connection with investigating the acquisition of a business, notwithstanding INDOPCO, it does not purport to address the situation at bar here. Thus, the analysis of Rev. Rul. 99-23 concerning whether an expenditure is investigatory and thus eligible for amortization under § 195 should be limited to situations where a taxpayer is investigating the acquisition of a new *business* rather than the acquisition of a *specific asset*. Accordingly, where a

taxpayer such as Corporation A incurs expenditures in investigating whether to acquire a specific asset (i.e., a loan) for use in an existing business, respondent should continue to argue that such expenditures are required to be capitalized (either under a significant future benefits analysis or under an acquisition of a capital asset analysis).

Issue 2: Whether expenditures incurred by Corporation A for commissions and offering expenses should be capitalized rather than deducted in the year incurred?

Expenses incurred to obtain a loan are capital expenditures that must be amortized over the period of the loan. Enoch v. Commissioner, 57 T.C. 781, 794-95 (1972), acq. on this issue, 1974-1 C.B. 1. In reaching its holding, the Tax Court relied on Lovejoy v. Commissioner, 18 B.T.A. 1179 (1930), in which the Board of Tax Appeals stated: "In its essence such a disbursement [commissions, fees, and printing costs] is not unlike bond discount, prepaid rent, cost of acquiring or disposing of a leasehold or item contract and many other transactions. They should be spread over the definite period of the loan, lease, or contract." See also, S. & L. Building Corporation v. Commissioner, 19 B.T.A. 788 (1930), acq. X-1 C.B. 60 (1931), reversed on another ground 60 F. 2d 719 (2d Cir. 1932), revd. 288 U.S. 406 (1933); Metropolitan Properties Corporation, 24 B.T.A. 220 (1931); Longview Hilton Hotel Company v. Commissioner, 9 T.C. 180 (1947), acq. 1947-2 C.B. 3; Rev. Rul. 86-67, 1986-1 C.B. 238; Rev. Rul. 81-161, 1981-1 C.B. 313; Rev. Rul. 75-172, 1975-1 C.B. 145; Rev. Rul. 70-360, 1970-2 C.B. 103.

In Anover Realty Corporation v. Commissioner, 33 T.C. 671 (1960), a transferee corporation that assumed a mortgage on transferred property argued that loan expenses that were incurred by the transferor for the sole purpose of acquiring a business asset (the mortgaged property) should follow the asset when it was transferred. The court stated that the loan expenses were made to obtain the use of the money; the purpose of the loan itself did not matter:

> It is not the purpose for which the loan is made that is important. It is the purpose of the expenditure for loan discounts and expenses. That purpose is to obtain financing or the use of money over a fixed period extending beyond the year of borrowing. When we analyze the reason behind the rule of amortizing such debt expenses, the distinction between this case and S. & L. Building Corporation and Longview Hilton Hotel Co. vanishes. Here, as in the cited cases, the mortgage discounts and expenses represent the cost of money borrowed for a period extending beyond the year of borrowing. It matters not that the proceeds of the loans be used to build an income-producing warehouse as in Julia Stow Lovejoy, or "to purchase additional properties" as in S. & L. Building Corporation or to buy the mortgaged premises, as in the instant case. In

> all such cases the expenditure represents an expenditure for the cost of the use of money and not a capital expenditure for the cost of any asset obtained by the use of the proceeds of the money borrowed.
>
> Amortization of the loan expense is related to the life of the loan and not the life of any asset obtained by use of the loan proceeds. The transfer of the asset obtained by use of the loan proceeds does not mean the transferee succeeds to the unamortized balance of the loan discounts and expenses. If the debt is assumed by the transferee it merely marks an earlier end to the period for which the borrower had the use of the money, which means the borrower, who has been amortizing the debt discounts and expenses he incurred or paid, and not the transferee, can take the unamortized balance as a deduction in the year of transfer.

33 T.C. at 675.

In the present case, Corporation A used funds obtained from the sale of the securities both for its daily operations and to purchase auto loans. See Petitioners' proposed finding of fact no. 167. Corporation A paid Firm 1, a brokerage firm, sales commissions and a due diligence fee to issue the securities, cc year notes redeemable by holders dd and ee months after date of issue. Corporation A incurred these costs to obtain financing or the use of money over fixed periods extending beyond the year in which the securities were issued. Therefore, such costs are not currently deductible, but rather are required to be capitalized and amortized over the terms of securities issued.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call if you have any further questions.

Lon B. Smith
Acting Associate Chief Counsel,
Financial Institutions and Products

By:______________________________
JOEL E. HELKE
Counsel to the Associate Chief
Counsel (Financial Institutions and
Products)