Report # 1017

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON ADVANCE NOTICE OF PROPOSED RULEMAKING ON DEDUCTION AND CAPITALIZATION OF EXPENDITURES CONNECTED WITH INTANGIBLES

July 25, 2002

Report on Advance Notice of Proposed Rulemaking On Deduction and Capitalization of Expenditures Connected with Intangibles

July 25, 2002

This report[1] comments on the advance notice of proposed rulemaking (the "Notice")[2] issued by the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") regarding the capitalization of expenditures incurred in acquiring, creating, or enhancing intangible assets. The stated goals of the Notice are (1) to provide greater certainty to the IRS and to taxpayers regarding the application of capitalization rules to such expenditures and (2) to reduce the administrative and compliance costs associated with determining whether and how to capitalize them. The Notice states that proposed rules will address the application of Section 263(a),[3] which denies a deduction for capital expenditures, to costs incurred in acquiring, creating, or enhancing intangible assets or benefits generally by setting out detailed rules regarding the treatment of specific types of expenditures incurred in connection with various transactions, possibly coupled with a general rule for other situations. The proposed rules will

1 This report was prepared by members of the Committee on Capitalization and Cost Recovery and the Committee on Tax Accounting of the Tax Section of the New York State Bar Association. The principal drafters of this report were David Mayo and Marci Poliakoff. Helpful comments were received from Samuel Dimon, David Hariton, Robert Jacobs, William McRae, Yaron Reich, Michael Schler, Marc Silberberg, Adina Spiro, and Alan Tarr.

2 Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461-02. The Notice was issued on January 17, 2002.

3 Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986 as amended (the "Code").

not alter the manner in which other sections of the Code, such as Sections 195, 263(g), 263(h), or 263A, apply to determine the correct tax treatment of an item. Presumably, they also will not alter the creation or treatment of a substituted or transferred basis in an intangible asset. The Notice solicits comments on a number of specific points that it discusses, as well as on certain general principles.

I. Summary

We applaud the goal of Treasury and the IRS, evidenced by the Notice, to create clarity and to reduce the litigation and administrative costs that have resulted from the unsettled state of the law regarding the treatment of costs incurred in connection with the acquisition, creation and enhancement of intangible assets. This report responds to a number of requests for comments made by Treasury and the IRS in the Notice, and it addresses certain other issues raised by the Notice.

A. General Approach

We endorse the general approach adopted by the Notice of identifying specific categories of expenditures that must be capitalized. We believe this approach is necessary to avoid reliance on general rules and principles, the application of which would be determined on a case by case basis, if the new rules are to achieve their objectives of reducing uncertainty, controversy and compliance costs. Nonetheless, we believe that a general rule, of relatively limited applicability, should be promulgated that would require capitalization of expenditures not otherwise set forth as capitializable in the regulations contemplated by the Notice. The scope of the suggested general rule is described in the next paragraph. We considered, but rejected, a recommendation that regulations promulgated pursuant to the Notice include a rule permitting deduction of all expenditures relating to the acquisition, creation or enhancement of intangible assets or benefits unless such expenditures expressly are required to be capitalized by the regulations contemplated by the Notice (or other prospective guidance). We were concerned that such a rule would not provide sufficient flexibility to deal with unanticipated classes of expenditures in a dynamic economy, and would provide an opportunity for taxpayers to rely on creative, but relatively immaterial, distinctions between expenditures they have made and those required to be capitalized, in order to claim unwarranted deductions.

B. Application of General Principles to Expenditures Not Specifically Listed

We believe that the IRS should be guided by several principles in creating a general rule that requires capitalization of expenditures to acquire, create, or enhance intangible assets that are not mentioned explicitly in the Notice. Specifically, the IRS should require capitalization only where (1) capitalization is necessary to reflect income clearly, taking into account the regular and recurring nature of the expenditure for the particular taxpayer as well as other relevant factors, (2) the expenditure creates a significant future benefit beyond the period described in the 12-Month Rule (defined below in IIIB), and (3) requiring capitalization is practical and administrable. Only expenditures that are not deductible under other existing authority should be subject to this rule. We believe that the IRS also should continue to follow the approach adopted in the Notice by identifying additional specific categories of expenditures that should be required to be capitalized or deducted as the IRS becomes aware of them.

C. Conformity with Financial Accounting

We recommend that the regulations not limit the federal income tax treatment of an expenditure to its treatment for financial or regulatory accounting purposes.

D. Use of De Minimis Rules

We applaud the suggestion that de minimis transaction costs be currently deductible, notwithstanding any other requirement that an expenditure be capitalized. We question, however, the extension of such de minimis rules to direct expenditures for the acquisition of intangibles, including in those circumstances described in the Notice.

E. Employee Compensation

We concur with the Notice's recognition that employee compensation almost always is an ordinary and necessary expense of a business and, therefore, should be subject to current deduction. We agree that it is appropriate generally to require the capitalization of bonuses or commissions paid in connection with the acquisition of intangible assets.

II. Background

The Code permits a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[4] Conversely, the Code does not allow a deduction for capital expenditures, described as amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[5] The goal of the Code sections and the interpretations that have followed is to ensure that taxpayers claim deductions for expenses in the taxable years to which such expenses properly are attributable and thereby clearly reflect income determined on a periodic

4 Section 162(a).

5 Section 263(a).

basis.[6] In theory, capital expenditures and deductible items would represent very different costs paid by a business. In practice, however, because of the factual nature of the inquiry, it has been difficult to distinguish between them, at least at the margin. As a result, a body of case law and rulings has developed analyzing whether certain business expenses may be deducted currently under Section 162(a) or must be capitalized under Section 263(a).[7] In addition, in connection with tangible assets, a body of statutory and regulatory law has been developed to classify expenditures.[8] No such statutory or regulatory law has been developed in connection with most intangible assets.

The inquiry of whether business expenditures may be expensed (deducted currently) is not a new one.[9] Universally, the cases have recognized that this inquiry inherently is fact-based with respect to the particular business involved.[10] Despite the heavily fact-intensive nature of the inquiry, there have been several relatively recent key cases that have laid the groundwork for

---

6 See, e.g., INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992); Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974).

7 See, e.g., INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992); Commissioner v. Idaho Power Co., 418 U.S. 1 (1974); Wells Fargo & Co. v. Comm'r, 224 F.3d 874 (8th Cir. 2000); PNC Bancorp, Inc. v. Comm'r, 212 F.3d 822 (3d Cir. 2000).

8 See, e.g., Section 263A and the regulations promulgated thereunder (providing uniform capitalization rules for certain tangible business property).

9 See, e.g., Welch v. Helvering, 290 U.S. 111 (1933); Deputy v. du Pont, 308 U.S. 488 (1940).

10 See, e.g., INDOPCO, 503 U.S. at 86; du Pont, 308 U.S. at 496 (recognizing that each case distinguishing between current expenses and capital expenditures "turns on its special facts"); Welch, 290 U.S. at 113-14 (stating that the ordinariness of an expense is a "variable affected by time and place and circumstance"); PNC Bancorp, 212 F.3d at 828, 834 (finding that in determining if expenditures are ordinary within the meaning of Section 162(a), the court must "examine the nature of the day-to-day operations of the particular business being considered" and that INDOPCO requires a "contextual, case-by-case approach to determining whether an expenditure better fits under the 'ordinary and necessary' language of section 162(a) or the 'permanent improvements or betterments' language of § 263(a)").

the modern discussion of whether business expenditures qualify for current deduction under Section 162(a) or must be capitalized under Section 263(a).

This case law has resulted in a number of imprecise and conflicting standards for determining when capitalization is required for expenses incurred in respect of intangible assets. Specifically, it has been difficult to identify the appropriate standards to use or the weight to give the relevant facts regarding particular expenditures. In addition, it often is hard to determine whether an expenditure relating to an intangible asset produces a long-term or short-term benefit, or both.

A. Lincoln Savings

Commissioner v. Lincoln Savings and Loan Ass'n[11] involved a dispute regarding funds required to be paid by a savings and loan to the Federal Savings and Loan Insurance Corporation to form an additional reserve fund in which, the Court found, the taxpayer had a "distinct and recognized property interest." The Supreme Court held that such payments were not deductible, even though required by law for all banks, but rather could be deducted when the funds in the reserve were used at some future time.[12] The Court found "important and controlling" the fact that the payment of funds to form the reserve served to "create or enhance . . . what is essentially a separate and distinct additional asset," as opposed to merely purchase deposit insurance. As an "inevitable consequence," the Court held that the payment was "capital in nature" and, therefore, not deductible under Section 162(a).[13]

---

[11] 403 U.S. 345 (1971).

[12] Id. at 358.

[13] Id. at 354.

B. INDOPCO

The Supreme Court clarified in INDOPCO, Inc. v. Commissioner that the creation or enhancement of a separate and distinct asset, while sufficient to require an expenditure to be capitalized in the case of long-lived assets, was not a prerequisite to such treatment.[14] The Court in INDOPCO held that the payment of legal and investment banking fees and miscellaneous expenses in connection with a friendly takeover of the taxpayer were not deductible under Section 162(a), but rather were required to be capitalized under Section 263(a).[15] The Court acknowledged that the expenditures at issue did not create or enhance a specific asset. Instead, the Court largely based its decision on the fact that the taxpayer would realize benefits from the expenditures beyond the year in which the expenditures were incurred.[16] Although Lincoln Savings stated that a future benefit was "not controlling,"[17] INDOPCO clarified that such benefit was "undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[18]

C. Developments Subsequent to INDOPCO

As a result of the INDOPCO decision, heightened attention has been paid to expenses that create, or have the potential to create, long-lived intangible assets. In the case of certain

---

14 INDOPCO, 503 U.S. at 86-87.

15 Id. at 90.

16 Id. at 87.

17 Lincoln Savings, 403 U.S. at 354 (also noting that "many expenses concededly have prospective effect beyond the taxable year").

18 INDOPCO, 503 U.S. at 87.

expenses, such as advertising expenses, the IRS has administratively assured deductibility.[19] The treatment of many other types of expenses, however, has been left to judicial development. Recent cases interpreting Lincoln Savings and INDOPCO have yielded inconsistent results. In particular, two courts of appeals cases have limited the scope of capitalization with decisions permitting current deduction of a number of expenditures incurred in connection with the acquisition of intangibles.[20] Shortly after the decisions in those cases, the Tax Court made clear its contrary position that some expenditures of a similar nature should be capitalized.[21] In Wells Fargo & Co. v. Commissioner, the IRS asserted that salaries paid to officers of a corporation were required to be capitalized because a portion of those salaries was attributable to services performed in connection with a friendly takeover of the taxpayer. The Eighth Circuit, reversing the Tax Court, held that such expenditures were deductible currently. The court narrowed the scope of INDOPCO by using an "origin of the claim" analysis.[22] In so doing, the court examined whether the salaries were related directly to the transaction (which admittedly provided a long-term benefit) or only indirectly so.[23] Because the court found that the origin of the salaries was the existing employment relationship between the officers and the company,

---

19 Rev. Rul. 92-80, 1992-2 C.B. 57.

20 Wells Fargo & Co. v. Comm'r, 224 F.3d 874 (8th Cir. 2000); PNC Bancorp, 212 F.3d 822 (3d Cir. 2000).

21 Lychuk v. Comm'r, 116 T.C. 374 (2001).

22 The court explained that under the origin of the claim doctrine, "the character of a particular expenditure is determined by the transaction or activity from which the taxable event proximately resulted." Wells Fargo, 224 F.3d at 887 (citing United States v. Gilmore, 372 U.S. 39, 47 (1963)).

23 224 F.3d at 886-7 (noting that the origin of the claim doctrine has been "extended to distinguish capital business expenses from ordinary business expenses" and that "the important consideration in determining the nature of an expenditure for tax purposes is the origin and character of the claim for which the expenditure is incurred").

rather than the acquisition of the company, the court determined that there was only an indirect relationship between the payment of the salaries and the acquisition itself (unlike the situation in INDOPCO, where the sole purpose of the payments to the law firm and investment bank was to facilitate the transaction, thereby making the expenditure directly related to the transaction).[24] As a result, the court permitted the taxpayer to deduct currently the total amount of the salaries, including the amount attributable to the transaction.[25]

The court also permitted a current deduction for certain fees paid to a law firm attributable to the "investigatory stage" of the transaction. The court agreed with the IRS's position, stated in Revenue Ruling 99-23, that investigatory expenses incurred before the final decision to acquire a business are deductible currently while those incurred after such final decision is made must be capitalized.[26] Based on all the facts and circumstances of the case, the court determined that the final decision was reached when the parties signed the transaction agreement. As a result, fees paid to a law firm attributable to due diligence and other investigatory activities that took place after such date were required to be capitalized under Section 263(a) while fees attributable to investigatory measures that took place before such date were deductible currently under Section 162(a).[27]

Similarly, in PNC Bancorp, the Third Circuit reversed a Tax Court decision largely on the basis of an "origin of the claim" analysis. This case addressed whether costs incurred by

---

[24] Id. at 887. A consequence of this origin of the claim analysis is to make the cost of third-party service providers more likely to be capitalized than the cost of in-house service providers providing similar services.

[25] Id. at 888.

[26] Id. at 889 (referring to Rev. Rul. 99-23, 1999-1 C.B. 998).

[27] Id.

banks for marketing, researching, and originating loans with a term greater than one year were deductible currently under Section 162(a) or were required to be capitalized under Section 263(a).[28] These costs included (1) payments made to third parties to help the bank decide whether to approve loans, such as payments for credit screenings and appraisals and (2) internal costs such as employee salaries attributed to originating and marketing the loans (for example, in completing and reviewing loan applications).[29] In permitting these expenses to be deducted currently, the court focused on the facts that (1) generally the profits earned from loaning money are the primary source of a bank's income and (2) in the banking industry, expenses incurred in loan origination are "normal and routine" in the business. Looking specifically at the case at hand, the court found that it was clear that the expenditures at issue were "routinely incurred in the banks' businesses."[30] Because of this routine recurrence of the types of expenditures at issue, as well as their integral role in the ability of the banks to generate business income, the court likened these expenditures to any other normal cost of doing business.[31] Further, the court noted that because of their regularity, the current deduction of the expenses at issue did not cause the distortion of income that Section 263(a) and the subsequent cases requiring capitalization of expenditures seek to prevent.[32]

---

28 PNC Bancorp, 212 F.3d at 824.

29 Id. at 826.

30 Id. at 829.

31 Id. at 834 (stating that activities at issue "lie at the very core of the banks' recurring, routine day-to-day business" and that the "Commissioner has not been able to articulate a principled reason why these normal costs of doing business must be capitalized, while other ordinary banking costs need not be").

32 Id. at 835.

More recently, the Tax Court revisited the capitalization issue in Lychuk v. Commissioner.[33] In a split decision including a number of partial concurrences (with the court's opinion joined in full by only 8 of the 16 participating judges), the court rejected the approach taken by the circuit courts in Wells Fargo and PNC Bancorp. In Lychuk, the taxpayer's sole business was the acquisition and servicing of automobile installment contracts.[34] Expressly disregarding the regular and recurring nature of the salaries and benefits paid to employees, the court required the taxpayer to capitalize such expenditures to the extent they were attributable to contracts actually acquired because such salaries and benefits were related directly to the acquisition of assets with useful lives longer than one year.[35] On the other hand, the court permitted the taxpayer to deduct currently the overhead costs associated with the same business of acquiring and servicing installment contracts, such as costs of printing, rent, computers, and utilities, because it found that such expenses were not related directly to such acquisition of long-term assets.[36] The Tax Court summarized its view of the law as requiring an expenditure to be capitalized when it creates or enhances a separate and distinct asset, produces a significant future benefit, or is incurred in connection with (i.e., is directly related to) the acquisition of a capital asset.[37]

---

[33] 116 T.C. 374 (2001).

[34] Id. at 376.

[35] Id. at 393-4. The taxpayer was permitted to deduct currently under Section 165 the portion of salaries and benefits attributed to installment contracts it never acquired. Id. at 386.

[36] Id. at 385.

[37] Id. at 385-86.

III. The Proposed Rules

The case law discussed above has generated significant uncertainty regarding capitalization issues. Government representatives have noted that the IRS is devoting more than 25% of its examination resources to capitalization questions in certain industries.[38] Uncertainty and controversy have prompted the IRS to issue the Notice.

As discussed above, the goal of rules proposed pursuant to the Notice will be to clarify the application of Section 263(a) to expenditures to acquire, create, or enhance intangible assets. According to the Notice, the IRS and Treasury will endeavor to describe clear rules outlining those expenditures that may be deducted currently and those that must be capitalized, taking into account administrative and record-keeping costs associated with capitalization, which may be weighed against any potential distortion of income caused by current deduction. In addition, to reduce administrative and compliance costs associated with determining the proper tax treatment of expenditures connected with intangibles, the IRS and Treasury hope to provide safe harbors and assumptions that will govern the application of the rules.

A. Amounts Paid to Acquire Intangible Property

The Notice provides that taxpayers would be required to capitalize amounts paid to purchase, originate, or otherwise acquire a security, option, any other financial interest described in Section 197(e)(1), or any evidence of indebtedness. This requirement would include both the cost of acquiring existing loans from another person and the amounts loaned to borrowers in the case of newly-originated loans.

---

38 Alison Bennett, Olson Calls for Broad Business Cost Rules, Signals Doubt on Future Value of Intangibles, Daily Tax Report, Aug. 8, 2001, at G-2.

In addition, amounts paid to another person to purchase or otherwise acquire intangible property from that person would be required to be capitalized. This rule would include the amount paid to another person to acquire an amortizable Section 197 intangible asset such as an existing customer base, but it would not include costs incurred to create one's own customer base or goodwill (such as advertising costs).

B. Amounts Paid to Create or Enhance Certain Intangible Rights or Benefits

The treatment of expenditures paid to create or enhance the intangible rights or benefits discussed in the Notice will be governed by the "12-Month Rule," a safe harbor that provides that capitalization of such expenditures would not be required unless they create or enhance intangible rights or benefits for the taxpayer that extend beyond the earlier of (i) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditures or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred. The Notice makes clear by example that even an expenditure paid in December of one year that provides benefits until December of the next year may be deducted currently in the first year by virtue of falling within the 12-Month Rule.[39]

The Notice lists a number of items that the proposed regulations would require to be capitalized, subject to the 12-Month Rule, under this heading. These include the following:

- Amounts prepaid for goods, services, or other benefits (such as insurance) that will be received in the future.

---

[39] On February 26, 2002, the IRS issued a memorandum instructing examiners to apply the 12-Month Rule to all examinations for which no Notice of Proposed Adjustment or Revenue Agent Report have been prepared. The IRS noted that such rule was designed to be consistent with the decision in U.S. Freightways Corp. v. Comm'r, 270 F.3d 1137 (7th Cir. 2001). In that case, the circuit court, reversing a Tax Court decision, held that expenditures that provided benefits for a 12-month period that spanned more than one taxable year could be deducted in the year in which such expenditures were incurred.

- Amounts paid to an organization to obtain or renew a membership or privilege from that organization, including the costs of obtaining admission to practice medicine in a hospital or a stock trading privilege, but excluding costs of obtaining ISO 9000 certification or similar costs.
- Amounts paid to a governmental agency for a trade name, trademark, copyright, license, permit, or other right granted by a governmental agency, such as an amount paid to a state to obtain an indefinitely valid license to serve alcohol.
- Amounts in excess of a specified dollar amount, suggested to be $5,000, paid to another person to induce that person to enter into, renew, or renegotiate an agreement that produces contract rights enforceable by the taxpayer. Such contract rights include leases, covenants not to compete, licenses to use intangible property, customer contracts, and supplier contracts.
- Amounts paid by (i) a lessor to a lessee to induce the lessee to terminate a lease of real or tangible personal property or (ii) a taxpayer to terminate a contract that grants another person the exclusive right to conduct business in a defined geographic area.
- Amounts in excess of a specified dollar amount (no example given) to facilitate the acquisition, production, or installation of tangible property that is owned by a person other than a taxpayer where the acquisition, production, or installation of the tangible property results in the type of intangible future benefit for which capitalization is appropriate.
- Amounts paid to defend or perfect title to intangible property.

C. Transaction Costs

The Notice states that the proposed regulations would require a taxpayer to capitalize certain transaction costs that facilitate the taxpayer's acquisition, creation, or enhancement of intangible assets or benefits described above. In addition, the rules would require capitalization of transaction costs that facilitate the taxpayer's acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of Section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. These transaction costs would include payment of legal fees to outside attorneys. The rules would not require capitalization of employee compensation (except bonuses and commissions that are paid with respect to the transaction) or fixed overhead costs. Finally, the rules would provide that transaction costs that do not exceed a certain minimum threshold dollar amount, such as $5,000, would not be required to be capitalized.[40]

IV. Detailed Comments and Recommendations

The IRS and Treasury requested comments on various general concepts and on specific aspects of the proposed rules. This report addresses the issues, both general and specific, about which comments were solicited and provides our suggestions and recommendations for the proposed rules to be issued pursuant to the Notice.

---

[40] On April 26, 2002, the IRS commissioners for the Large and Mid-Size Business Division and the Small Business/Self-Employed Division issued a memorandum instructing their employees not to propose capitalization of employee compensation, fixed overhead, or de minimis (not exceeding $5,000) transaction costs because, in light of the Notice, the IRS no longer is prepared to litigate these issues. The memorandum stated that "examination resources would be better utilized on other high-risk compliance areas rather than to continue to propose capitalization of costs [that would be deductible under the rules described in the Notice]." "IRS Memorandum From Large and Mid-Size Business Division Commissioner Larry R. Langdon and Small Business and Self-Employed Commissioner James G. Kehoe Regarding Guidelines for Intangibles Under I.R.C. Section 263(a)," TaxCore, Bureau of National Affairs, Inc. (May 8, 2002).

A. General Approach

We applaud the goal of Treasury and the IRS to create clarity in this difficult area and to reduce the litigation and administration costs that have ensued as a result of the unsettled state of the law. We believe that the approach adopted by the Notice of identifying specific categories of expenditures that must be capitalized is appropriate for a number of reasons. First, Treasury and the IRS have an understanding of and experience with the relevant areas that are likely to give rise to controversy. They are able to use that experience to tailor rules addressing the most common areas in which capitalization issues arise, thereby fostering clarity in the law and reducing disputes. Further, the broad language of the INDOPCO decision has spawned uncertainty as to the appropriate treatment of many expenditures the treatment of which before the decision was relatively certain, or at least unchallenged. This is particularly true in the case of expenditures that may be seen as creating or enhancing intangible assets. Many expenditures, such as, for example, expenditures for recruiting, that are incurred for a particular short-term purpose may also create or enhance an intangible asset, such as workforce in place or, more generally, the overall goodwill and going concern value, of the taxpayer incurring the expense. The holding of INDOPCO, with its emphasis on the creation of future benefit as a reason for capitalization, called into question the proper treatment of such "mixed" expenses. The approach adopted by the Notice, if carried into the final regulations, should bring about a return to the pre-INDOPCO certainty. Finally, much, although not all, of the controversy that stems from the INDOPCO decision relates to relatively short timing differences between the deduction or amortization of expenditures, such as the loan origination expenses at issue in PNC Bancorp. In these cases, significant audit and perhaps other enforcement resources must be devoted to what ultimately is merely the collection of interest on underpayments for a few years. Although we are not seeking to allocate the IRS's audit and enforcement resources or minimize the importance of timing differences, we believe the IRS could rationally seek to limit the resources devoted to issues of this nature by creating bright-line rules and eliminating discretion to capitalize or deduct particular expenditures.

We believe Treasury and the IRS in drafting the regulations should take care to emphasize the broad nature of the categories. In our view, this is necessary to avoid providing an opportunity for taxpayers to rely on creative, but relatively immaterial, distinctions between expenditures they have made and those required to be capitalized in order to claim a deduction for items that appropriately are capitalized. This should be accomplished through careful drafting of the categories themselves, coupled with appropriate examples and perhaps general language providing that the categories are to be construed liberally so that the categories, or the principles set out in the categories, will cover as many actual expenditures as possible.

B. Principles of Capitalization or Deduction

Applicability of the clear reflection of income standard, which is the general goal of income tax accounting,[41] has been accepted by courts in determining whether a particular expenditure will be required to be capitalized.[42] We believe that clear reflection of income generally will be furthered by permitting the deduction of expenditures that create (or arguably

---

41 See Section 446(b); Treas. Reg. § 1.446-1(a)(2). The treatment of a particular item as deductible or capitalizable constitutes a "method of accounting" under applicable precedent. Rev. Proc. 97-27, § 2.01(1), 1997-1 C.B. 680, 681.

42 See, e.g., Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283 (1967) ("under the circumstances involved herein [i.e., the treatment of overhead in connection with self-constructed assets], section 263 and 446 are inextricably intertwined").

create) a future benefit[43] if such expenditures are regular and recurring for a taxpayer or in the taxpayer's industry.[44] Nonetheless, we recognize that in some circumstances a regular and recurring item may be required to be capitalized to reflect clearly the income of a taxpayer, either by the terms of the specific categories in the regulations or, as discussed below, pursuant to a general rule. For example, an investment business may incur significant transaction expenses in connection with its investments well in advance of realizing income from the investments. Despite the fact that the investment business likely incurs such costs on a regular and recurring basis, clear reflection of income and general capitalization principles should require that such expenditures be capitalized into the cost of the investments rather than deducted when such costs are incurred. Nonetheless, the regular and recurring nature of an expenditure should be an important factor contributing to the determination of whether such expenditure is required to be capitalized or is permitted to be deducted currently for several reasons.

First, as a matter of statutory construction of the relevant Code sections, current deduction of such expenditures generally is appropriate. Section 162 provides that a deduction is allowed for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," and it includes as examples of such deductible items

---

[43] If a particular expenditure does not create a future benefit and was not incurred in connection with a transaction that creates a future benefit, it generally should be deductible currently regardless of the fact that it is not regular or recurring, so long as the other requirements for deductibility are met.

[44] As discussed above, whether an expenditure is "ordinary and necessary" such that it may be deducted currently under Section 162(a) is determined based on the facts and circumstances surrounding the industry and the specific business involved. Similarly, whether an expenditure is regular and recurring should be determined both with respect to the taxpayer involved and its industry.

reasonable compensation for services actually rendered, travel expenses and rents.[45] The general rule of Section 162(a) has, of course, been applied to many expenses not enumerated there. For purposes of applying the general rule of Section 162 to other items, the term "ordinary" means "normal, usual, or customary"[46] and the term "necessary" means "helpful" or "appropriate."[47] An exception to the rule of current deduction of expenditures is provided for "capital expenditures" in Section 263, which provides that "no deduction is 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."[48]

The purpose of Section 162 and Section 263 is to determine taxable income,[49] which generally is synonymous with net income.[50] Notwithstanding the often-stated presumption that expenditures should be capitalized unless Congress provides otherwise,[51] allowance of deductions is necessary to measure appropriately net income. On the other hand, the allowance of deductions for expenditures that are capital in nature also is inconsistent with a tax on net

---

[45] Section 162(a).

[46] Deputy v. Du Pont, 308 U.S. 488, 395 (1940).

[47] See, e.g., Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Welch v. Helvering, 290 U.S. 111, 113 (1933).

[48] Section 263(a)(1).

[49] See Section 161 ("in computing taxable income . . . there shall be allowed as deductions the items specified in this part . . ." which includes Section 162); Section 261 ("In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part" which includes Section 263).

[50] See, e.g., NCNB Corp. v. Comm'r, 651 F.2d 942, 948 (4th Cir. 1981) (stating that "[o]ur system of income taxation attempts to match income and expenses of the taxable year so as to tax only net income"), vacated on other grounds by NCNB Corp. v. United States, 684 F.2d 285 (4th Cir.) (reaffirming quoted principle). For a discussion of the development of the concept of taxable income from net income, see McGee Grigsby and Cheryl M. Coe, The Norm of Capitalization: An Unwarranted Presumption, TAXES, Mar. 1999 at 35-36.

[51] See, e.g., INDOPCO, 503 U.S. at 84.

income. Such deductions would enable taxpayers to deduct the costs of investments that produce future income. For businesses, such investments are equivalent to savings, and permitting them to be deducted currently would result in the taxation only of income net of such savings, which effectively would create a consumption tax for businesses.

A line must be drawn between deductible and capitalizable items in order to accomplish the statutory goal of defining net income. Congress recognized the distinction between these two categories of expenditures when it included examples of deductible items (e.g., salaries) and capitalizable items (e.g., buildings) in Sections 162 and 263. The contrast between the specific examples in the statute should inform the application of both Sections to other expenditures. It is our view that regular and recurring expenditures generally more closely resemble the "ordinary and necessary" expenses described (and exemplified) in Section 162 than the expenditures incurred for "permanent improvements or betterments" of buildings or other property required to be capitalized under Section 263.

Some of the post-INDOPCO case law supports generally permitting the deduction of regular and recurring items. In particular, the reasoning described above was adopted by the court in PNC Bancorp.[52] The court in PNC Bancorp recognized that it could not create a bright-line rule for distinguishing between deductible and capitalizable expenditures that could apply to all factual situations. Rather, the court sought to consider the language of Section 162 and Section 263 and determine whether the specific expenditures at issue more closely resembled an

---

[52] PNC Bancorp, 212 F.3d at 834 (stating that "the INDOPCO analysis demonstrates the contextual, case-by-case approach to determining whether an expenditure better fits under the 'ordinary and necessary' language of Section 162(a) or the 'permanent improvements or betterments' language of Section 263(a)").

ordinary expense contemplated by Section 162 or a permanent improvement or betterment contemplated by Section 263.[53]

The Notice reflects the approach of permitting current deduction of regular and recurring items in many of the rules that it suggests. For example, in the Notice Treasury and the IRS suggest a regular and recurring standard may be appropriate for determining the treatment of transaction costs. In addition, the 12-Month Rule, which generally would allow a current deduction for an expenditure that creates benefits of not more than 12 months' duration even when such benefits will be realized in more than one tax year, reflects the business reality that in all likelihood a similar expenditure will be made the next year for the same item. (For example, a one-year insurance policy with a single premium due in July will, in all likelihood, be followed by another insurance policy the next year.) Similarly, the allowance of a deduction for most employee compensation expenditures is consistent with a policy decision to allow a current deduction for regular and recurring costs because such compensation expenditures are incurred each year regardless of the timing of benefits realized by the employer as a result of the specific services performed by the employee in a given year. The Notice does not, however, adopt fully the approach of PNC Bancorp in permitting the deduction of all regular and recurring items; for example, in connection with transaction costs, the Notice suggests that regular and recurring may be an appropriate standard to use in determining deduction, but does not adopt it.

---

53 PNC Bancorp, 212 F. 3d at 835.

C. General Areas on Which Public Comment is Requested

1. Principles of a General Rule

The Notice is not entirely clear regarding the expected treatment under the regulations of expenditures that are not set out in a specific category. On the one hand, the introductory language of the Notice states that the IRS and Treasury anticipate that such expenditures will not be subject to capitalization. On the other hand, the body of the Notice provides that the IRS and Treasury are considering general principles of capitalization that would require capitalization of certain costs of acquiring, creating, or enhancing intangible assets that are not mentioned in the Notice. It is anticipated by the Notice that such principles would be applied by the regulations to require capitalization only in rare and unusual circumstances. In connection with those statements, the IRS and Treasury requested comments as to what general principles of capitalization should be so used.

Although the potential limits of the rule are not entirely clear, at the very least the Notice presents a presumption that expenditures not described in the Notice will be deductible currently. We recognize that Treasury and the IRS are seeking to reduce uncertainty and controversy through the issuance of the Notice and, ultimately, regulations. Nonetheless, in our view it would be impossible for the IRS to identify every category of expenditure that should be required to be capitalized, even in light of its significant audit experience. Further, if capitalization treatment were limited to enumerated categories, taxpayers might attempt to characterize their expenditures so as to avoid having them fall within one of the categories, even when such expenditures were of the type that should be capitalized under Section 263.

For these reasons, and because we believe that a presumption of deductibility would be inconsistent with the general statements regarding capitalization applied in INDOPCO and Idaho

Power, we recommend that the IRS include in the regulations a general rule requiring capitalization of certain expenditures that do not fall within one of the categories laid out in the Notice. Further, we suggest that such a general rule not be limited by its terms to application only in rare and unusual circumstances. We doubt that a significant number of taxpayers, if any, would view the circumstances of their expenditures as either rare or unusual, so that at best the general rule including such a term would be applied only in the audit context and the limitation would not serve to reduce uncertainty. Nevertheless, we believe relatively narrow drafting of the general rule and a liberal construction of the categories should result in limited application of the general rule.

In formulating such a general rule, we believe the IRS should look to several guiding principles, the application of which would help achieve the Notice's goals of certainty and administrability. Specifically, we believe the IRS should draft a rule that generally requires capitalization only where requiring capitalization of such expenditures is necessary to reflect clearly the taxpayer's income[54] and the expenditures provide future significant benefits beyond the time period described in the 12-Month Rule.[55] Further, we believe that it should be clear, perhaps through examples, that the rule should be applied to require capitalization only of expenditures where capitalization is both practical for the taxpayer and administrable for the IRS. This point is intended to ensure that the general rule furthers one of Treasury's and the IRS's stated goals in issuing the Notice, that of reducing the administrative and compliance costs

54 We believe that a general rule requiring capitalization only to reflect clearly the taxpayer's income would result in continuing uncertainty and controversy regarding the capitalization requirement.

55 We believe inclusion of the 12-Month Rule is consistent with both current administrative practice and the proposal that is described in the Notice.

associated with determining whether particular expenditures should be deducted or capitalized. In the interest of clarity and certainty, we also believe that any general rule should provide by its terms that it would not be applied in the case of any expenditure for which a specific rule (of either capitalization or deduction) were otherwise provided, either in the regulations or in other guidance.[56]

Although a general rule of capitalization is necessary to ensure appropriate treatment of those expenditures connected with intangibles that should be capitalized under Section 263 but were not specifically identified in the Notice, we also recognize that a general rule could result in continued uncertainty and additional controversy and litigation, all of which the Notice was intended to reduce, regarding the interpretation of the rule and its application to particular expenditures. For this reason, consistent with the creation in the Notice of a broad list of categories into which the vast majority of expenditures connected to intangibles should fall, we encourage the IRS to continue to identify, through the issuance of revenue procedures or other guidance, specific categories of expenditures that should be required to be capitalized or permitted to be deducted as the IRS becomes aware of them. This practice would be consistent with the general approach taken by the Notice and would serve to reduce the number of capitalization issues subject to dispute by limiting the expenditures to which taxpayers and the IRS would be forced to apply the general rule.[57] At the same time, it would permit Treasury and the IRS to target regularly arising problem areas through the issuance of additional specific

---

[56] For example, it should be clear that advertising expenditures, the deductibility of which is permitted by Rev. Rul. 92-80, supra, would not be required to be capitalized by reason of such a general rule.

[57] This is particularly desirable given the frequent assertion that the rule stated in INDOPCO requires capitalization of expenditures the proper treatment of which was assumed by taxpayers to be deductible before INDOPCO was decided.

guidance. This high level of detail is appropriate in this context in light of the administrative burdens associated with resolving capitalization issues, the nature of the stakes involved for taxpayers and the IRS, and the IRS's ability to identify through the audit process areas of dispute in which new rules of either capitalization or deduction should be created.

2. No Book-Tax Conformity

Treasury and the IRS sought comments regarding whether tax accounting for particular items should be conformed to the financial accounting for such items. Consistent with existing authority, we do not believe the treatment of expenditures for financial accounting purposes generally should be determinative of their treatment for tax purposes.[58] In the first instance, financial accounting standards are not identical for all purposes and may include generally accepted accounting principles, management accounting and, depending on the taxpayer's industry, regulatory accounting. Second, the rules for financial accounting are intended to achieve goals that are different from, and sometimes conflict with, federal income tax accounting principles. The latter are intended to measure taxable income; financial accounting as embodied in generally accepted accounting principles generally is intended to provide financial information for shareholders and other business owners. Other forms of financial accounting have different intended audiences, including management or industry regulators. Finally, we believe that the Service should not cede authority to define taxable income to other agencies or to private

[58] See, e.g., Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979) (denying deduction for inventory depreciation determined in accordance with generally accepted accounting principles because such deduction did not clearly reflect income for tax purposes); PNC Bancorp at 832 (rejecting the use of financial accounting standards in determining the tax treatment of expenditures because of differing incentives involved in financial and tax accounting); but cf. Treas. Reg. § 1.472-2(e) (requiring book-tax conformity for use of LIFO inventory method.)

regulatory bodies. Similarly, we believe that the authority to determine the amount of taxable income of a particular taxpayer should not be ceded to such entities.[59]

3. Amortization Periods

Treasury and the IRS sought comments regarding the appropriate amortization period for expenditures that are required to be capitalized but that do not result in the creation of an asset that has a readily ascertainable useful life. We believe that existing Code provisions are relevant guidance as to appropriate amortization periods. Specifically, either a 5-year or a 15-year amortization period for such expenditures would be appropriate. Applying a 5-year amortization period to such expenditures would be consistent with the 60-month period that applies to organizational expenditures of a corporation under Section 248 and start-up expenditures of a trade or business under Section 195. On the other hand, applying a 15-year amortization period to expenditures connected with acquiring, creating, or enhancing intangible assets or benefits would be consistent with the 15-year amortization period applicable under Section 197 to certain intangibles held in connection with the conduct of a trade or business or for the production of income. Applying this amortization period would ensure consistent treatment between acquisition expenditures to acquire assets amortizable under Section 197 and those not falling within that section (for example, if they are not acquired in connection with the acquisition of a trade or business), as well as between expenditures incurred in acquiring intangible assets and expenditures incurred in creating or enhancing such assets. Although there are arguments supporting either a 5-year or a 15-year amortization period, ultimately, the choice of

[59] We believe that significant administrative complexity and potential distortion could arise if taxable income were required to be restated each time some form of financial accounting income were required to be restated. Similarly, we do not believe it would be appropriate to limit the circumstances in which income for prior periods could or should be corrected to those that also result in a restatement of financial accounting income.

amortization period for expenditures without readily ascertainable useful lives is a policy decision based on the desirability of facilitating the types of transactions at issue and the cost to the Treasury. We note that if the 15-year rule were adopted as the general rule, the IRS should consider establishing a special 5-year amortization period for those intangibles that are sufficiently similar to organizational or start-up expenditures. Regardless of the amortization period chosen, amortization should not apply to certain assets with theoretically unlimited lives, such as those described in Section 197(e)(1)(A) (interests in corporations, partnerships, trusts and estates), as well as similar intangibles described in regulations.

4. De Minimis Rules

The Notice suggests that regulations permitting the deduction of de minimis transaction costs (which are suggested to be transaction costs of less than $5000) and de minimis amounts paid to obtain or modify contracts (also $5000) or paid in connection with tangible property owned by another (with no suggested amount) each be subject to current deduction. The Notice requests comments regarding whether it would be appropriate to prescribe de minimis rules for other categories of expenditures.

We support the suggested approach with respect to transaction costs. We believe that a de minimis rule is appropriate to reduce administrative burdens of identifying and tying transaction costs to specific transactions. Accordingly, the thresholds should be set sufficiently high to reduce effectively those burdens, particularly for small businesses. We do not offer any view with respect to whether a $5000 threshold is the appropriate level to provide meaningful relief from excessive administrative burden at an acceptable cost to the fisc.

We question, however, the appropriateness of a de minimis rule with respect to amounts paid to obtain or modify contracts or amounts paid in connection with tangible property owned by another. We do not view such a rule as necessary to achieve administrability goals. We also note that the Notice does not include a de minimis rule for any of the other amounts paid to create or enhance intangible rights or benefits. For certain expenditures such a rule clearly would be inappropriate. For example, the Notice treats loans as intangible assets. As the notice clearly indicates, the amount loaned (i.e., the cost of acquiring the asset for the lender) is not subject to a current deduction merely because the amount is less than $5000. We do not believe that a different result is warranted for the direct costs to acquire the specific assets proposed by the Notice.

We also suggest requiring the aggregation of expenditures of similar types that are incurred in a single transaction or a series of related transactions in applying the minimum thresholds. Failure to require aggregation could lead to abuse of the de minimis rule and promote the artificial fragmentation of large expenditures into many smaller expenditures, each of which falls below the threshold amount. For expenditures that exceed the de minimis amount, we recommend that the full amount be required to be capitalized. We note that de minimis rules in other contexts are applied in this manner (i.e., if the de minimis amount is exceeded, the treatment of the entire amount is affected). For example, Section 954(b) provides that if a taxpayer's foreign base company income and gross insurance income do not exceed a minimum threshold, then such amounts are not considered foreign base company income or gross insurance income; however, if the threshold is exceeded, the entire amounts are considered these types of income.[60] This is consistent with the justification for de minimis rules as rules of convenience. We note that this approach may be seen as imposing a penalty on exceeding the

---

60 See also Sections 453A and 1274 (providing thresholds for qualification as an installment obligation and qualification for certain imputed interest rules, respectively).

threshold, particularly by small amounts, but that penalty does not seem unduly harsh in light of the nature of the de minimis rule as a rule of convenience.

5. Other General Suggestions

The Notice discusses a number of expenditures the treatment of which has been subject to significant controversy. If regulations consistent with the Notice are proposed and finalized, such controversy should decrease. Nonetheless, the Notice, and any subsequent regulations, will not eliminate all issues with respect to expenditures connected to the acquisition, creation, or enhancement of intangibles. For example, the Notice does not address the issue of when expenses associated with a transaction are investigatory (i.e., currently deductible) and when they are required to be capitalized. The case law and Revenue Ruling 99-23, described above, indicate that all costs incurred after the "final decision" is made to enter into a transaction are required to be capitalized. Further guidance, including examples, likely will be needed as to when such a "final decision" will be considered to have been made.

The Notice arguably leaves open the question of whether a transaction cost (as distinct from a direct cost) could be required to be capitalized when the corresponding direct cost to create or acquire an asset would not. To deal with that situation, we suggest explicitly adopting an approach that would conform the treatment of transaction costs to the treatment of the direct costs to which such transaction costs are attributable to determine when transaction costs, other than de minimis transaction costs, are required to be capitalized. That is, if a direct cost incurred to create or acquire an asset would be required to be capitalized, then a transaction cost incurred with respect to that type of an asset and transaction also would be required to be capitalized. Conversely, if a direct cost would be deductible currently, then the transaction costs associated with that type of expenditure also should be deductible currently. For example, transaction costs incurred in connection with the creation of a taxpayer's customer base, such as hiring a marketing firm, should be deductible currently because the cost of creating a customer base is deductible.[61]

D. Specific Requests for Comments

1. Application of 12-Month Rule to Certain Contracts

The IRS and Treasury requested comments regarding the application of the 12-Month Rule to expenditures paid to create or enhance rights of indefinite duration and long-term contracts subject to termination provisions (such as contracts terminable at will). Specifically, they ask whether the 12-Month Rule should permit current deduction of such expenditures, presumably because such expenditures could provide benefits only during a period described in the 12-Month Rule. We do not think that the 12-Month Rule should affect the tax treatment of expenditures simply because they relate to a right of indefinite duration or a long-term contract that may be terminated prematurely, even without penalty. We believe that parties to such contracts generally expect that the contracts will survive to their term, or indefinitely, even if such expectation is not contractually protected, as evidenced by the expenses incurred to enter into them. Accordingly, these expenditures should be capitalized, and presumably amortized over the expected life of the asset in the absence of termination or over the safe harbor period if no such life is ascertainable. If the right or contract is terminated in a year prior to the year in which the expenditures have been recovered fully, then, consistent with existing authority, the

---

61 See, e.g., Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973); but cf. Treas. Reg. § 1.173-1(c) (implying that certain circulation expenditures would be chargeable to the capital account absent Section 173, which permits their deduction).

taxpayer should be entitled to deduct the amount of the expenditures at that time under Section 165.[62]

2. Standard for Amounts Paid for Tangible Property Owned by Another

The IRS and Treasury requested suggestions as to standards that could be used to determine whether expenditures to produce or acquire tangible property owned by another result in the type of intangible future benefit to a business for which capitalization is appropriate, as well as an appropriate de minimis amount for such expenditures. The Notice refers to Kauai Terminal, Ltd. v. Commissioner in describing the type of intangible benefits to be subject to the proposed rule. In that case, the taxpayer paid $200,000 as a contribution to the construction costs of a breakwater that would reduce the taxpayer's transportation expenses, improve the efficiency of its operations, and enable it to improve its service.[63] In determining that the expenditure was required to be capitalized rather than deducted currently, the Board of Tax Appeals focused on the intent of the taxpayer in contributing the money (i.e., reducing costs and increasing profits, rather than the disinterested generosity associated with a deductible charitable contribution). In addition, the court required the taxpayer to capitalize the expenditure because the benefits obtained by the breakwater extended beyond the year in which the expenditure was paid.[64]

---

62 See Lychuk, 116 T.C. at 375 (holding that previously capitalized expenditures for the acquisition of installment contracts were deductible under Section 165 in the year in which the taxpayer ascertained that the installment contracts would not be acquired).

63 Kauai Terminal, Ltd. v. Comm'r, 36 B.T.A. 893, 895, 897 (1937).

64 Id. at 897.

Given the board's reliance on the realization of future benefits, the application of the 12-Month Rule to the requirement to capitalize this type of expense is appropriate. Further, it also is important to take into account, as the board did in Kauai, the taxpayer's intent when making the payment in determining if capitalization (if the motive is to contribute directly to the running of the business, as in Kauai) or a deduction (if the motive is to benefit the community and only incidentally the particular taxpayer) is appropriate. This type of expenditure often benefits parties other than the taxpayer, and it is likely that some combination of direct profit motive and a desire to help the community (which may include an indirect profit motive through increased goodwill if such a contribution will be publicized) will lead to a taxpayer's decision to incur many such costs. For example, a manufacturer may contribute funds to a hospital or paramedic organization for the acquisition of equipment. Such contributions generally would be made with the primary purpose of benefiting the community and, therefore, should be deductible as charitable contributions (subject to generally applicable limitations), even though the expenditures also likely would provide an incidental benefit to the taxpayer itself in the form of enhanced medical services in the case of accidents. On the other hand, the ownership by another party of a particular fixed asset, such as the asset at issue in Kauai, may directly benefit the taxpayer and only incidentally benefit the public or the owner of the asset, in which case the expenditure should be capitalized.

3. Employee Compensation

The Notice proposes a general rule that all employee compensation be deductible currently, except for bonuses and commissions that are paid with respect to a capital transaction. We believe that the IRS is correct in recognizing that employee compensation generally is ordinary and necessary, as reflected in the language of Section 162(a). Compensation expenditures, in our view and consistent with existing authority,[65] usually are better viewed as arising from the employment relationship, and therefore as deductible, rather than relating directly to the particular transaction in respect of which services are performed by the employee, which might require capitalization of a portion of the expenditures. Although a rule of general deductibility favors transaction costs paid to in-house service providers (e.g., lawyers) over those paid to outside service providers (e.g., law firms), which are more likely to be required to be capitalized, we believe that, in light of the language of Section 162 and of administrability concerns, the rule is appropriate.[66]

We view the requirement that bonuses and commissions paid with respect to capital transactions be capitalized as one that should be of limited applicability. To the extent that a bonus or commission easily can be identified as resulting from the transaction (for example, bonuses paid after a business combination in consideration of the additional efforts required and bonuses determined specifically by reference to the size or value of a transaction), we would support a rule of capitalization, although we note that tying such a bonus to a particular transaction may well be difficult. We suggest applying a "but for" test to determine whether a bonus or commission results from a specific transaction. That is, if the amount would not have been paid but for the completion of a specific transaction, then such amount generally should be

---

65 See, e.g., Wells Fargo, 224 F.3d at 887-88.

66 Although we believe it often would create an additional burden to require allocations of employees' salaries to various intangible assets, particularly salaries of officers of corporations engaging in frequent acquisition transactions, in some situations financial accounting principles may already require such allocations. To the extent that businesses make these allocations of employee compensation for financial reporting purposes, it arguably would not be burdensome to require similar allocations for tax reporting purposes. Although we generally do not favor the imposition of book/tax conformity for its own sake, as discussed above, in this instance the accounting treatment could alleviate some of the concerns about the practicality of a decision by the IRS to require capitalization of portions of employee salaries because such capitalization would not be as difficult to administer as it otherwise would seem.

capitalized, as would any other transaction costs. A more difficult case, as to which we do not express a view, involves a transaction that both gives rise to a commission and a capital asset (for example, the making of a loan or the entry into a lease) but that itself is a regular or recurring integral part of day-to-day income-producing activities of the taxpayer. On the one hand, such a bonus may be a substitute for periodic compensation for which capitalization would not be required. On the other hand, to the extent that the rule permitting deduction of most compensation is a rule of convenience, the rationale for not capitalizing such payments is not met, and they should be subject to capitalization, subject to generally applicable exceptions. All other employee compensation should be deductible currently.

80226729_3.DOC