OFFICE OF
CHIEF COUNSEL

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

MEMORANDUM FOR

FROM: Associate Chief Counsel (Income Tax & Accounting)
Douglas A. Fahey, Acting Chief, Branch 5

SUBJECT: Request for Field Service Advice,

This Field Service Advice responds to your memorandum dated September 26, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Taxpayer =

States =

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =

ISSUES

1. Should commissions paid to employees for obtaining new cellular telephone service customers be capitalized pursuant to § 263?

2. Should losses incurred by the taxpayer from the sale of equipment at less than fair market value to newly-acquired customers be capitalized under § 263?

3. Should "residual" commissions paid to third-party agents be capitalized under § 263?

CONCLUSIONS

1. Additional factual development is required.

2. Additional factual development is required.

3. The residual commissions paid to third-party sales agents should not be capitalized pursuant to § 263 under the facts described below.

FACTS

Taxpayer is a telecommunications company that offers cellular mobile telephone service through its subsidiaries and managed partnerships in States. Taxpayer markets its wireless services to new customers in rural and smaller metropolitan areas through both an internal and an external sales force. The third party agents are paid a one-time commission for each new or upgraded customer contract plus a residual commission for each customer who remains with Taxpayer for more than six months. The residual commission is paid every six months and is based on a percentage of revenue generated in that period (excluding toll and roaming charges) by each customer. The percentages range from Amount 1 to Amount 2 based on the number of contracts initiated by the agent during each 6 month review period. The external agents are responsible for providing customers with any necessary phone equipment. Taxpayer generally does not absorb any of the cost of providing telephones or other equipment to customers obtained by the external agents.[1]

The internal sales agents are employees of Taxpayer and/or its subsidiaries. The employees who are internal sales agents spend “virtually” all of their time on sales. Some also sell related services, such as call waiting, and do minimal customer service work, but Taxpayer characterizes these duties as negligible in comparison to their sales responsibilities.

The most common compensation package for these employees is $0 base salary, car allowance, company benefits, and commissions for new or upgraded customer contracts. The commission payments are based on “net sales,” which are defined as completed customer contracts, less the termination of any customer contract previously sold by the employee within six months of service initiation. Thus, employees only receive commissions on customer contracts which continue past an initial six month period.

The sales by employees generally include the sale of telephone equipment. The average cost of the equipment sold is Amount 4, while the average sales price is Amount 3. Taxpayer absorbs the loss on these equipment sales. It generally takes Taxpayer two to six months to recoup its commissions and any applicable losses on equipment sales.

The vast majority of all new customer contracts have an initial term of one year. After expiration of the year, the contracts continue indefinitely until terminated by one of the parties on 30 days’ notice. A very small number of contracts begin either with a month-to-month or a two year term. Taxpayer’s data shows an average 13.77% termination rate for new customers during months seven through twelve of the one-year contracts during 1989-95. Taxpayer has provided no data on its retention rate for customers beyond the initial one-year period. Taxpayer assess a penalty for early termination in the approximate amount of Amount 5, plus an additional fee for loss on the equipment sale, if applicable. It bills customers for this fee, but takes no other affirmative steps regarding collection.

LAW AND ANALYSIS

Section 162(a) allows a deduction for al ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. In

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[1] One of Taxpayer’s recently-acquired subsidiaries does provide telephone equipment to its external sales agents at below cost.

order to be deductible under § 162(a), an expenditure must be: (1) an expense; (2) ordinary; (3) necessary; (4) incurred during the taxable year; and (5) made to carry on a trade or business. Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345 (1971).

Section 263(a) generally provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2(a) provides that the costs 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 are capital expenditures.

It is well-established that deductions are a matter of legislative grace and that the taxpayer bears the burden of proving entitlement to the deduction sought. ; INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Lincoln Sav. & Loan Ass'n, 403 U.S. at 352; New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

An expenditure is capital if it creates or enhances a separate and distinct asset, Lincoln Savings and Loan Ass'n, 403 U.S. 345, or produces a significant long-term benefit. INDOPCO, 503 U.S. 79. A capital expenditure is not an "ordinary" expense within the meaning of § 162(a). Lincoln Savings, 403 U.S. at 354; INDOPCO, 503 U.S. at 87-88. Costs incurred in connection with the acquisition or disposition of a capital asset are to be treated as capital expenditures. Ancillary expenses incurred in acquiring or disposing of an asset are as much a part of the cost of that asset as is the price paid for it. Woodward v. Commissioner, 397 U.S. 572 (1970). For example, the general rule is that wages paid in the carrying on of a trade or business qualify as a deduction from gross income, but wages paid in connection with the construction or acquisition of a capital asset must be capitalized. Commissioner v. Idaho Power, 418 U.S. 1, 13 (1974). In Idaho Power, the Supreme Court also noted that all other construction-related expense items, such as wages, tools and materials must be treated as part of the cost of the acquisition of a capital asset.

Amounts incurred in connection with the acquisition of capital assets or significant long-term benefits are generally required to be capitalized. Idaho Power Co., 418 U.S. at 13 (1974); see also INDOPCO, 503 U.S. at 88 (taxpayer did not demonstrate that investment banking fees, legal, and other costs incurred "in connection with" the transaction are deductible); Woodward, 397 U.S. 572 (requiring capitalization of accountants and appraisers fees incurred "in connection with" sale of stock pursuant to appraisal litigation).

The case law illustrates the highly factual nature of the inquiry and that the distinctions between capital and deductible items are "those of degree and not of kind,” INDOPCO, 503 U.S. 79, 85 (quoting Welch v. Helvering, 290 U.S. 111, 114 (1933)), and therefore, each case “turns on its special facts.” Id. at 86 (quoting Deputy v. DuPont, 308 U.S. 488, 496 (1940)).

The residual commissions are paid to external agents each six months, based on a customer’s continued use of Taxpayer’s services during that six month period. Because the commissions are based on each customer’s use of services during a particular six month period of time, they are tied to current production of income and are thus more appropriately deductible under § 162 than capitalized under § 263. See, e.g., Lykes Energy, Inc. v. Commissioner, T.C. Memo 1999-77 (rebates paid to purchasers of appliances deductible because they were made in connection with current sale of a product); Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1993-467 (cost of stock warrants deductible because they were issued as a sales discount on a volume sale of computer products).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The field asserts that the internal commissions and the losses on telephone equipment sales at issue in this case are properly capitalized under § 263. By contrast, the taxpayer contends that they are currently deductible under § 162. An important factor in determining whether the appropriate tax treatment is immediate deduction or capitalization is the taxpayer’s realization of benefits beyond the year in which the expenditure is incurred. See INCOPCO, 503 U.S. at 87; United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968); Vanalco, Inc. v. Commissioner, T.C. Memo 1999-265. [redacted]

Please call me or [redacted] of my office at (202) 622-4950 if you have any further questions.

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