INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTH TEXAS DISTRICT
ATTN Avery Cousins, III CC:MSR:NTX:DAL

FROM: Associate Chief Counsel CC:ITA

SUBJECT: Tax Treatment of Costs Associated with Computer Service Contracts

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated September 5, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>

A =
B =
C =
D =

E =
F =
x =
y =
Date 1 =
Year 1 =

Date 2 =
Year 2 =

<u>ISSUE</u>

Under the circumstances described below, should the cost of computer equipment provided to customers without charge be capitalized?

CONCLUSION:

In general, existing authority supports capitalization of the cost of the computer equipment.

FACTS:

A provides computer services to automobile dealerships, and it expanded its business in Year 1 when it acquired a competitor operated by C, doing business as B. At the time of acquisition, B was the leading provider of computer information systems, hardware, software, and related automotive dealership services to C and C-related dealers. The computer applications offered met the internal sales, service, parts, office needs, and dealer-to-manufacturer communication needs of dealers. The software applications in essence fully automated the dealerships. For example, specialized software applications monitored sales prospects, performed credit checks, coordinated insurance, tracked parts inventory, prepared service invoicing, maintained customer satisfaction index information, and performed all accounting and payroll functions.

The purchase agreement was executed on Date 1 and closed on Date 2. A formed D to own and operate the acquired business (previously B), which continued to serve only C dealers. Upon acquisition, B ceased operations, and its dealership contracts either terminated or were continued and replaced over time (most between Year 1 and Year 2) with new contracts between the dealerships and D. The purchase of B and formation of D provided 4,000 new clients to A.

D wanted to keep as many of B's dealership clients as possible. The services provided by the two entities were basically the same, but D's service contracts were between x months and y months duration, whereas B's contracts for hardware maintenance were of indefinite duration and terminable on one month's notice. B, though, was obligated to provide software maintenance for five years.

Prior to the acquisition of B, the systems developed by A ran on computer equipment manufactured by F, while B's systems used equipment made by E. Several months after the acquisition, the equipment used for B's systems was discontinued following an acquisition of E. For former clients of B who had recently purchased E equipment, D offered to replace the equipment at no cost to the client with equipment made by F. The offer was contingent on the client signing a multi-year maintenance contract. The offer was not extended to former clients who had not recently purchased equipment. Those clients had to purchase equipment made by F if they wanted to use A's systems.

A argues that these "promotional giveaways/discounts" were inducements to the former clients of B to maintain their business with D, and that the expenses incurred in purchasing the equipment were ordinary and necessary business expenses given the unique circumstances of the discontinuance of the E equipment.

A notes that many of the B clients were not in favor of the sale of B by C to A and, in fact, did not transfer their business to D. After the acquisition, some of the D clients sought to get out of the service contracts that they had entered with D. D would only let them out of the service contracts if the clients paid off substantially all the service payments set forth in their contracts. The service contracts provided that default made all amounts due under the contract immediately due and payable. Some dealerships completed the buyout, and others did not.

A claimed the cost incurred in purchasing the giveaway items as a cost of goods sold expense. The Service disallowed the claimed expenses, determining that they were capital expenditures. A's position is that the F equipment was provided in difficult circumstances where it stood to lose substantial business if it took no action. According to A, the provided equipment allowed the continuation of an ongoing relationship among the dealer clients, car manufacturer C, and computer service provider D, who wanted to serve B's previous customer base. The purpose was to preserve, not increase or enhance, the dealer clients. That is, neither car manufacturer C nor D could afford to have the dealer computer network undermined by an unexpected market development. A states that the program was part of D's effort to prevent existing clients from leaving by providing them the products and services that met their needs. Most of the dealers taking advantage of the conversion program signed new contracts with D over the time period from Year 1 to Year 2.

A also argues that D did not secure any significant benefit as a result of the longer duration of its contracts. D assumed that all clients would be long-term clients regardless of any written contract. Its business projections in considering the acquisition reflected its expectation that customer relationships would continue for the indefinite future.

For purposes of analysis, we will consider the cost of goods sold expense as the equivalent of a business expense deduction.

LAW:

I.R.C. § 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg. §1.162-1(a) provides that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. If the expenses in issue meet the threshold requirements for section 162 expenses, it must then be determined whether they are capital expenditures pursuant to section 263(a) and thus excepted from current deductibility under section 162. See section 161 (section 263 provides an exception to section 162).

The term "necessary" imposes only the minimal requirement that the expense be appropriate and helpful for the development of a taxpayer's business; the function of the term "ordinary" is to clarify the distinction between deductible expenses and capital expenditures. Commissioner v. Tellier, 383 U.S. 687, 689 (1966). Any necessary expense which is not a capital investment and which is incurred in good faith is to be considered an ordinary expense of that business. Lutz v. Commissioner, 282 F.2d 614, 617 (5th Cir. 1960).

Deductions are matters of legislative grace and are exceptions to the norm of capitalization. Accordingly, deductions are strictly construed, and the burden of clearly showing the right to the claimed deduction is on the taxpayer. Commissioner v. Idaho Power, 418 U.S. 1 (1974).

Section 263(a) provides that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. The taxpayer must capitalize and amortize over the life of the property any expenditure which restores, adds to the value of, or substantially prolongs the useful life of that property, Capital expenditures are further defined in Treas. Reg. 1.263(a)-2(a) as expenditures which result in the acquisition of assets with useful lives substantially beyond the taxable year.

In Commissioner v. Lincoln Savings & Loan Assoc., 403 U.S. 345 (1971), the Supreme Court held that the premium payment at issue created or enhanced a secondary reserve account which was a separate and distinct asset, and accordingly, the premium payment was a capital expenditure. INDOPCO v. Commissioner, 503 U.S. 79 (1992), resolved a conflict among the Circuit Courts on the interpretation of Lincoln Savings.

The Supreme Court in INDOPCO considered whether certain investment banking and legal fees incurred by a target corporation incident to a friendly takeover produced significant long-term benefits for the taxpayer. The Court identified two significant long-term benefits, namely, potential synergistic benefits to be derived from being associated with the acquirer’s business and the avoidance of shareholder relation expenses and complications shouldered by a publicly-held corporation. The Court clarified that Lincoln Savings stands for the proposition that the creation of a separate and distinct asset may be a sufficient, but is not a necessary, condition to classification as a capital expenditure. The presence of a future benefit is a means of distinguishing a business deduction from a capital expenditure. Although some future aspect or an incidental future benefit may not warrant capitalization, a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. In making this determination, it is important to consider the duration and extent of the benefits realized by the taxpayer.

Section 263(a)(1) refers to permanent improvements or betterments and envisions an inquiry into the duration and extent of the benefits realized by a taxpayer. The fact that expenditures do not create or enhance a separate and distinct additional asset is not controlling where the expenditures produce significant benefits extending beyond the tax year. INDOPCO, supra.

The distinction between current expenses and capital expenditures is one of degree and not of kind. Welch v. Helvering, 290 U.S. 111, 114 (1933), and each case turns on its unique facts. Deputy v. duPont, 308 U.S. 488, 496 (1940). The law in this area is not entirely clear. Some cases seem inconsistent, but it is the particular facts of the cases controlling the outcome, rather than definitive legal principles alone.

ANALYSIS:

Understandably the sometimes difficult categorization between deductible and capital expenses has been frequently litigated. Since INDOPCO in 1992, the Service has often argued (with mixed results) that expenditures that produce future benefits for the taxpayer must be capitalized and/or that costs created a separate and distinct asset. In this case, we agree with your view that existing authority may support capitalization of the equipment costs at issue. We can make the following arguments.

A. Customers Required to enter Long Term Contracts: An expenditure is capitalized when it creates or enhances a separate and distinct asset. Commissioner v. Lincoln Sav. & Loan Assoc., 403 U.S. 345, 354 (1971)

A formed D and sought to obtain B's stable customer base by signing long-term contracts with B's previous customers. That is, its carryover customers had month to month contracts and were free to take their business elsewhere, which apparently some did. D's offer of the new computer equipment to certain customers required the customer to sign a long-term contract with D. An analogy may be drawn to organization costs (organizing, recapitalizing, merging) which are generally considered capital expenditures. INDOPCO, supra at 89-90; E.I. du Pont de Nemours v. United States, 432 F.2d 1052, 1058 (3d Cir. 1970); Skaggs Cos. v. Commissioner, 59 T.C. 201, 206 (1972).

All businesses seek to develop goodwill, or the expectancy of continued patronage. In Welch v. Helvering, 290 U.S. 111 (1933), aff'g Welch v. Commissioner, 25 B.T.A. 117 (1932), the taxpayer paid the outstanding debts of his prior business in order to "build up his new business." Welch, 25 B.T.A. at 119. The Board of Tax Appeals agreed with the Service that the payments had to be capitalized as an intangible asset, the development of reputation and goodwill. The Supreme Court, although not discussing an intangible asset, determined that under the definition of ordinary as used in the predecessor of section 162, a person does not ordinarily pay another person's debts unless under obligation. This case may be relied on for the proposition that expenditures to build up relations with the customers of a prior business must be capitalized. The term "ordinary", of course, serves to distinguish deductible and capital expenses. See Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966).

In Wells Fargo v. Commissioner, 224 F.2d 874 (8th Cir. 2000), the Service had disallowed deductions for salaries paid to officers of a subsidiary attributable to services performed in merging several companies, and disallowed legal and investigatory expenses. The court determined that the salaries were deductible as they were directly related to the employment relationship and only indirectly related to the capital transaction. The salaries existed and were paid irrespective of the capital transaction. The legal and investigatory expenses which were incurred after the final decision regarding the acquisition had to be capitalized. Accordingly, expenses directly related to a capital transaction (and thus a long term benefit) should be capitalized. Wells Fargo, 224 F.3d at 888-89. See also Lychuk v. Commissioner, 116 T.C. No. 27 (May 31, 2001) (Taxpayer's business is servicing installment contracts. Salaries and benefits are capital as they are directly related to acquisition of installment contracts; overhead expenses are deductible as they are not directly related to the contracts. Professional fees and expenses relating to private placement offerings of notes are capital, but costs related to installment contracts which were never acquired are deductible.)

With respect to the salary issue, in Wells Fargo, the officers had responsibilities other than the capital transaction; whereas, in Lychuk presumably the court relied on the fact that 100% of employee time was devoted to activities involving obtaining and servicing installment contracts. For this case, of course, a demonstrated strong relationship between the free computer equipment and D's new long term contracts would point to capitalization.

Metrocorp, Inc. v. Commissioner, 116 T.C. 211 (2001), to be discussed infra, demonstrates the importance of factual development in carefully delineating the precise long-term benefit associated with the costs at issue (as well as carefully considering whether they are associated with a capital asset). In this case, was there any other motive for D to offer the free computer equipment that would render incidental the benefit derived from obtaining a long term contract from a customer?

In summary, it will be important to demonstrate that the free computer equipment was used to develop or build up D's business. Many recent capitalization cases seem to turn on their facts.

B. Contracts Represent a Long-Term Economic Benefit: A Capital Expenditure Produces A Significant Future Benefit. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).

The contracts represent a long-term economic benefit both due to their full term value but also due to the required buyout penalty if terminated prematurely. D specifically offered the E computers only if dealers entered a contract with D.

In Lykes Energy, Inc. & Subs. v. Commissioner, T.C. Memo. 1999-77, the taxpayer was a public utility that distributed natural gas in Florida and was subject to regulation by the Florida Public Service Commission (PSC). Pursuant to the Energy Efficiency and Conservation Act (FEECA) the PSC required the taxpayer to design and administer programs that would reduce consumption of high cost petroleum and lower electrical energy consumption. Some of the programs designed by the taxpayer were intended to encourage consumers to purchase new gas products from it and brought current realization of income from the sale of the products. Other programs were directed at converting electric energy users into natural gas users and were intended to increase the taxpayer's customer base (increase gas customers).

The expenditures incurred in connection with the sale of specific products were deductible because they related to the sale of particular products and only had incidental future benefits, such as repeat business and potential sales of related products. The expenditures incurred in connection with the programs designed to increase customer base had a substantial impact on the taxpayer's future income stream and, thus, required capitalization. The court looked to the effect the expenditure had on the taxpayer's future income to determine whether a particular expenditure should be capitalized. "This projected revenue stream, which is the direct object of People's promotional expenditures, is a significant future benefit." Lykes Energy, supra. Where the impact was great the expenditure was capitalized. Where it was incidental or insignificant, the expenditure was deductible. See also Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814, 817 (4th Cir. 1937) (intensive campaign to obtain new customers at any time, not only in early or formative stages of a company, gives rise to capital expenditures).

Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff'd, 349 F.2d 515 (1st Cir. 1965), supports capitalizing the costs of the free computer equipment in this case. The taxpayer gas company did not charge installation fees to customers leasing gas appliances, and the court disallowed a deduction for the installation cost. "It is not necessary that the taxpayer acquire ownership in a new asset, but merely that he may reasonably anticipate a gain that is more or less permanent." Fall River, 349 F.2d at 516-17. The court found that the expenditure was made in anticipation of a continuing economic benefit over a period of years (rental income, greater gas consumption), which is a capital expense. The record of gas sales and leased installations supported the court's conclusion notwithstanding that initial leases did not exceed one year's duration and that some appliances could be removed at the will of the customers on 24 hours' notice.

The question of economic benefit brings to mind Metrocorp, supra, in which a bank holding company's subsidiary purchased a failed savings and loan, which was insured by the Savings Association Insurance Fund (SAIF), and the subsidiary was insured by the Banking Insurance Fund (BIF). Through a conversion transaction taxpayer chose to insure the former savings association liabilities through BIF. The subsidiary was required to pay entrance and exit fees to the Federal Deposit Insurance Corporation, which it then deducted. The Tax Court disagreed with the Service's view that capitalization was required. The court held that because the subsidiary derived no significant long-term benefit from its payment of either fee, the fees were deductible. The court conceded that there may have been some future benefits, but none of those benefits was enough to require capitalization.

The Service pointed to the following long-term benefits: taxpayer was able to insure its entire liability for deposits through one fund, thus coming under only one regulatory scheme and minimizing the risk of compliance problems; insurance premiums under BIF were less than insurance premiums under SAIF; and BIF was more stable than SAIF. To the court, these benefits were not significant. The court said that the exit fee was a nonrefundable, final premium for insurance already received; the entrance fee was a nonrefundable premium for the current year's insurance.

We believe that the lesson derived from Metrocorp is to carefully consider the factual context of the expenses along with analyzing any long-term benefits. As the Court said in INDOPCO, supra, an incidental future benefit does not warrant capitalization. It will be important to demonstrate that there is a future benefit attributable to D's long term contracts with its customers, and that the benefit is not incidental. Some benefits can certainly be rationalized for any transaction, but that alone does not justify capitalization on a long-term benefit theory. A demonstrable significant long term benefit must exist.

C. Free Computer Equipment Used to Obtain Service Contracts:
A Capital Expenditure is incurred in connection with/is directly related to the Acquisition of A Capital Asset. Commissioner v. Idaho Power Co., 418 U.S.1 (1974).

As the Supreme Court said in Lincoln Savings, supra, a taxpayer's expenditure that serves to create or enhance a separate and distinct asset should be capitalized under section 263. In this case, we believe that you may be able to factually demonstrate that the computer equipment giveaways were instrumental in obtaining intangible assets—the service contracts.

In PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822 (3d Cir. 2000), rev'g 110 T.C. 349 (1998), at issue was whether certain costs incurred by banks for marketing, researching, and originating loans were deductible as ordinary and necessary business expenses. The Tax Court agreed with the Commissioner that the origination costs created a separate and distinct asset, the loans, and must be capitalized over the life of the loans. In reversing, the Third Circuit held that because loan operations were the primary method of income production for the banks and expenses incurred in loan origination were normal and routine in the banking business, the costs at issue were deductible business expenses. The court was highly critical of the Tax Court's "broad reading of Lincoln Savings [which] essentially treats the term 'separate and distinct asset' as if it extends to cover any identifiable asset. We do not subscribe to this broad read of Lincoln Savings." PNC Bancorp, 212 F.3d at 830.

We believe that PNC Bancorp is distinguishable from your case. PNC's loan origination costs were part of its routine, everyday business activities, whereas the costs incurred in giving away computer equipment upon signing a long-term contract clearly are not. A concedes as much in emphasizing the unique circumstances relating to the discontinuance of the E equipment.

Also with respect to capitalizing costs incurred in connection with the acquisition of an asset, the Tax Court made an interesting comment in Metrocorp, supra. Though ruling against the Commissioner and finding that the entrance and exit fees provided no significant long-term benefits to the taxpayer, it specifically noted that "respondent did not determine, and has declined to argue, that the fees should be capitalized on the grounds that they were necessarily incurred in connection with the acquisition of another financial institution or, more specifically, the acquisition of the assets and liabilities of another financial institution…we save any comment on that theory for another day." Id. at 217. Though we cannot say how the Tax Court would have ruled on the argument, we can at least say that its reference to this unraised argument implies general agreement with capitalizing costs connected with the acquisition of either tangible or intangible assets.

D. D's Treatment as Cost of Goods Sold (COGS)

Another issue raised is whether items included in COGS (as taxpayer did) may be removed from inventory and capitalized.

The cost of goods acquired for resale may be removed from inventory costs and COGS computation if the goods cease to be held primarily for sale to customers in the ordinary course of business. <u>See</u>, <u>e.g.</u>, <u>Lattimer-Looney Chevrolet, Inc. v. Commissioner</u>, 19 T.C. 120 (1952) (dealership could treat cars used for business purposes, even if later sold, as capital assets and identical cars held primarily for sale to customers as inventory).

E. Amortization Period

Capitalized costs which are directly related to the creation of the long-term contracts are amortized over the useful life of the underlying contract pursuant to section 167(a). The useful life is the contract life.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

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If you have any further questions, please contact the attorney assigned to this matter at 202-622-4950.

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