APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE SETTLEMENT GUIDELINES

INDUSTRY: Data Processing

ISSUE: Capitalization of Lease Related Expenses

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APPROVED:

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REGIONAL DIRECTOR OF APPEALS **DATE**
NORTH ATLANTIC REGION

/s/ Gary W. Knott 1/19/93
for **NATIONAL DIRECTOR OF APPEALS** **DATE**

EFFECTIVE DATE: 1/15/93

SETTLEMENT GUIDELINES

CAPITALIZATION OF LEASE RELATED EXPENSES

STATEMENT OF ISSUE

Whether costs directly associated with the acquisition of lease contracts on equipment and costs associated with preparing the equipment for use should be capitalized under section 263 and amortized over the life of the lease.

EXAMINATION DIVISION'S POSITION

Where the leases are considered to be capital assets the costs associated with lease acquisition and costs associated with preparing the equipment for use should be capitalized under section 263 and amortized over the life of the lease.

DISCUSSION

Within the data processing industry, manufacturers often lease and service their manufactured equipment. The leasing contracts typically provide for terms of more than one year and may not be terminated prior to the expiration of the lease term without incurring a substantial penalty. In connection with these leases the manufacturers incur a variety of costs, such as: installation costs; commissions and bonuses to sales personnel for securing the leases; costs to develop software for the lessees; system application and support costs; and expenses for customer training, site planning, etc.

The position taken in the Coordinated Issue Paper is that a lease contract represents a capital asset of the lessor and therefore the costs directly associated with the acquisition of a lease are capital expenditures which may not be currently deducted, but which must be amortized over the life of the lease.

The Paper contends that while section 162 allows deductions for ordinary and necessary business expenses, section 263 disallows deductions for amounts paid for the acquisition or creation of a capital asset. The Paper also relies on Regulation 1.461-1 for the proposition that "Usually, the cost of assets or benefits that last beyond the taxable year must be capitalized."

The first issue addressed in the Coordinated Issue Paper is whether leasing contracts are capital assets. In concluding that they are, the Paper relies on the following authorities:

(1) Commissioner v. Lincoln Savings and Loan Association [71-1 USTC ¶ 9476], 403 U.S. 345 (1971). The court held that an "additional premium" paid to the Federal Savings and Loan Insurance Corporation was not deductible as an ordinary business expense in the year paid, but was a nondeductible capital investment in FSLIC. The court noted that:

> The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset."

There was one dissenting opinion by a Justice who felt that the "additional premium" was an ordinary and necessary business expense.

(2) National Starch and Chemical Corporation [90-2 USTC ¶ 50,571], 918 F.2d 426 (3d Cir. 1990). The court held that consulting fees, legal fees, and other expenses incurred in the process of deliberating and accepting a friendly takeover bid were not currently deductible. The court held that the expenses were nondeductible capital expenditures because even though no separate and distinct asset had been created or enhanced, the change in ownership would produce benefits for an indefinite period into the future.

In INDOPCO, Inc. v. Commissioner, 92-1 USTC ¶ 50,571 (Sup. Ct., 1992), the Supreme Court affirmed the decision of the Third Circuit in National Starch and Chemical Corporation.

In discussing the relationship between current deductions and capital expenditures, the court noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." The court also noted that "a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise." However, after examining several cases dealing with the distinction between current expenses and capital expenditures, the court observed that "the cases sometimes appear difficult to harmonize."

The court discussed its decision in Commissioner v. Lincoln Savings and Loan Association, (supra). The court stated:

> Lincoln Savings stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance ... a separate and distinct" asset should be capitalized under section 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct

> assets are to be capitalized under section 263.
>
> Nor does our statement in Lincoln Savings ... that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure. Although the mere presence of an incidental future benefit--"some future aspect"--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.

(3) Seligman v. Commissioner, 84 T.C. 191 (1985). The court held that "lease administration expenses" payable during the first 12 months of 41-month computer lease terms were capital expenditures amortizable over the entire 41-month lease terms. The court noted that:

> ... there is no precise line of demarcation separating business expenditures currently deductible under section 162(a) and those which constitute nondeductible capital expenditures within the scope of section 263.

The court stated:

> Generally, expenditures to acquire assets or secure benefits which last beyond the taxable year must be capitalized. ... The mere presence of some possible future benefit from an expenditure, however, is not determinative.

The court held that the expenses at issue were capital expenditures because they:

> ... created separate and distinct assets for petitioners, i.e., the right to have various administrative duties performed for them during the entire 41-month periods. The fact that these expenditures created a separate and distinct intangible asset, i.e., the legally enforceable right to receive certain administrative services in the future, instead of a tangible asset, does not warrant a different conclusion.

(4) Central Texas Savings & Loan Association v. U.S. [84-1 USTC ¶ 9471], 731 F.2d 1181 (5th Cir. 1984). The court held that start up costs incurred in the investigation and establishment of four branch banks were nondeductible capital expenditures because they created separate and distinct assets whose lives extended beyond the taxable year in which the expenses were incurred. The court stated that:

> Section 162 further requires that an item be paid or incurred and the benefit exhausted during the taxable year to be deductible. While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item.

The court refused to follow the decision of the Fourth Circuit in NCNB Corp. v. U.S. [82-2 USTC ¶ 9469], 684 F.2d 285, (4th Cir. 1982), which held that costs incurred by a bank to develop branch banking facilities were currently deductible because they were incurred to expand an existing business and not to acquire separate or distinct additional assets.

(5) Shutler v. U.S. [73-1 USTC ¶ 9145], 470 F.2d 1143 (10th Cir. 1972). The court held that the cost of the acquisition of a state owned lease on a tract of land was a nondeductible capital expenditure even though only four months remained on the term of the lease. The court reasoned that since there was a reasonable certainty of renewal, the benefits secured would last indefinitely into the future. The court stated:

> It is well established that the statute authorizing a deduction from gross income of all ordinary and necessary business expenses does not authorize a deduction for capital expenditures.

Quoting from its earlier decision in U.S. v. Akin [57-2 USTC ¶ 9999], 248 F.2d 742 (10th Cir. 1957), the court stated:

> It is not always easy to find a verbal formula which readily supplies an unerring guide in drawing the boundary line between current expenses and capital outlays. But it may be said in general terms that an expenditure should be treated as one in the nature of a capital outlay if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has life of more than one year.

(6) Munger v. Commissioner, 14 T.C. 1236 (1950), the court held that a commission paid to obtain five-year oil and gas leases were capital expenditures. The court stated:

> We see no reason to hold that a lessor does not add to his assets in obtaining a short term lease. He has acquired a contract from which income may be derived in the future, just as in obtaining a long term lease.

Having concluded that the leases in question are capital assets, the Coordinated Issue Paper goes on to discuss whether costs associated with the acquisition of the leases should be capitalized and amortized over the lives of the leases to which they relate. The Paper concludes that such costs are capital expenditures, amortizable over the lives of the leases, relying on the following authorities:

(1) Revenue Ruling 68-561, 1968-2 C.B. 117. The taxpayer, a public utility engaged in the sale and distribution of natural and manufactured gas, incurred promotional payments as part of its general campaign to increase the consumption of gas. The ruling held that the payment of cash incentives to builders, contractors, and owners of buildings for either the construction of "all gas" homes of the conversion of heating, hot water, or other systems to gas were capital expenditures because the payments were to:

> ... secure benefits to the taxpayer that can reasonably be expected to have value extending beyond the years in which they were paid or incurred.

However, the ruling also held that other expenses incurred in the campaign (salaries paid to the taxpayer's representatives, allowances paid directly to builders and apartment house owners who advertise homes or apartments making reference to gas, and direct advertising costs) were currently deductible as ordinary and necessary business expenses because such expenses:

> ... are less directly and significantly productive of intangible assets having a value extending beyond the taxable years in which they were paid or incurred.

(2) Louisiana Land and Exploration Co. v. Commissioner, 7 T.C. 507 (1946), aff'd, 161 F.2d 842 (5th Cir. 1947). The taxpayer acquired mineral leases and incurred costs for a geological survey. The court held that the survey costs were capital expenditures because:

> ... the survey was the first step in the over-all development for oil [sic] of these tracts of land ... the benefit derived from the expenditure was to be enjoyed by petitioner in its business during the entire useful life of the asset being developed.

(3) Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff'd, 349 F.2d 515 (1st Cir. 1965). The taxpayer was in the business of both selling and leasing gas appliances. The court held that the installation costs incurred with respect to the leased appliances were capital expenditures. The court stated:

> The leases were productive of rentals to the appliance company throughout the time that the consumers used the leased appliances, and the cost of installing the appliances was clearly capital in nature, a charge against those rentals over their anticipated life, to be taken in the form of annual amortization or depreciation deductions, and not as a single expense deduction in 1 year.

(4) Houston Natural Gas Corp. v. Commissioner [37-2 USTC ¶ 9354], 90 F.2d 814 (4th Cir. 1937), cert. denied, 302 U.S. 722 (1937). The court held that expenditures incurred by a gas company in soliciting new customers and installing free service lines on customer property were capital expenditures.

(5) Revenue Ruling 69-331, 1969-1 C.B. 87. The taxpayer was engaged in the business of selling gas and

leasing water heaters. The ruling held that bonuses and commissions the taxpayer paid to its own salesmen and to dealers and plumbing contractors in connection with the leasing of the water heaters were capital expenditures because:

> ... the taxpayer has acquired contracts from which income will be derived in the future.

(6) Ellis Banking Corp. v. Commissioner [82-2 USTC ¶ 9630], 688 F.2d 1376 (11th Cir. 1982). The court held that accounting fees incurred by a bank holding company in connection with the acquisition of the stock of a bank had to be capitalized as part of the cost of the stock. The court reasoned that since the bank stock was a capital asset, the accounting fees directly associated with the acquisition of the stock was a capital expenditure.