APPEALS

INDUSTRY SPECIALIZATION PROGRAM

COORDINATED ISSUE PAPER

INDUSTRY: Railroad

ISSUE: Trackage Rights and Other Protective Conditions

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SETTLEMENT GUIDELINES

TRACKAGE RIGHTS AND OTHER PROTECTIVE CONDITIONS

STATEMENT OF ISSUE

Whether expenditures relating to efforts to defeat a proposed merger and to obtain protective conditions from the ICC result in the creation of an intangible asset as well as whether such expenditures constitute non-deductible capital expenditures.

BACKGROUND

In recent years, the weaker smaller railroads have followed a trend of merging into larger railroads. Mergers can harm the competitive position of unrelated railroads, which in turn can harm the public by limiting competition and diminishing the adequacy of transportation available to the public. Mergers may limit unrelated railroads' access to rail corridors, yards, bridges, tunnels, or similar facilities. Competing railroads, that may be harmed by the newly formed railroad, file petitions with the Interstate Commerce Commission (ICC) seeking to halt the proposed merger. If the ICC declines to halt the merger, competing railroads file a request with the ICC seeking protection from the effects of the proposed merger. The types of expenses incurred in these efforts include:

* Legal and professional fees and expenses.
* In-house salaries and related cost.
* Travel and out-of-pocket expense of management personnel.
* Expert witness fees and expenses.
* Cost of conducting hearings.

Railroads generally deduct these expenses as operating expenses. Under the Railroad ISP, the Examination Division proposes to capitalize such cost.

The ICC is a Federal agency charged with the responsibility to regulate the railroad industry. One of its responsibilities is to determine if a proposed merger is in the best public interest, and to approve or disapprove mergers accordingly. While there are numerous factors to be considered, the two most important factors are:

* Effect on competition.
* Adequacy of transportation available to the general public.

The ICC is authorized to impose protective conditions to eliminate potential harm to the public. Most mergers have both a positive and negative impact on the public. Normally, there are proponents and opponents of a proposed merger, including other modes of transportation, Federal and State agencies, in addition to the competing railroads. The ICC approval process is lengthy and costly, often spanning five or more years.

Unlike a merger in an unregulated industry, railroad mergers may be reversed by the ICC after a trial period. Mergers are not always final. The ICC has approved a proposed merger on a temporary basis, only to revoke the approval several years later. The competing railroads claim the first objective is to defeat a proposed merger. If the ICC only approves a proposed merger on a temporary basis, the competing railroads continue to oppose the merger, while at the same time seeking protective conditions. Thus, the ICC petition process may include efforts to concurrently defeat a proposed merger and to obtain concessions (protective conditions) from the newly merged railroad.

The efforts to defeat a proposed merger and to gain protective conditions often span four or more years. At the outset, prediction of the outcome is uncertain. Likewise, the ICC process makes an accurate allocation of the cost incurred between the efforts to defeat and gain concessions impractical if not impossible. Under the Federal income tax annual accounting convention, railroads must decide whether the costs in question are expired or will benefit future periods. Traditionally, railroads have claimed a current deduction on the basis the expenditures were incurred as operating expenses.

The ICC often imposes protective conditions favoring the competitors of the merged entities. In their petitions, the competing railroads request specific protective conditions. At the conclusion of the ICC hearing process, the competing railroads are normally granted operating rights by the ICC as a condition to approving the merger. These rights give the competing railroads substantial benefits that normally extent far into the future.

Protective conditions may include:

* Trackage Rights.
* Independent Rate Making Authority.
* Access to Switching and Classification Yards.

Trackage Rights

Trackage rights require the newly merged railroad to give a competing railroad access to the rail line between two points, such as cities. This may include vital bridge and tunnel links. The ICC mandates the merged railroad lease the rail line to the competing railroad. The lessee pays an annual fee and a share of the operating and maintenance expense. The trackage rights extend the competing railroad's operating territory beyond that originally held. The trackage rights term may be 99 years, and may be extended by the ICC.

Independent Rate Making Authority

Independent Rate Making Authority (IRA) allows the competing railroad to exercise independent pricing on joint rates of it and the merged railroad. Under the IRA, the competing railroad would pay the merged railroad a share of the revenue generated over the merged lines. The competing railroad benefits by:

* Underpricing, compared to the merged railroad, to attract shippers.
* By-passing costly ICC rules that delay setting rates over the merged lines.

Switching and Classification Yards

Railroads build rail yards at strategic locations to regroup rail cars into trains with common destinations. These areas are referred to as switching and classification yards. Access to the yards is necessary to move freight cars through one or more transfer points and on to the final destination. Mergers may limit or deny access to the yards by competing railroads.

EXAMINATION DIVISION'S POSITION

Examination views the railroad's actions to oppose the merger and seek concessions as a single effort which results in the creation of an intangible asset, protective conditions. The value assigned to the protective conditions is the accumulated costs incurred by the railroad in carrying on the anti-merger activities. No deduction is allowable under §162 or §165. The entire cost incurred is allocated to the protective conditions ultimately obtained and none of the cost is allocated to protective conditions sought, but denied in the process. None of the cost is allocated to the efforts to defeat the proposed merger. In Examination's view, the collective efforts resulted in the granting of protective conditions that permanently enhanced the railroad's competitive position.

TAXPAYER'S POSITION

The railroads' primary defense is to treat all the costs in question as currently deductible as:

1. Ordinary and necessary expense.
2. Incurred to protect the safety of its business.

In the alternative, the railroads seek to allocate the cost incurred between:

1. Efforts to defeat the merger,
2. Protective conditions granted, and
3. Unsuccessful effort to gain protective conditions.

DISCUSSION & SETTLEMENT GUIDELINES

LAW[1]

I.R.C. §162(a) allows the deduction of all the ordinary and necessary expenses paid or incurred during the taxable years in carrying on any trade or business. By comparison, §263 bars deductions for amounts paid out for permanent improvements or betterments made to increase the value of any property or estate. The Supreme Court ruled in **New Colonial Ice**, 292 U.S. 435, 440 (1934) that income tax deductions are a matter of legislative grace. The Supreme Court ruled in **Interstate Transit Lines**, 319 U.S. 590, 593 (1943) that the burden of showing the right to a claimed deduction is on the taxpayer.

[1] Section references are to the Internal Revenue Code of 1986.

Deductibility of expenses under §162 depends on whether the expense is "ordinary and necessary" within the meaning of §162. The Supreme Court determined the term means "appropriate and helpful" in **Welch v. Helvering**, 290 U.S. 111, 113 (1933). The Supreme Court ruled in **Deputy v. DuPont**, 308 U.S. 488, 493 (1934) that it is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.

However, an expenditure must be capitalized if it creates, enhances, or is part of the cost of acquiring or defending a tangible or intangible asset with a useful life greater than one year. **Commissioner v. Lincoln Savings and Loan Association**, 403 U.S. 345, 27 AFTR2d 71-1542, 1546 (1971); **Central Texas Savings & Loan Association v. United States**, 731 F.2d 1181, 53 AFTR2d 84-1474 (5th Cir. 1984; and **Cleveland Electric Illuminating Company v. United States**, 7 Cl. CT. 220 (1985). If such expenditures do not create a capital asset, but are made to protect a taxpayer's business, they are currently deductible. **First National Bank of Skowhegan, Maine**, 35 B.T.A. 876 (1937) acq. 1937-1 C.B. 9.

Capital expenditures may be amortized or depreciated over the life of the applicable asset. Where the useful life can not be ascertained, or no specific asset can be identified, no depreciation is allowed and the asset is deductible only upon dissolution of the business. See §167(a) and §336(a).

There are no litigated cases on this issue.

Initial Question

The initial question is whether the expenditures in question were incurred to defend the railroad's business (deductible under §162) or whether the primary purpose was to secure protective conditions with an unlimited life (capitalize under §263). If the expenditures were made to secure a protective condition, did the expenditures create an asset?

Is Asset Created?

The proper inquiry of whether an asset is created focuses on what long-term benefit the railroad obtains as a result of making the expenditure. The Government's position is that protective conditions:

* Extend operating territory.
* Improve position as a transcontinental carrier.
* Improve ability to offer direct line service to shippers.
* Improve competitive position through independent rate making authority.

The general rule of capitalization under §263 refers to any permanent improvements or betterments made to increase the value of any property. The reference to improvements and betterments examines the duration and extent of the benefits realized from the expenditures.

Expenditures that secure a right from a regulatory agency to operate a business are capital expenditures under §263. **Chandler Trailer Convoy, Inc**, T.C. Memo 1973-285 (capitalized expenditures made to secure ICC operating rights); **Richmond Television Corp. v. United States**, 354 F.2d 410, 16 AFTR2d 6109 (4th Cir. 1965); **KWTX Broadcasting Co. v. Commissioner**, 31 T.C. 952 (1959), aff'd per curiam, 272 F.2d 406, 4 AFTR2d 5893 (5th Cir. 1959) (capitalized cost of television licence); **Norman Shutler**, 470 F.2d 1143, 31 AFTR2d 73-519 (10 Cir. 1973), cert. denied 411 U.S. 982 (1973) (capitalized cost of preferred right land lease). The protective conditions sought by the railroads are granted by the ICC. The Government was successful in capitalizing similar costs in the **Darlington-Hartsville Coca-Cola Bottling Co.**, 393 F.2d 494, 21 AFTR2d 1193 (4th Cir., 1968), cert. denied 393 U.S. 962 (1968) (amounts spent to purchase soft drink syrup contracts were capital expenditures).

Protective conditions grant the holder thereof the right to do business in new territories, to attract new customers, and to challenge competitors in new markets. As in the railroad industry, a bank's right to operate is granted by a charter issued by a regulatory authority. In **Central Texas Savings & Loan Association v. United States**, supra at 84-1477, the court held expenditures to acquire these rights were capital. The court's holding requires expenditures incurred to gain protective conditions be capitalized.
Where the transaction is an element of a multi-part plan to acquire an intangible business advantage lasting more than one year, the expenditures are capital in nature.

Benefits Incidental?

Railroads may argue that these benefits are merely incidental or entirely speculative. How can it be argued that extending operating territory, gaining rights to more direct rail routes, and gaining the right to set more competitive freight rates, does not benefit the railroads in more than an incidental manner? Under the terms of the ICC mandated protective conditions, these rights benefit the railroads for often as long as 99 years, and may be extended. The purpose for these expenditures is to improve the railroads operations over an extended period of time. For all practical purposes, the expenditures improve a railroad's operating rights for the duration of its existence. This is clearly the type of future benefits envisioned under §263 that must be capitalized. **General Bancshares Corporation v. Commissioner**, 326 F.2d 712, 13 AFTR2d 549 (8th Cir. 1964), cert. denied 379 U.S. 832 (1964). Even where the expenditures fail to create a specific asset, but do provide a long-term benefit, as protective conditions certainly do, the expenditures must be capitalized. **INDOPCO, INC.**, 112 S. Ct. 1039, 69 AFTR2d 92-396 (1992), aff'g sub nom **National Starch and Chemical Corp. v. Commissioner**, 918 F.2d 426 (3rd Cir. 1990).

What Expenditures Are To Be Capitalized?

Capital expenditures are not limited to the actual acquisition cost of assets, but include legal, brokerage, accounting, appraisal and other ancillary expenses incurred in acquiring an asset. **Fred W. Woodward v. Commissioner**, 397 U.S. 572, 576-77, 25 AFTR2d 70-964 (1970); **INDOPCO, INC.**, supra.

Preliminary Review

Appeals officers should conduct a careful preliminary review of new cases with the protective conditions issue. The case file should include the history of the railroad's efforts to protest the proposed merger and to seek protective conditions. This is a facts and circumstances question. The evidence of the railroad's intent is often found in official filings, public reports (like annual reports and SEC filings), and in personal interviews of railroad officers conducted by the agents. These types of evidence will generally be gathered before the case comes to Appeals. The Supreme Court opinion in **INDOPCO, INC.** , supra, specifically referred to investment banker's reports to the Board of Directors and to published reports issued to stockholders and other outsiders. Where cases are received absent this evidence, consideration should be given to returning the work unit to the District Director for further development.

Cost Allocations

Few, if any, taxpayers account separately for all expenses incurred in the ICC hearing process. Some costs are more readily identified than others, such as legal, professional, and expert witness fees. Even these fees may be difficult to segregate where the professional argues to halt a merger and in the same ICC hearing argues for protective conditions. In-house cost of executives and staff personnel cost are more difficult to isolate. The Examination Division may rely upon an estimate from the taxpayer to make the cost allocations. This is a potential area of disagreement between taxpayers and the IRS, which the appeals officer must resolve based on the probable value of the evidence.

Cases sent to Appeals should contain a thoroughly developed factual position identifying the expenditures at issue. When cases are received with insufficient factual development, consideration should be given to returning the case for development of the issue. The decision to return the case or resolve the issue based on the evidence presented in the file rests with the local Appeals Office.

Conflict in Examination's Position

The initial announcement of this issue, as summarized by the Railroad Examination ISP Coordinator dated April 30, 1986, established several thresholds to be met before the protective conditions issue could be raised:

> "Protective conditions arise as a consequence of objections from one railroad that the merger of two or more other railroads will cause it grave injury. The ICC imposes protective conditions when it refuses to stop the merger, so that it is necessary for a finding of harm, plus approval for a merger, before this issue comes into play."

The two thresholds that must be met to raise the issue are:

1. Approval of a merger by the ICC, and
2. A finding of harm by the ICC to the competing railroads.

The coordinated position reasoned that no harm could exist absent the approval of the proposed merger. Only then could the ICC rule that the merger caused harm to competing railroads. The protective conditions issue could only be raised after the ICC ruled both conditions existed, after which the ICC could consider granting protective conditions to the competing railroads.

The implication of the coordinated position using the thresholds approach is that the initial purpose for the expenditures, to halt the merger, is different from the expenditures made after the merger is approved. This conflicts with the position that the collective efforts be viewed as a single effort to create a capital asset, protective conditions.

The conclusion that the collective efforts result solely in the creation of an intangible asset, protective conditions, is prejudiced by this conflict in Examination's position. The threshold approach relied upon in Examination's position supports the railroad's position that anti-mergers expenditures may be severed from the efforts to gain protective conditions, giving rise to a deduction for anti-merger expenditures incurred to protect the business.

Effect of Uncertainty in ICC Process

This issue is complicated by the ICC approval process that:

* Normally lasts several years.
* Sometimes issues only temporary approval for mergers.
* Reverses mergers later.

As compared to mergers in unregulated industries, the contradictory ICC rulings make the facts uncertain. Mergers temporarily approved by the ICC have been later reversed, making the temporarily granted protective conditions void. Are railroads entitled to deduct previously capitalized expenditures when the merger is reversed and the protective conditions are void? Are railroads required to capitalize expenditures when mergers are only approved on a temporary basis?

In cases where the ICC process spans several years, no protective conditions may have been granted after the expensive ongoing ICC approval process rules against the petitioning railroad. In other cases, no protective conditions have been granted on the first proposed merger, but a new ICC proceeding resulted in a merger between yet another group of railroads, and protective conditions were issued to the newly formed competing railroads. Are railroads required to capitalize the cost from both the first and second ICC proceeding? Examination has taken the position that:

* Expenditures capitalized from the first ICC proceeding may be expensed when the temporary merger approval is revoked by the ICC.

* Expenditures from the second ICC proceeding should be capitalized.

* Expenditures made with the expectation to create a capital asset, such as protective conditions, must be capitalized.

The character of an expenditure, whether it is capital or is ordinary and necessary, determines whether it may only be deducted as a §165 loss when the investment fails, or whether it is currently deductible. Under §263, expenditures are not currently deductible, but are deductible only by the legislative grace of specific Code section, such as §167 depreciation. Expenditures made with the contemplation that they will result in the creation of a capital asset cannot be deducted as ordinary and necessary business expenses even though that expectation is subsequently frustrated or defeated. **Union Mutual Life Insurance Company v. U.S.**, 570 F.2d 382, 392, 40 AFTR2d 78-836, (1st Cir. 1978), cert. denied, 439 U.S. 821 (1978). Such frustrated or defeated expenditures are only deductible as capital losses, under capital loss rules.

Taxpayers in the broadcasting industry have argued that expenditures incurred to secure an FCC licence are currently deductible where the outcome is unknown at the end of the taxable year. The Tax Court held in **Radio Station WBIR, Inc,** 31 T.C. 803 (1959), that the expenditures were made to acquire a capital asset. The fact that the radio station might not be successful does not make the expenditures a loss in the current year. A loss from a capital asset is only recognized in the year it is realized. It is a common accounting practice to charge capital payments to deferred accounts pending the final completion of the transaction and determination of its status. **Radio Station WBIR, Inc,** supra at 814. This rule applies with equal authority to railroad expenditures incurred in the ICC hearing process.

Allocation Between
Protection of Business v. Creation of an Asset

The Supreme Court in **INDOPCO, Inc.**, supra, clearly required acquisition related expenses be capitalized in cases where corporate restructuring occurs. Unlike the facts in **INDOPCO, Inc.**, the outcome of railroad ICC anti-merger proceedings is often not final, and is uncertain. The prerequisite to grant protective conditions, that is, the approval of a proposed merger, may be years distant. Clearly, under **INDOPCO, Inc.**, after the ICC has approved a merger, further cost can relate to creating the asset of protective conditions. Under these circumstances, the expenditures must be capitalized.

However, the distinctions of an incomplete restructuring diminishes the value of the **INDOPCO, Inc.** decision to require that railroads capitalize all expenditures related to the ICC proceedings, particularly when the indecision spans several accounting periods. The Government does not agree with the position argued by the taxpayer in **Chandler Trailer Convoy, Inc.**, supra, that a deduction is allowed for expenses incurred in creating an intangible asset. However, railroads may argue that only a portion of the expenditures relate to efforts to secure protective conditions, and that the early expenditures relate to anti-merger efforts, which are fully deductible under §162 in the year incurred.

Shortly after the intent to merge is announced, the first reaction by the competing railroads is to attempt to defeat the proposed merger. Examination's position[2] concedes the following:

* Origin of taxpayer's involvement stems from its need to protect its business.
* Character of taxpayer's efforts are open to subjective valuation.
* Facts show the primary purpose of the effort is to defeat the merger.
* Testimony indicates the primary purpose is to defeat the merger.
* ICC proceedings deal primarily with approval or disapproval of the merger.

Examination's position confirms the railroads claim that the expenditures at issue have a dual purpose:

* Protection of a trade or business.
* Creation of an asset.

The Court of Claims in **Arnold R. Blitzer v. U.S.** 684 F.2d 875, 50 AFTR2d 82-5293 (Ct. Cl. 1982), held that an expenditure having the dual purpose of capital and expense must be allocated to the applicable portion of each, rather than being allocated totally to the primary purpose for which it was incurred. The railroad bears the burden of proof to make a proper allocation. Given the length of time over which the expenditures are made, and the fact that a portion of the amount in question is clearly incurred to protect the trade or business, the Court of Claims' dual purpose test may act to impede Government attempts to totally attribute all expenditures to the creation of the protective conditions.

The Supreme Court held the distinctions "between current expenses and capital expenditures are those of degree and not of kind." **Welch v. Helvering**, supra. Each case turns on its own facts, **Deputy v. DuPont**, supra. The expenditure allocation process is necessarily based on specific services performed. This is a potential area of disagreement between taxpayers and the IRS, which the appeals officer must resolve based on the probable value of the evidence and the facts and circumstances of each case.

Unsuccessful Efforts to Gain Protective Conditions

May the railroads allocate a portion of the expenditures to unsuccessful efforts to gain protective conditions? Examination's position contends if the efforts result in any protective conditions, none of the expenditures may be allocated to the unsuccessful efforts. As authority for this contention, Examination relies on **Commissioner v. Lincoln Savings and Loan Association**, supra; **First National Bank of Skowhegan, Maine**, supra; **Radio Station WBIR, Inc,** supra; and **Central Texas Savings & Loan Association v. United States**, supra. None of these cases are exactly on point.

On the other hand, there is authority supporting the position that expenses attributable to abandoned activities are deductible. Rev. Rul. 67-125, 1967-1 C.B. 31, for example, provides that in the event that the proposed redemption of stock is abandoned, the capitalized fees attributable to such proposed redemption are deductible in the taxable year of abandonment. In addition, a bankruptcy court recently upheld the principle that an abandonment loss deduction may be taken for expenditures for activities that are intended to produce a capital asset or a long-term benefit, but which are later abandon or do not result in a long-term benefit. **See in the Matter of Federated Department Stores, Allied Stores Corporation, et al., debtors,** 1992-1 USTC ¶

[2] See Examination Industry Coordinated Position, page 7.

50,097 (Bankr. S.D. Oh., Jan. 8, 1992) (breakup fees incurred in connection with an abandoned transaction were deductible under I.R.C. § 165(a)).

Based on the decision of the United States Supreme Court in **INDOPCO, Inc.**, supra, however, the standard is not whether an activity is successful or unsuccessful, but rather whether the expenditures produced a long-term benefit. Applying the rationale of **INDOPCO, Inc.**, the railroads' expenditures should be analyzed factually to determine whether they produce long-term benefits. In cases where long-term benefits are sought, expenditures should be allocated between actions undertaken to provide long-term benefits and those that were not.

Railroads' Defense
Primary Purpose Test

Railroads may argue that the primary purpose of making the expenditures is to protect their business. The Supreme Court in **Woodward v. Commissioner**, 397 U.S. 573 (1970), however, held that the primary purposes test does not determine whether an expenses is currently deductible or capital. With regard to capital expenditures, the correct standard to be applied is the origin of the claim as set forth in **United States v. Gilmore**, 372 U.S. 39 (1963), and relied upon in **Woodward**, supra. While railroads may argue that the origin of the claim in securing protective conditions is the protection of their business, the Government would counter that the origin of the claim is the creation of a long-term benefit.

Conclusion

Inferences may generally be drawn from the case law to support both the taxpayer's and Examination's positions. This is an issue in which reasonable people can reach dissimilar logical conclusions. The appeals officer must carefully evaluate the strengths and weaknesses of the respective positions to determine the hazards facing both the Government and the taxpayer. Expenses incurred to merely halt the merger are clearly deductible, for if the merger was prevented, no basis to grant protective conditions would arise. Expenses incurred in the hope of gaining protective conditions are capital in nature. A loss from a capital asset is only recognized in the year it is realized. The question of allocating the expenditure between the respective efforts turns on the facts and circumstance of each case.

Although every attempt has been made to consider a wide range of protective conditions situations, appeals officers may encounter situations not adequately addressed by these settlement guidelines. Appeals officers should contact the Appeals Railroad ISP Coordinator for guidance on situations not addressed by these settlement guidelines. It is suggested, but not required, that any disposition of a protective conditions issue that involves a mutual concession of another issue be set forth in a letter of understanding executed by both the taxpayer and the Government, which is made a part of the Appeals Audit Statement issued to the taxpayer.

If the entire case is not settled, a partial settlement of the protective conditions issue still may be appropriate, but before a settlement offer is made, the details should first be coordinated with the Appeals ISP Railroad Coordinator.

The settlement guidelines do not extend to taxpayers that have litigated the issue and for which opinions are pending.

J. W. Wyatt