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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

SEPT 20, 1999

Index (UIL) No.: 263.13-06; 162.26-00
CASE MIS No.: TAM-109736-99
CC: DOM: IT & A: BS
District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Customer 1 =
Customer 2 =
Customer 3 =
Customer 4 =
Customer 5 =
$u =
$v =
$w =
$x =
$y =
$z =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUE:

Are amounts incurred by Taxpayer for employee compensation and travel in connection with soliciting, evaluating, and negotiating five long-term service contracts currently deductible under § 162 or are such amounts required to be capitalized under § 263?

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CONCLUSION:

The amounts at issue should be capitalized because they result in the acquisition of an asset and provide significant long-term benefits.

FACTS:

Taxpayer provides services to clients. During the years at issue, Taxpayer entered into several large ten year contracts with various customers to provide services. Taxpayer incurred approximately $u for employee compensation and travel costs in obtaining the five contracts at issue.

Taxpayer obtains customers in two ways, by solicitation or by direct contact from a prospective customer's request for a proposal (an "RFP"). In this case, at least three of the contracts at issue resulted from RFPs. From the date of initial contact or receipt of an RFP, Taxpayer's employees work to build personal and business relationships with individuals who work for the prospective customer. These informal meetings and relationship building meetings, presentations, and events continue throughout the solicitation, evaluation and negotiation process and throughout the term of the client engagement.

When a customer submits an RFP, Taxpayer prepares a response which it believes will best meet the services that the customer desires. In the response to the RFP, Taxpayer attempts to convince the prospective customer that it is most desirable to negotiate with Taxpayer rather than any of the other companies responding to the same RFP. Once Taxpayer and other companies submit bids, the prospective customer will choose to continue discussions with one group or a single provider. This is often referred to as the bid award date.

After the award date, Taxpayer continues its evaluation of the customer and provides greater detail on its solution and analysis of the customers' issues. During this time, Taxpayer develops a detailed solution for the prospective customer's issues. As Taxpayer and the client come closer to a mutual understanding, legal personnel work on drafting the operative contract. The contract is reviewed by the members of the team working with the client. Once all the details are worked out, the contract is signed by both parties.

This case concerns the federal income tax treatment of amounts incurred for employee compensation and travel related to obtaining five contracts. Of the five contracts at issue, the contracts with Customers 2 and 4 are new contracts with existing clients. The other three contracts are with new clients. Each contract had an initial

term of 10 years. The following are details regarding the anticipated revenues and present status of the five contracts:

Customer 1 - a $v contract signed in Year 1. The contract was renegotiated and substantially modified.

Customer 2 - a $w contract signed in Year 2. The contract provided for a substantial payment to Taxpayer if the contract terminated early. The contract was amended and the services provided by Taxpayer have been substantially changed.

Customer 3 - a $x contract signed in Year 2. The contract provided for a substantial payment to Taxpayer if the contract terminated early. The contract has not been amended.

Customer 4 - a $y contract signed in Year 3. The contract provided for a substantial payment to Taxpayer if the contract terminated early. The contract was amended several times.

Customer 5 - a $z contract signed in Year 3. The contract was terminated in June of Year 4. In a settlement agreement reached in January of Year 5, Taxpayer agreed to provide services during a transition period which ended in April of Year 5.

Although each contract was different, the contracts generally provided that Taxpayer would hire the other party's employees and use them to provide services to that other party. Generally, the other party would agree to allow Taxpayer to use its existing assets in performing those services. In several cases the was actually sold to Taxpayer as part of the agreement. In addition, Taxpayer was provided with office space by the other party and even, in several cases, assumed lease obligations on that space as part of the transaction.

LAW AND ANALYSIS:

Section 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To qualify as an allowable deduction under § 162(a), an item must (1) be paid or incurred during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. Commissioner v. Lincoln Sav. & Loan Ass'n., 403 U.S. 345, 352 (1971). The term "ordinary" has been seen as a way 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." Commissioner v. Tellier, 383 U.S. 687, 689-690 (1966).

Section 263 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) clarifies that § 263 requires the capitalization of costs incurred to acquire property having a useful life substantially beyond the close of the taxable year. An expenditure is capital if it creates or enhances a separate and distinct asset or if the expenditure produces a significant long-term benefit. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Lincoln Sav. & Loan Ass'n. While the mere fact that a taxpayer may receive some future benefit from an expenditure does not require capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is an important factor in determining whether the expenditure is deductible in the year incurred or capitalized. INDOPCO at 87-88.

In this case, the amounts incurred by Taxpayer for employee compensation and travel in obtaining the five contracts at issue should be capitalized because Taxpayer both acquires an asset, the contract, and receives a significant long-term benefit from those expenditures. This is explained below and is followed by an analysis of Taxpayer's contrary arguments.

I. Capitalization

The expenditures at issue created Taxpayer's long-term contracts. Long-term contracts are considered to be capital assets subject to amortization and depreciation under § 263. See Lincoln Sav. & Loan Ass'n.; PNC Bancorp, Inc. v. Commissioner, 110 T.C. 349 (1998); and Stewart Title Guaranty Co. v. Commissioner, 20 T.C. 630 (1953). The court in Stewart held that "a contract which is expected to be income-producing over a series of years is in the nature of a capital expenditure which must be amortized ratably over the life of the asset or the period of the contract." Id. at 636. The five contracts at issue here are all for a ten year duration and for significant monetary value. Although the contracts would not necessarily be profitable, there is little doubt that the contracts were intended to produce a continuing economic benefit over a period of years. The courts have held that it is not necessary that the business realize a profit. For example, in Fall River Gas Appliance Co. v. Commissioner, 349 F.2d 515 (1st Cir. 1965), the court held that when looking to see whether expenditures are ordinary or capital one must look at the totality of the expenditure and see if it was made in anticipation of a continuing economic benefit over a period of years. It makes no difference that some of the expenditures were poor investments. See also Lincoln Sav. & Loan Ass'n.

The expenditures incurred by Taxpayer should also be capitalized because they result in a significant long-term benefit. In particular, the expenditures resulted in five separate and distinct long-term contracts, each of which was expected to produce between $x and $y of revenue over its ten-year life. Accordingly, the expenses at issue here should be capitalized under § 263. See Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir. 1937); FMR Corp. v. Commissioner, 110 T.C. 402 (1998); Lykes Energy, Inc. v. Commissioner, T.C. Memo. 1999-77. Indeed, in Lykes Energy the court required amounts that it characterized as promotional and selling activities to be capitalized where the direct object of the expenditures was obtaining new customers. While the types of items at issue in Lykes Energy differ materially from those at issue in this case, the court's willingness to capitalize amounts incurred for promotional and selling activities indicates that those amounts are not automatically deductible.

II. Taxpayer's Arguments

Taxpayer contends that the costs incurred by it, in connection with soliciting, evaluating, and negotiating five long-term contracts are currently deductible under § 162. Taxpayer makes four main arguments in support of its contention that the costs incurred are deductible under § 162 and not subject to capitalization under § 263. First, Taxpayer argues that the costs it incurred are selling expenses and therefore deductible as ordinary and necessary business expenses. Taxpayer then asserts that the costs incurred are regular and recurring and as such, should be deducted currently. In addition, Taxpayer contends that the legislative history to § 197 supports allowing a current deduction. Finally, Taxpayer believes that the amounts at issue should be currently deductible as investigatory expenses.

A. Selling Expenses

Taxpayer contends that the costs incurred in obtaining the five contracts are selling expenses and, as such, deductible under § 1.162-1(a) which indicates that selling expenses generally are business expenses. See Rev. Rul. 92-80, 1992-2 C.B. 57. Because the term "selling expense" is not defined in the regulations under § 162, Taxpayer looks to § 1.451-3(d)(5)(iii)(A) which includes bidding expenses in its definition of selling expenses.[1] Accordingly, Taxpayer reasons that bidding costs are deductible selling costs. Taxpayer also relies on RJR Nabisco v. Commissioner, T.C. Memo. 1998-252. In that case the court held that advertising expenses were deductible under § 1.162-1(a), notwithstanding the decision in INDOPCO. Taxpayer asserts that since the regulation under § 162 refers to both advertising and selling expenses, and that selling expenses by the definition found in § 1.451-3(d)(5)(iii)(A),

[1] Section 1.451-3 provides rules for accounting for long term contracts.

include bidding expenses, the result reached in RJR should be applied here; a current deduction should be allowed.

We are not persuaded by Taxpayer's argument because the regulations under § 451 do not address the timing of deductions under §§ 162 and 263. In addition, the present case does not involve the completed contract method of accounting. Further, under § 1.451-3(d)(6)(ii)(S) bidding expenses incurred in the successful solicitation of an extended period long-term contract must be capitalized over the life of the contract. Thus, it is clear that amounts expended in bidding on contracts are not per se deductible. See Lykes Energy (amounts incurred for promotional and selling activities required to be capitalized).

B. Recurring Expenditures

Taxpayer argues that a current deduction should be allowed for the amounts at issue because capitalization will do little to alter Taxpayer's total salary and related expenses and, thus, would do little to improve the clear reflection of Taxpayer's income. This reasoning is based on the recurring nature of the amounts at issue. Taxpayer asserts that each year, after the first few years of capitalization, the amortization deductions will approximate the amount that would be deductible if a current deduction were allowed.

Contrary to taxpayer's assertions, the recurring nature of the amounts at issue does not require allowing a current deduction in this case. Indeed, the Tax Court rejected a similar argument in PNC Bancorp. In that case, the court stated:

> Petitioner failed to cite, nor do we find, any authority which stands for the proposition that expenses incurred in the creation of separate and distinct assets are currently deductible if such expenses are incurred regularly. Accordingly, the fact that the banks incurred expenditures on a recurring basis does not ensure their characterization as "ordinary" if they are incurred in the creation of a separate and distinct asset. See Helvering v. Winmill, 305 U.S. 79, 84 (1938) (denying deduction for commissions even though they were regular and recurring expenses in the taxpayer's business of buying and selling securities).

110 T.C. at 368. As a result, the court required the taxpayer in PNC Bancorp to capitalize its loan origination costs. Because the expenditures in this case resulted in the creation of assets – ten-year contracts – they are appropriately capitalized under § 263 even though Taxpayer regularly incurs such expenditures.

Taxpayer contends that the Tax Court's decision in PNC Bancorp is inapplicable to the costs at issue in this case because loan origination expenses are substantially

different from the costs to obtain service contracts. Taxpayer asserts that the once the loan is made, the bank has fulfilled its obligation with respect to the loan contract and that no other services are required by the bank other then processing the principal and interest payments. Taxpayer is of the opinion that a separate and distinct asset has not been created because it must perform substantial services in order to earn the revenues provided for in the contracts.

This distinction is not persuasive because the court in FMR Corp. held that expenditures incurred in the creation of mutual fund management contracts provided the taxpayer with significant long-term benefits and did not qualify for a deduction under § 162(a). Under the facts in FMR Corp. the taxpayer had to perform substantial services over the life of each contract. Therefore, the facts that future services must be performed does not cause an expenditure to be deductible under § 162(a). See also Lykes Energy (amounts incurred to obtain new customers required to be capitalized; taxpayer required to provide future utility services).

C. Self-Created Intangibles

Taxpayer states that the contracts in question are self-created intangible assets and that the costs incurred to create them are currently deductible. In support of this assertion Taxpayer relies on the legislative history to § 197 which indicates that the costs of creating intangibles such as customer lists or goodwill are generally currently deductible. Joint Committee on Taxation, Present Law and Proposals Relating to the Federal Income Tax Treatment of the Costs of Acquiring Goodwill and Certain Other Intangibles, 102d Cong., 2d Sess. 17 (1992); see also Joint Committee On Taxation, Technical Explanation of the Tax Simplification Act of 1993, 103d Cong., 1st Sess. 158-162 (1993). This argument is not persuasive because there is nothing in the legislative history to § 197 that indicates a Congressional desire to change the treatment of costs incurred to acquire or create assets. Such costs were then, and remain now, capitalizable under Lincoln Sav. & Loan Ass'n., and Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). Further, the amounts at issue in this case are appropriately capitalized as they are attributable to specific identifiable contractual assets-and not to customer lists or goodwill. See FMR Corp. (costs of creating a mutual fund and related management contract required to be capitalized); PNC Bancorp (costs of originating loans required to be capitalized).

D. Investigatory Costs

Taxpayer contends that if the Service finds that the expenditures incurred by Taxpayer to obtain the five long-term contracts are capital, the Service should allow a deduction under § 162 for the costs incurred prior to the bid award date. It is Taxpayer's opinion that if there is any date prior to the date the contract is signed, that

establishes a benchmark by which to characterize costs incurred before that date as being too preliminary to be associated with a particular contract, it is the bid award date.

Taxpayer's argument is not convincing because costs are appropriately capitalized as part of a transaction before the parties are legally bound. For example, in Norwest Corp. v. Commissioner, 112 T.C. No. 9 (1999), the taxpayer argued that costs incurred in investigating the expansion of a business could be deducted currently where the costs were incurred before the time the taxpayer formally decided to proceed with the transaction. The Tax Court rejected this argument noting that the fact that preparatory costs were incurred before the formal decision to proceed with the transaction does not change the fact that the costs were related to a capital transaction.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.