THE M&A Tax Report

VOLUME 8, NUMBER 2
SEPTEMBER 1999

THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

ADVANCE PRICING AGREEMENT FEES: *INDOPCO* EXEMPT!

by Robert W. Wood • San Francisco

Here at *The M&A Tax Report*, we have occasionally been accused of exaggerating the importance of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). It does seem (at least to me) that *INDOPCO* has invaded every aspect of the corporate tax regime. While *INDOPCO* is legitimately a takeover topic, it has been applied to many varieties of costs, including: environmental remediation (see Lipton, "IRS Reverses Environmental TAM," Vol. 4, No. 9, *M&A Tax Report* (April 1996), p. 1); aircraft maintenance (see Chambers and Schiffhouer, "INDOPCO Takes Flight: The Capitalization of Aircraft Maintenance Costs, Parts I and II, Vol. 5, Nos. 5 and 6, *M&A Tax Report* (December 1997), p. 1 and (January 1998), p. 1); employee training (see Wood, "Are Training Costs Exempt From INDOPCO?" Vol. 5, No. 7, *M&A Tax Report* (February 1997), p. 1); and employee salaries (see Muntean and Wood, "Tax Court Bloats INDOPCO in Norwest Corp. v. Commissioner, Vol. 7, No. 10, *M&A Tax Report* (May 1999), p. 1).

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Even salaries before an acquisition were held nondeductible in *Norwest Corp. v. Commissioner*, 112 T.C. No. 9 (1999). (For discussion, see Wood, "Preacquisition Salaries Nondeductible Under INDOPCO," Vol. 7, No. 9, *M&A Tax Report* (April 1999), p. 7.) And, even lease rollover or lease termination fees were held nondeductible (see Muntean, "INDOPCO Not Ready to Roll Over in U.S. Bancorp," Vol. 7, No, 4, *M&A Tax Report* (November 1998), p. 1). In short, *INDOPCO* has been applied to many ostensibly deductible expenses. That has caused a good deal of consternation among all of us.

It was therefore with considerable relief that we reviewed the Service's recent release of Technical Advice Memorandum 1999929038 (Tax Analysts Doc. No. 1999-24848). In that Tech Advice Memo, the IRS ruled that a U.S. manufacturer can deduct under Section 162 the consultant fees it incurred in the development of a transfer pricing methodology that was part of an advance pricing agreement (in the field of foreign taxes, known as an "APA").

The expenses for such a venture can be considerable. The company involved in the Tech Advice was a manufacturer, and it retained an economic consulting firm (that sounds expensive already!) to develop a methodology for transfer pricing. Over a period of several years, this economic consulting firm worked with the company (as well as the Internal Revenue Service) to make appropriate modifications to the transfer pricing methodology.

At the end of the day, the IRS and the manufacturer entered into an APA. In it, the IRS agreed to impose no transfer pricing adjustments for the tax years under negotiation. On two different tax returns (the consulting payments spanned two years), the manufacturer deducted the fees paid to the firm in each of the years. On audit of the returns, the IRS agent suggested capitalizing these fees under Section 263.

INDOPCO Doesn't Apply

In the tech advice, the IRS observed that the question whether costs are capital expenditures is intensely factual. For advance pricing agreements (and for that matter, for the preliminary transfer pricing methodology, too), the IRS noted that the fees paid to the economic consulting firm did not provide the manufacturer with the types of significant future benefits necessary to require capitalization. This "significant future benefits" terminology, *M&A Tax Report* readers will recognize right away, is usually the catch phrase used to immortalize (and expand) the reach of *INDOPCO*. For a recent example of the "future benefits" analysis, see *Norwest Corp. v. Commissioner*, 112 T.C. No. 9 (1999).

In TAM 1999929038, the Service noted that both the transfer pricing methodology and the APA were not separate and distinct assets. (Interestingly-although I certainly do not disagree with the Service's conclusions here-one probably could dispute this point in the case of an advance pricing agreement, even though amortization for such an agreement would not be appropriate.) Concluding that there was no distinct asset created, at least no asset within the meaning of Section 263(a), the Service concluded that the manufacturer could claim current deductions under Section 163 for all of the consulting fees paid.

INDOPCO Paranoia?

Perhaps we have overreacted a little in assuming that *INDOPCO* will be applied to virtually every cost under the sun. Happily, TAM 1999929038 proves us wrong. Of course, we're also comforted by the couple of areas that the courts have stayed away from when they were asked to expand the reach of *INDOPCO*. The courts said "don't go there" to the

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The M&A Tax Report ISSN 1085-3693 is published monthly by Panel Publishers, a division of Aspen Publishers, Inc., *A Wolters Kluwer Company*, 1185 Avenue of the Americas, New York, NY 10036. Subscription price, $375 per year, single issue price, $32. Multiple subscription rates are available upon request. First-class postage paid at New York, NY, and additional mailing offices.

POSTMASTER: Send address changes to:
The M&A Tax Report,
Dept. ADV,
PO Box 3000, Denville, NJ 07834

Customer services: (800) 562-1973

Editorial queries:

Robert W. Wood
Robert W. Wood, P.C.
477 Pacific Avenue, Suite 300
San Francisco, CA 94133
(415) 834-1800
Fax: (415) 834-1888

Editor: Robert W. Wood

Publisher: Dean Vogel
Director of Circulation: Gerry Centrowitz
Product Development: Carol Lillienstein
Managing Editor: Elizabeth Daniele
Production: Michele Jankowski

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IRS when it came to graphic design for new products in *RJR Nabisco, Inc. v. Commissioner*, T.C. Memo 1998-252 (1998), and when it came to mutual fund launch fees in *FMR Corp. v. Commissioner*, 110 T.C. No. 30 (1998). For discussion, see Muntean, "Is the INDOPCO Cookie Beginning to Crumble?" Vol. 7, No. 2, *M&A Tax Report* (September 1998), p. 1.

It's nice that a few costs still haven't been INDOPCOed!