Overhead Deduction on Acquistion Allowed

by Robert W. Wood • San Francisco

In *Lychuk v. Commissioner*, 116 T.C. No. 27 (May 31, 2001), the Tax Court upheld an automobile financing company's ability to currently deduct overhead expenses relating to its acquisition of retail installment contracts. The Tax Court concluded that all indirect expenses associated with originating loans could be currently deducted. Most observers assumed that the IRS would appeal the Tax Court's decision. That it did not—and that an appeal would now be too late—makes the *Lychuk* case especially interesting.

Capitalize vs. Deduct

Lychuk is widely cited for the notion that business salaries and benefits paid in connection with the acquisition of installment contracts must be capitalized, but it is the overhead cost element of the case that is most interesting. The Tax Court, in a divided opinion, held that the salaries and benefits paid by an S corporation for the acquisition of auto financing installment contracts had to be capitalized. That is bad. But—the company's overhead expenses were deductible under Section 162(a). That is good.

The Automotive Credit Corp. (ACC) acquired and serviced installment contracts from car dealers who sold cars to high credit-risk individuals. Its primary business was credit investigation, credit evaluation, documentation, and monitoring collections. The IRS determined that all of ACC's salaries, benefits, and overhead costs related to its acquisition operation were capital expenditures. The IRS also determined that ACC had to capitalize professional fees and commissions, or offering expenditures, related to its offering of notes in 1993 and to a second offering that was planned in 1993 but abandoned in 1994.

Judge David Laro, who was joined by seven other Tax Court judges, held that ACC's salaries and benefits were capital expenditures. The court held that ACC's payment of the salaries and benefits was directly related to its acquisition of the installment contracts. However, the court held that ACC's overhead expenses were deductible as business expenses, finding that those expenses weren't directly related to the anticipated acquisition of any of the installment contracts. The court added that any future benefit that ACC received from the overhead expenses was incidental to its payment of them.

Harmonizing *INDOPCO*

The court explained that in arriving at its conclusion, it adhered to the Supreme Court's mandate that requires capitalization of an expenditure when it: (1) creates or enhances a separate and distinct asset; (2) produces a significant future benefit; or (3) is incurred in connection with the acquisition of a capital asset. Next, the court held that Section 165(a) allowed ACC to deduct part of the capitalized salaries and benefits that were attributable to installment contracts it never acquired. The court concluded that ACC could deduct those amounts for the respective years in which it determined that it wouldn't acquire the related contracts.

Finally, the court held that ACC had to capitalize all its offering expenditures, but that it could deduct part of the capitalized offering expenditures that were attributable to an abandoned offering. Seven judges concurred with the majority regarding the capitalization of ACC's salaries and benefits. However, they disagreed that the overhead expenses weren't directly related to the acquisition of the installment contracts. Judge Robert P. Ruwe wrote that the majority's conclusion on that point wasn't consistent with its findings of fact. Judge Stephen J. Swift wrote a separate concurrence.

The Tax Court in *Lychuk* agreed that the overhead expenses could be deducted based primarily on a factual conclusion, albeit one that hinged on the court's reading of *INDOPCO.* The Tax Court found that the overhead expenses could be deducted because it concluded that they were not directly related to the anticipated acquisition of any of the installment contracts. The Tax Court further concluded that any future benefit that the company received from the overhead expenses was incidental to the company's payment of those expenses.

Using these two factual conclusions, the Tax Court referred to the Supreme Court mandate that an expenditure must be capitalized when either: (1) it creates or enhances a separate and distinct asset (see *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971)); or (2) when it produces a significant future benefit (see *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)).

PNC Bancorp Remembered

The *Lychuk* case should stir up memories of the Third Circuit's decision in *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3rd Cir. 2000). The issue in *PNC Bancorp* was whether certain costs incurred by banks for marketing, researching, and originating loans are deductible as ordinary and necessary business expenses under Section 162, or must rather be capitalized. Not surprisingly, the Service had concluded that the expenses in question were not deductible, and instead had to be capitalized and amortized over the life of the loans.

The Tax Court had upheld the IRS' views. The Third Circuit (thankfully) reversed, and the decision was widely seen as an important limitation on the scope of the *INDOPCO* doctrine. (For prior *M&A Tax Report* coverage, see Muntean, "Third Circuit Puts Brakes on Service's Wild *INDOPCO* Driving," *M&A Tax Report*, Vol. 8, No. 12 (July 2000), p. 6.)

The costs in question in *PNC Bancorp* were internal and external costs incurred in connection with the issuance of loans to customers. These costs were a routine part of the bank's daily business, integral to its basic operations. Historically, the costs were deductible in the year they were incurred. The IRS rejected this treatment relying on *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

The Third Circuit in *PNC Bancorp* didn't just look at *INDOPCO*. It also reviewed the Tax Court's application of the Supreme Court's holding in *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971). In *Lincoln Savings* the Supreme Court examined whether loan origination expenses were ordinary expenses, or whether such costs "create[d] or enhance[d] a separate and distinct asset." In *PNC*, the Tax Court had concluded that PNC's consumer and commercial loans "clearly" were separate and distinct assets of the bank, and that the costs incurred in originating and processing the loans "created" these separate and distinct assets.

What's Creating a Separate Asset?

The Third Circuit found the Tax Court in *PNC Bancorp* to have given an overly broad reading of "separate and distinct assets." Furthermore, the Third Circuit criticized the Tax Court for taking an overly expansive reading of the notion of what it means to "create" such assets. Sensibly, the Third Circuit did not agree that marketing and origination activities actually "created" the bank's loans. The Tax Court's conclusion that these expenses themselves created the loans was viewed as faulty by the court of appeals, which concluded that the term "create" could not be stretched quite that far.

The Third Circuit in *PNC Bancorp* summed the area up nicely, saying that we must all remember that the "future benefit" analysis adopted in *INDOPCO* is not meant as a be-all-and-end-all, bright-line test. (See *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482, 489 (7th Cir. 1997).) In *A.E. Staley*, the court had said that in *INDOPCO*: "The Court did not purport to be creating a talismanic test that an expenditure must be capitalized if it creates some future benefit."

Instead, a factual analysis is necessary to determine whether an expenditure can properly be expensed under the ordinary and necessary language of Section 162(a), or must be capitalized under the permanent improvements or betterments language of I.R.C. Section 263(a). Based on that, the court concluded that the loan marketing activities at issue in *PNC Bancorp* lie at the very core of the bank's recurring, routine, day-to-day business. The court held that the Service failed to articulate a principled reason why these normal costs of doing business must be capitalized, while other ordinary banking costs need not be.

Conclusion

Acquisition lawyers may not find *Lychuk* and *PNC Bancorp* to be terribly significant cases. After all, they deal with financing contracts, not with corporate acquisitions. That view may be shortsighted.

Indeed, any curtailment of the *INDOPCO* doctrine is a victory for M&A lawyers. *Lychuk* allows a financing company to write off overhead expenses relating to the acquisition of the installment contracts. In this sense, *Lychuk* involved a limited asset acquisition, blessing deductions at least in a limited context. *PNC Bancorp* seems to be the other side of the coin, upholding a deduction for the costs and expenses associated with the origination of loans (as opposed to their acquisition).