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The Continuing Flap Over Expenses—Takeover and Otherwise

by Robert W. Wood • Bancroft & McAlister

One of the issues that just will not die this year is whether expenses can be deducted or have to be capitalized. Although we tend to lump this issue under the 90's moniker of *National Starch* (or use the even more hip *INDOPCO* handle), these issues can come up in a variety of contexts. (For recent coverage of this issue in and out of bankruptcy, see Schiffhouer, "Indopco, Federated and Beyond," 1 *M&A Tax Rep't* 1 (August 1992), p. 1). If we needed any confirmation that the deduction/ capitalization dichotomy will be one of the hot growth areas of the tax law in this decade, the Service gave it to us in a widely discussed as-yet-unpublished TAM concerning the capitalization of asbestos removal costs.

What do asbestos removal costs have to do with takeover fees? The TAM concludes that the cost of asbestos removal cannot be deducted, and must instead be capitalized. Relying on the Supreme Court's decision in *INDOPCO, Inc.*, 112 S.Ct. 1039 (1992), the Service expounded that to currently deduct the costs of asbestos removal, such expenditures would have to be for incidental repairs that neither materially add value to the taxpayer's property nor appreciably prolong its life.

Cynics may say that this rule encourages inefficiency, providing gold-plated tax treatment only when the item evaporates. But on a more fundamental level, many taxpayers are concerned about the depth of the Service's commitment to *INDOPCO*. If an *INDOPCO* analysis does not fit into a discussion of whether asbestos removal costs have to be capitalized (indeed, *INDOPCO* seems irrelevant to this inquiry), then *why* is the Service talking about it?

It must be that the Service intends to spread the *INDOPCO* plague across our villages and cities indiscriminately. Whether one chooses to take this doomsayer's view or not, the fact remains that the Service is at least paying lip service to *INDOPCO*'s applicability *outside* the takeover area. That means, or could mean, that *inside* the takeover area, a high level of scrutiny will be applied to claimed deductions.

With IRS guidance in this area having been promised, this first tip of the iceberg suggests a long, hard winter.

From Asbestos to Advertising

The first helpful hint on this gloomy weather front came in *Rev. Rul.* 92-80, 92-39 IRB 1, in which the Service addressed the deductibility of advertising costs. Everyone had assumed that such costs were deductible before the post-*INDOPCO* chill; fortunately, the wisdom of that view was confirmed in the ruling.

The ruling explicitly considers the effects of *National Starch/ INDOPCO*, and concludes that that decision does not affect the treatment of advertising costs under Section 162. The ruling confirms that such costs are "generally" deductible, even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising do the costs of the advertising have to be capitalized.

From Advertising to Audits

As the issuance of a revenue ruling would indicate, *National Starch/INDOPCO* issues have become prominent. The Service has also issued a recent TAM in which it similarly declined to adopt the reasoning of *National Starch/INDOPCO*.

In TAM 9237006, a public electric utility had built a nuclear facility and sought to have the costs included in its rate base. Under state law, these costs could not be included in its rate base unless a prudency audit was conducted and a state agency concluded that the utility's costs were prudent. The prudency audit was conducted at the utility's expense. The utility also retained a law and consulting firm concerning the reasonableness of the construction costs.

The TAM concludes that the costs of conducting the prudency audit and the related fees are currently deductible

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under Section 162. As in *Rev. Rul.* 92-80, the Service expressly declined to follow the holding of *National Starch/INDOPCO*, noting that the cost of constructing the nuclear facility, not the audit, was the ultimate basis for the rate increase.

According to the Service, the utility's expenses in setting rates are recurring and typical of the industry, and therefore ordinary within the meaning of Section 162. Unlike the expenditures involved in *National Starch/INDOPCO*, the expenditures incurred by the utility were not connected to the creation of a property interest, identifiable asset, or long-term benefit.

Starch in Your Deductions

It may be too soon to be overjoyed about the prognosis of these no-*Starch*-please rulings. Indeed, in *Rev. Rul.* 92-80 and TAM 9237006, the inapplicability of *National Starch/INDOPCO* would seem to be self-evident. And in the TAM applying the *National Starch* rationale to asbestos removal costs, the decision that capitalization would be required certainly could have been reached without regard to the Supreme Court's decision. Given the current volume of cases reportedly pending in audit and appeals that directly raise these issues, it is likely that the last word on this hot topic has yet to be uttered. ■

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