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Expenditure Deductions
The Right Track for Capitalization of Costs

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One of the many tensions pervading the income tax regime is whether an expenditure may be deducted in full during the current period or must be capitalized and then deducted, if at all, over future periods. Various provisions of the Internal Revenue Code attempt to deal with this issue, in particular section 263.

Section 263(a) is designed to prevent the distortion of taxable income through a current deduction of expenditures relating to the production of income in future years. In interpreting §263(a), the U.S. Supreme Court has focused on whether an expenditure produces a "significant future benefit" in determining when capitalization is required. *See, for example, INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). This standard, unfortunately, has not provided the desired certainty and clarity to allow easy compliance with, and enforcement of, the law.

The Treasury Department issued proposed regulations on December 18, 2002, setting forth a general framework for capitalizing amounts paid to acquire, create, or enhance intangible assets under §263(a) of the code. In the proposed regulations, Treasury has provided specific categories of intangible assets for which capitalization is required and clarified that §263 applies only in these cases. Although the proposed regulations do not apply to most intangible interests in land, such as timber rights, they do affect the real estate industry in a number of respects.

Prepaid Expenses

The proposed regulations require capitalization of amounts prepaid for benefits to be received in the future. Accordingly, capitalization of prepaid expenses is required on the ground that the prepayment creates an intangible asset in the form of a right; specifically, the right to receive goods, services, or other benefits in the future.

The regulations provide the following example: X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the signing, X prepays $240,000. No other amounts are due under the lease. The $240,000 is an amount prepaid by X for future benefits and must be capitalized. Even though the lessor is required to recognize $240,000 of ordinary net income immediately, this result comes as no surprise.

What the proposed regulations do not mention is that certain code sections, such as §467, may apply in this type of situation that could vary the result determined under the proposed regulations. Section 467 provides various methods of allocating rent over the term of a lease. Section 467 attempts to put lessors and lessees on equal footing by having the lessor recognize income over time as the lessee accrues its deductions for rental expense. It is unclear if the proposed regulations are intended to override this approach of §467 or if they are solely aimed at situations where §467 is not otherwise applicable.

Tenant Inducements

The proposed regulations generally provide that a taxpayer must capitalize amounts paid to another party to induce that party to enter into, renew, or renegotiate certain agreements, including leases.[1] These amounts, "tenant inducements," are generally written off over the term of the lease. Thus, in a typical case, where the landlord pays the tenant in order to induce him to enter into the lease, those expenses are treated as if they were the mirror image of prepaid rent in that the tenant has up-front income and the landlord has a write-off over the term of the lease.

The proposed regulations then say something mysterious in that this rule "does not apply to amounts paid by a lessor to a lessee as a construction allowance for tangible property (*see*, for example, section 110)."

Section 110 of the code modifies the typical treatment of a cash payment from a landlord to a tenant (*i.e.*, a tenant inducement). This section provides that the gross income of a lessee does not include any amount received in cash (or treated as a rent reduction) by certain commercial lessees from a lessor for the purpose of any such lessee's constructing or improving qualified long-term real property for use in the lessee's trade

or business, but only to the extent that such amount does not exceed the amount expended by the lessee for the construction or improvement.

Any amount excluded from a lessee's income by reason of §110 is treated by the lessor as the acquisition of nonresidential real property. Thus, if the landlord gives the tenant cash, which the tenant uses to improve the leased space, and the other requirements of §110 are met, the tenant does not recognize income and the landlord depreciates the amount spent on the improvement (generally over 39 years).

As the landlord is deemed to own the improvement under §110, no intangible asset is created; hence the exception from the rule provided in the proposed regulations.

Why does the exception apply to construction allowances where §110 does not apply? It is generally thought that when a landlord gives cash to a tenant and the situation falls outside the scope of §110 the tenant has currently includable income and the landlord must deduct the expenses over the term of the lease. Since this result is consistent with the proposed regulations' "tenant inducement" rule, it is possible that these expenses were carved out of the proposed regulations for that reason.

Contract Terminations

The regulations also provide that a lessor must capitalize amounts paid to a lessee to terminate a lease of real or tangible personal property.

What is the proper period over which these amounts are to be written off? There is case law authority for three possible amortization periods: the remaining term of the terminated lease; the term of the lease of a replacement tenant; or the life of the building as if the expenses were incurred to create an improvement to the building (*i.e.*, 39 years).

The preamble to the regulations states that the lease termination expenses should be written off over the remaining term of the terminated lease.

The preamble also clarifies that when a tenant pays its landlord to terminate a lease, the tenant can deduct that cost. The rationale here is that the tenant does not acquire a right for which capitalization is appropriate. This outcome might change, however, if the tenant is making the payment to terminate the lease agreement in order to facilitate another transaction and that other transaction is expressly conditioned on the termination of the existing lease.

Another type of intangible asset specifically described in the regulations, and for which an entirely new regime is created, arises from amounts paid to acquire real property that is relinquished to another, or to produce or improve real property that is owned by another, if the real property is reasonably expected to produce significant economic benefits for the taxpayer.

This rule acknowledges a long line of cases and rulings requiring capitalization in such circumstances. For example, expenditures incurred by a taxpayer to pave a public road that benefited the taxpayer's business were required to be capitalized, and expenditures incurred by a railroad company for construction of a state-owned highway bridge over its tracks created a long-term business benefit for the taxpayer and were therefore held to be capital expenditures.

The proposed regulations limit this rule to real property. Real property is defined in the regulations to include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities, and pollution control facilities.

Exceptions

This rule requiring capitalization does not apply to situations where the payment (i) is part of a transaction involving the sale of the real property by the taxpayer; (ii) is part of the sale of services by the taxpayer to produce or improve the real property; (iii) is a payment by the taxpayer for some other property or service provided to the taxpayer; or (iv) is a payment by the taxpayer to another party to create another intangible described in the proposed regulations.

Neither the proposed regulations nor the preamble provides any explanation for why it is inappropriate in these cases to treat the expenses incurred as creating separate intangible assets and the examples in the proposed regulations do not describe the situations the exceptions were intended to address.

The first exception, where the taxpayer is selling real property, could conceivably include a situation where a developer builds a common improvement (such as a golf course), the ownership of which he gives up in order to induce buyers to purchase residential units. In such a case, the basis for the common improvement would be allocated to the basis of the residential units sold and thus there is no separate intangible asset.

The second exception may have been intended to address the situation where a contractor provides construction services for a customer (the owner of the real property). Since the contractor receives cash payment for the services he provides and, therefore, has no future benefit attributable to the cost of the improvements, they are not required to be capitalized.

The third exception could apply in a case where a taxpayer makes improvements to a neighbor's property in exchange for an easement allowing the taxpayer access through his neighbor's property. In such a case, the expenditure does not create a separate intangible, rather it goes into the cost of the easement.

For those costs that must be capitalized under this rule, the proposed regulations also modify §167 of the code, which provides a depreciation deduction for the exhaustion and wear and tear of property used in a trade or business, or of property held for the production of income, to permit amortization of the capitalized costs ratably over a 25-year period.

This new 25-year period was chosen arbitrarily rather than adopting a method based on the recovery period otherwise prescribed for the taxpayer's property under §168.

The 25-year "safe harbor" recovery

period is intended to eliminate the uncertainty involved in determining the period of the expected future benefit over which amortization would otherwise be required and related questions of appropriate class life or recovery period typically required under the code.

The new regulations specifically do not change the result in Revenue Ruling 2002-9 (2002-10 I.R.B. 614), regarding the treatment of impact fees paid by a developer of real property.[2] Section 263A provides that in the case of real property produced by the taxpayer, the direct costs of producing the property, and the property's proper share of indirect costs (including taxes) which are allocable to such property, must be capitalized.

Revenue Ruling 2002-9 provides that impact fees incurred by a developer in connection with the construction of real property are indirect costs that must be capitalized under §263A because they directly benefit, and are incurred by reason of, the production activity. The proposed regulations provide that these impact fees do not create a separate intangible asset for which capitalization is required, but rather these costs are still subject to the §263A regime.

The proposed regulations also provide that real property turned over to a government entity in connection with a real estate development project (such as dedicated improvements) are beyond the scope of this rule. Like impact fees, such costs are allocable to the property produced and are governed by the principles of §263A the regulations thereunder.

Effective Date

The new regulations are proposed to be applicable on the date on which the final regulations are published in the Federal Register.

The proposed regulations also provide rules applicable to taxpayers seeking to change their method of accounting to comply with the rules contained in the final regulations.

Taxpayers may not change a method of accounting in reliance upon the rules contained in the proposed regulations until the rules are published as final regulations in the Federal Register.

Although these regulations do not become effective until they are published as final regulations, they represent a common sense approach to an area that has been fraught with uncertainty for many years.

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[1] This rule does not apply if the aggregate amount of all payments made to the party being induced does not exceed $5,000 (the *de minimis* exception).

[2] *See* "The Impact of Impact Fees," by Morris and Dyckman, New York Law Journal; June 26, 2002, discussing Revenue Ruling 2002-9.

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