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Accounting for Prepaid Items: "U.S. Freightways v. Commissioner"

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There has long been uncertainty as to the appropriate treatment by an accrual method taxpayer of an ordinary and necessary business expense producing a benefit that extends into the following tax year: for example, an annual premium for insurance coverage over a 12-month period straddling two taxable years. Can such an expense be deducted in the year it was made, or must it be capitalized and then written off over the term of the resulting asset (e.g., the insurance policy)?

Cash method taxpayers have generally been permitted a full deduction for insurance premiums and other ordinary and recurring expenditures in the year of payment where the payment results in a benefit for one year or less. It has been unclear, however, whether such a one-year rule applies to accrual method taxpayers as well.

In *U.S. Freightways Corp. v. Commissioner*, No. 00B2688 (7th Cir. Nov. 6, 2001), the Court of Appeals, reversing the Tax Court, held that insurance and other expenses that are ordinary, necessary, and recurring, and that clearly provide a benefit for not more than twelve months, are deductible expenses under Internal Revenue Code section 162(a) and need not be capitalized.

About two months after the decision, the IRS issued an announcement, briefly discussed below, stating that the IRS expects to propose regulations later this year concerning the treatment of expenditures for intangible assets. The regulations will include a 12-month rule similar to that set forth in the case.

Facts in U.S. Freightways

U.S. Freightways Corp. ("Freightways"), a long-haul trucking company using the accrual method of accounting, regularly purchased permits and licenses, and paid fees and insurance premiums, to operate its vehicles. These expenditures were referred to collectively as "FLIP expenses."

None of the FLIP expenses incurred by Freightways in 1993 (the taxable year at issue) resulted in a benefit that extended beyond one year from the date the expense was incurred. For financial reporting purposes, the FLIP expenses were taken into account ratably over 1993 and 1994, with approximately 55% of the expenses being allocated to 1994. For tax purposes, however, Freightways deducted in 1993 the entire amount of FLIP expenses paid in that year.

Following an audit, the Commissioner asserted a tax deficiency on the basis that Freightways should have taken the FLIP expenses into account for tax purposes in the same manner as had been done for financial reporting purposes – namely, by capitalizing the expenses and then deducting them ratably over the period of not more than 12 months to which each expense related.

Following the filing of a petition for redetermination by Freightways, the Tax Court sustained the determination of the Commissioner.

It was undisputed that the expenses were ordinary and necessary business expenses within the meaning of Code section 162(a). The Tax Court concluded, however, that under Code section 263, and taking into account that Freightways was an accrual method taxpayer, case law and regulations required capitalization where the expenditures resulted in benefits that extended beyond the taxable year in which the expenditures were made.

Having sustained that IRS determination, the Tax Court concluded that it did not need to address a second issue raised by the Commissioner, namely, whether the Freightways method of accounting failed to reflect its income clearly, so that under Code section 446(b) the Commissioner could select and impose on Freightways a method of accounting that in the Commissioner's opinion *did* clearly reflect income.

Seventh Circuit Decision

On appeal, the Court of Appeals for the Seventh Circuit reversed the Tax Court's ruling.

The Seventh Circuit decision characterized the issue before it as being whether the expenditures were ordinary and necessary business expenses deductible under Code section 162(a), or capital expenditures that were required

to be capitalized under Code section 263(a) regardless of whether they were also described in section 162(a).

The Supreme Court has stated that the fundamental rationale for the rules distinguishing between capital expenditures and immediately deductible items is "to match expenses with the revenues of the taxable period to which they are properly attributable" (*INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)). The Court of Appeals noted that the Supreme Court has acknowledged that expenditures providing no more than an incidental future benefit may be currently deductible; however, at the same time, the Treasury Regulations state that "a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year" must be capitalized (Reg. §1.461-1(a)(2)(i)).

The appellate court further observed that the taxpayer was not disputing the validity of the relevant regulations under Code sections 263 and 461, but rather whether the Commissioner's interpretation of the regulations in this matter was reasonable.

The Tax Court decision under review asserted that, even if there was a "one-year rule" permitting cash method taxpayers to deduct expenditures resulting in a benefit of no more than 12 months' duration, such a rule could not apply to accrual method taxpayers. The Court of Appeal rejected this conclusion.

Specifically, the Court of Appeals found that this distinction between accrual method and cash method taxpayers was not supported by the case law, apart from, perhaps, earlier decisions of the Tax Court that were not binding on the Court of Appeals. The appellate court also accepted the taxpayer's argument that the use in the regulations under Code section 461 of identical language in describing expenditures that are required to be capitalized by cash method and accrual method taxpayers implied that the same capitalization rules should be applied regardless of which accounting method was used.

(In fact, the regulation under section 461 regarding the timing of deductions for cash method taxpayers states only that an expenditure having a useful life extending substantially beyond the end of the year "may not be deductible, or may be deductible only in part" in the year in which it is made. Further discussion might have been appropriate as to whether this provision is the same in substance as the equivalent provision for accrual method taxpayers, to the effect that any such expenditure "is" capitalized.)

Without significant further discussion, the Court of Appeals concluded that "the decision whether to expense or capitalize a particular item should not turn on whether the taxpayer uses the cash or accrual method of accounting."

The court then considered the applicability of regulations under Code section 263, the provision mandating nondeductibility of "capital expenditures," and found that they too did not clearly resolve the issue.

The decision notes that the FLIP expenses were not of the same nature as the examples of capital expenditures listed in Reg. section 1.263(a)-2. Those examples generally deal, as does section 263(a) itself, with expenditures to acquire capital goods (such as buildings and securities) and with expenditures to improve such property that would generally be capitalized and become part of the basis of such property.

By contrast, the FLIP expenses at issue did not result in, or otherwise relate to the acquisition of a longer-lived asset.

The Court of Appeals then turned to a review of how the IRS had applied the regulations relating to capitalization through published rulings. The decision cites various rulings, and cases as well, in which expenditures creating value for a period of not more than one year had been held to be deductible.

The court agreed with the Commissioner that none of the cases or rulings established as a general proposition that all prepaid expenses with a useful life of not more than one year are entitled to be treated as deductible expenses. The Court further observed, however, that the Commissioner had not adopted a consistent practice of requiring capitalization of such expenditures; the lack of such a consistent practice undercut the Commissioner's position here.

The Commissioner argued, as might be expected, that failure to capitalize these expenses would cause distortion in computing the taxpayer's income and allow Freightways to, in a sense, repeatedly borrow deductions from future years.

The court conceded this point but indicated that "perfection" in the matching of expenses with revenues "is a lot to ask for." The court also noted that there was no reason to believe that Freightways' pattern of FLIP expenditures was motivated by tax planning.

The petitioner argued that the administrative burden of allocating FLIP expenses between the two tax periods to which they typically related would be substantial, and outweighed the gain in precision for the tax authorities. This argument was somewhat curious in the context before the Court of Appeals because, as the Commissioner argued, the IRS was only seeking to require that the taxpayer apply for tax purposes a method already being used by it for financial accounting.

The court concluded, nonetheless, that requiring capitalization for tax purposes would impose an administrative burden on Freightways regardless of how its financial records were kept. (The merits of the administrative burden argument would be clearer, of course, with respect to taxpayers that do not maintain a separate accounting system for financial reporting purposes.)

The court concluded that the balance of factors favored treatment of the one-year expenses at issue as deductible expenses not subject to capitalization, and reversed the Tax Court's ruling to the contrary.

The court then, however, remanded the case to the Tax Court to address the other issue that had been raised by the Commissioner. Taking into account the Commissioner's broad discretion in determining methods of accounting, the court found that the record was insufficient for the court to determine whether

Freightways' method of accounting clearly reflected its income.

Observations

It can be argued that the Court of Appeals decision is flawed in its review of the regulations on point, and more specifically that the regulations under section 461 relating to accrual method taxpayers clearly mandated capitalization by Freightways of at least some of the expenses at issue. There is, however, a great deal of common sense appeal to the court's decision.

In January of this year, the IRS issued an announcement that describes rules to be proposed later this year that will address capitalization issues for expenditures relating to intangible assets. With regard to the issue addressed in the *Freightways* decision, Announcement 2002-9 states that, under the anticipated regulations, capitalization will not be required for an expenditure within any of several enumerated categories (including prepayments for insurance and other goods and services) "unless that expenditure created or enhanced intangible rights or benefits for the taxpayer that extend beyond the earlier of (i) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred."

The announcement does not address the anticipated effective date of the regulations, and a review of the provisions of the announcement is beyond the scope of this article. The anticipated adoption by regulation of a modified version of the one-year rule that was applied by the Court of Appeals in *Freightways* to an accrual method taxpayer should, however, be good news for many other taxpayers.

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