Taxation

PROF. MCINTYRE
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CHAPTER 5

Capital Recovery

CAPITAL EXPENSES, DEPRECIATION, ANNUITIES, INVENTORY

Business Costs and Expenses

DEDUCTION AND CAPITALIZATION RULES

- Personal — not deductible
- Business — deductible some time
  - **Cost** (long-term) — deduct later
    - Improvement
    - Acquisition
      - Capital Asset
      - Inventory goods
  - **Expense** (current) — deduct now
    - Repair
    - Operating expense

Code Section 263

CAPITAL EXPENDITURES

(a) *General rule*. No deduction shall be allowed for —

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to —

* * *

(B) research and experimental expenditures deductible under section 174,

* * *

(G) expenditures for which a deduction is allowed under section 179,

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

* * *

Code Section 263A

CAPITALIZATION AND INCLUSION IN INVENTORY COSTS

(a) *Nondeductibility of certain direct and indirect costs*. (1) *In general*. In the case of any property to which this section applies, any costs described in paragraph (2) —

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property, shall be capitalized.

* * *

(b) *Property to which section applies*. Except as otherwise provided in this section, this section shall apply to —

(1) *Property produced by taxpayer*. Real or tangible personal property produced by the taxpayer.

(2) *Property acquired for resale*. * * *

Rev. Rul. 2001-4

IMPROVEMENTS, MAINTENANCE OF AIRCRAFT AIRFRAME

Facts. Tp has two aircraft in for a "heavy maintenance visit." Aircraft #1 is fixed up but not enhanced, and its useful life is not extended. Aircraft #2 has panels of outside skin replaced and upgrades installed.

Issue. Are the costs incurred for heavy maintenance deductible?

Holding. Yes for aircraft #1 and no for improvements on aircraft #2.

Fall River Gas Appliance (1965)

INSTALLATION COSTS FOR LEASED GAS APPLIANCES

- **Facts**: Tp sells natural gas to retail customers. It leases to customers gas burners (replacing oil burners) and water heaters. Spends $90 to install conversion burner and $65 to install water heater.
- **Issue**: Must cost of installation be capitalized or is it deductible as business expense?
- **Holding**: Cost must be capitalized because it was incurred to get continuing economic benefit over indefinite future period.

Midland Empire Packing (1950)

FIXING BASEMENT LEAKING OIL AND WATER (NOT IN BOOK)

- **Facts**: Tp has leaking basement in its packing plant. After refinery moved in next door, oil, rather than water, started leaking in and damaging business. Tp spent $$$ for concrete liner to basement, which eliminated water and oil leak.
- **Issue**: Is cost of concrete liner deductible as ordinary and necessary business expense?
- **Holding**: Yes, it was a repair because it did not enhance utility of basement to Tp.

Idaho Power (1974)

CAPITALIZING DEPRECIATION EXPENSE (NOT IN BOOK)

- **Facts**. Tp operates a power company. It buys a truck for $10,000 with a 10-year life and uses it in year 1 to build a building with a 50-year life.
- **Issue**. How much depreciation deduction in year 1?
- **Holding**. $20 ($10,000 × 1/10 × 1/50). Cost of truck used to create building is written off over life of building.

Mt. Morris (1955)

DRIVE-IN THEATER (NOT IN BOOK)

- **Facts**. Tp built a drive-in Theater. The paving of the parking area, which was on a hill, increase water flow to neighbor's land. To settle suit with neighbor, Tp build a drainage system on the neighbor's land, which was connected to the city sewer system.
- **Issue**. Can the cost of the drainage system be deductible?
- **Holding**. No. It provided a future benefit and should have been part of the initial construction.

Norwest Corp. (1997)

REMOVAL OF ASBESTOS IN RENOVATION PROJECT

- **Facts**: Tp decided to remodel its bank building. To do so, it must remove asbestos materials at significant cost. Without remodeling, the asbestos could have remained in place.
- **Issue**: Can cost of removal of asbestos be deducted as business expense?
- **Holding**: No, the removal is an integral part of the capital improvement of the building.

INDOPCO (1992)

EXPENSES OF TARGET COMPANY IN FRIENDLY TAKEOVER

- **Facts**: Tp was the target of a friendly acquisition. It spent $2.2 million on fees to Morgan Stanley to set value of company and various other fees of around $0.5 million.
- **Issue**: Can the various fees be deducted on ground that they did not create separate and distinct asset?
- **Holding**: No, they are capital in nature because the merger enhanced earning potential of company.

Santa Fe Pacific Gold Co. (2009)

TERMINATON FEE TO FAILED"WHITE KNIGHT" (ON WEB SITE)

- Facts: Santa Fe, fearing a takeover by Newmont, made a merger deal with smaller Homestake. Santa Fe promised Homestake $65 million if it canceled the deal. It was forced to accept acquision bid by Newmont and paid the $65 m to Homestead.
- **Issue:** Can Santa Fe deduct the $65 m as a business expense, or does INDOPCO require capitalization?
- **Holding:** Deductible. Santa Fe did not get any continuing benefit from the payment to Homestead.

Wells Fargo (2000)

LIMITATION ON INDOPCO

- Facts. Bank anticipated, correctly, that it might be a target for a takeover and paid certain investigatory expenses. It also incurred legal fees in connection with the takeover and paid salaries to officers working on the takeover.
- **Issue**. Does the rule in INDOPCO apply to deny the deductions?
- **Holding**. Only the legal fees need to be capitalized (distinguishing INDOPCO incorrectly). The employee expenses are deductible because they are an "ordinary" expense.
- **Comment**. Lawless decision, inconsistent with the main holding of INDOPCO.

Treasury's INDOPCO Rules

PRO-TAXPAYER GUIDANCE ON CAPITALIZATION

- Capitalization required ONLY for:
  - Identified intangibles acquired by purchase;
  - Identified intangibles created by taxpayer;
  - Separate and distinct intangibles;
  - Future benefits identified in future regulations.
- Rule of INDOPCO that unidentified intangibles must be capitalized is overturned (in effect).

Cost Recovery Methods

RECOVERING COSTS THAT WERE CAPITALIZED

Depreciation — Recovery of basis in tangible personal property used in a business. Code § 167.

Amortization of Intangibles — Goodwill and other business assets with no clear useful life. Code § 197.

Annuities — Payments of income and return of principal over some period, typically the holder's remaining life. Code § 72.

Depreciation and Accounting

ACCOUNTANTS LIKE TO MATCH INCOME AND EXPENSES

- Accountants typically measure income for taxpayer's *income statement*, which is provided to investors to indicate how the company is doing over some period. Different from tax goal.
- Matching cost of capital to income from that capital means that a portion of the capital cost is deducted over the life of the asset. See examples in Casebook at p. 149.
- Depreciation is a special rule, allowing a deduction for estimated declined in value without any realization event.

Deduction for Depreciation

CODE SECTION 167

(a) *General rule*. There shall be allowed **as a depreciation deduction** a **reasonable allowance for the exhaustion, wear and tear** (including a reasonable allowance for obsolescence) —
  (1) of property used in the trade or business, or
  (2) of property held for the production of income.
(b) *Cross reference*. For determination of depreciation deduction in case of property to which section 168 applies, **see section 168**. [*Note: Most of the important rules are found there.*]

(c) *Basis for depreciation*.
  (1) *In general*. **The basis** on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property **shall be the adjusted basis provided in section 1011**, for the purpose of determining the gain on the sale or other disposition of such property.

Accelerated Cost Recovery System

CODE SECTION 168

(a) *General rule*. Except as otherwise provided in this section, the depreciation deduction provided by **section 167(a)** for any tangible property shall be determined by using —

(1) the applicable depreciation method,
(2) the applicable recovery period, and
(3) the applicable convention.

(b) *Applicable depreciation method*. [200% declining balance method, AKA Double declining balance method (DDBM); alslo150% DBM and Straight line method.]
(c) *Applicable recovery period*. For purposes of this section, the applicable recovery period shall be determined in accordance with the following table: [e.g., 7-year property = 7 years]
(d) *Applicable convention* [Generally half-year convention.]

Recovery Period of Property

LINKED TO CLASS LIFE OF PROPERTY

Except as otherwise provided in this subsection, property shall be classified under the following table:

Property shall be treated as:	*If such property has a class life (in years) of:*
3-year property	4 or less
5-year property	More than 4 but less than 10
7-year property	10 or more but less than 16
10-year property	16 or more but less than 20
15-year property	20 or more but less than 25
20-year property	25 or more.

Class Life

SECTION 168(I)(1)

(i) *Definitions and special rules*. For purposes of this section —
(1) *Class life*. Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 . . . .

[That is, the class life is the life provided in, e.g., §168(e)(3) or the class life under the pre-1986 rules that linked the period for depreciation with actual estimates of useful life.]

[Examples from § 168(e)(3): 5-year = automobiles and light trucks; 7-year = railroad track; 10-year = fruit trees.]

Some History

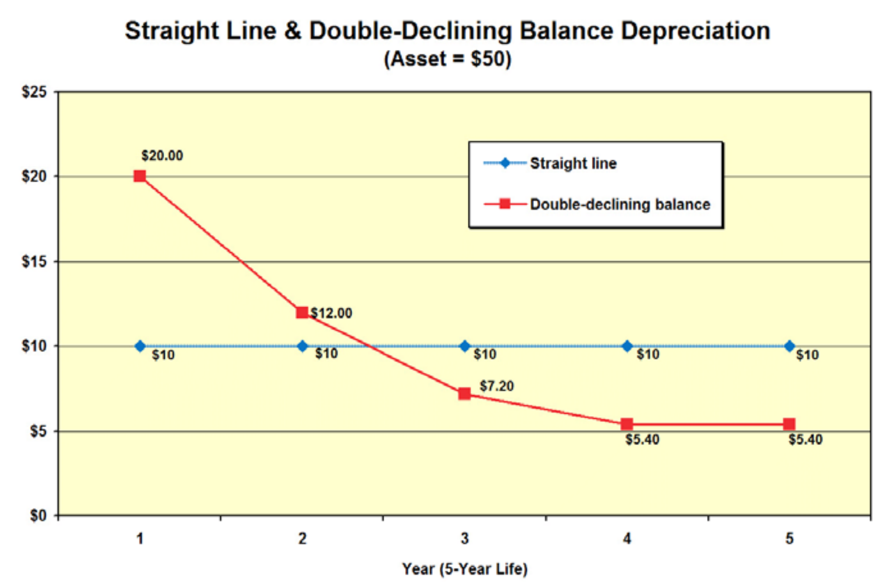
THE DEVELOPMENT OF THE CONCEPT OF "CLASS LIFE"

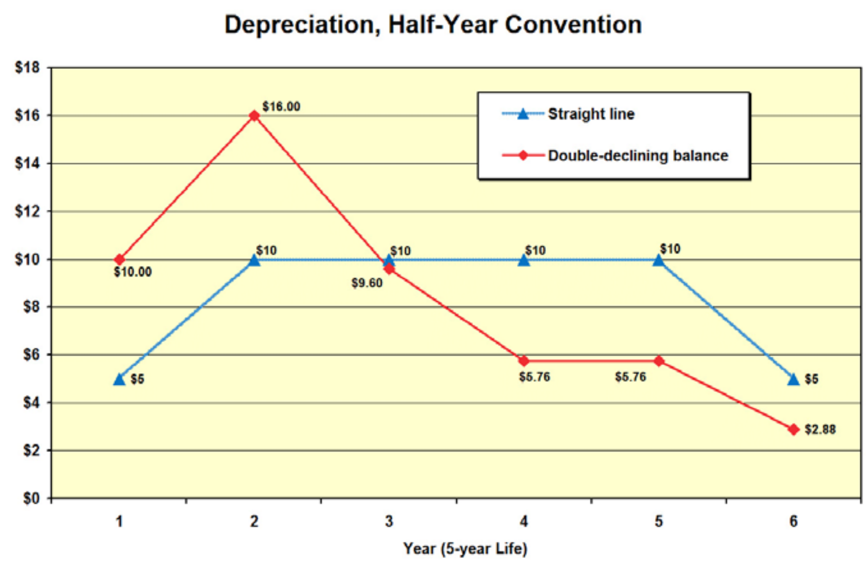
- **FDR** wanted to raise taxes on business, and his IRS Commissioner, Guy T. Helvering (1933-43), offered to get the job done by reforming depreciation, cutting back on abuses.
  - IRS produced **Bulletin F**, which contained a list of thousands of assets with an assigned (and short) useful life.
- **JFK** relax depreciation rules; the new rules grouped assets into classes, and the class life was 25% shorter than the average from Bulletin F.
  - A "reserve ratio" (RR) test was added to require businesses to increase lives if their experience in future warranted.
- **Nixon** shortened the class lives, eliminated RR test and salvage, and gave pro-taxpayer half-year conventions. Modified by Congress.
- **Reagan** eliminated the link to useful life but used "class life" to determine artificial recovery period.

Methods of Depreciation

MANY METHODS, BUT ONLY TWO FOR THIS COURSE

- **Straight line (S/L) method**. Divide the basis by the recovery period and take the amount so determined each year.
  - *Example*. Asset has a recovery period of 5 years and a basis of $1,000. Each year, the Tp can deduct $200 ($1,000/5).
- **Double (200%) Declining Balance (DDB) Method**. Determine the percentage of basis allowable under S/L. Double this percentage and multiply that rate each year by the adjusted basis.
  - *Example*. Facts same as above. The S/L percentage is 20% ($200/$1,000), so the DDB percentage is 40%. For the first year, the amount allowed is $400 (40% of $1,000). For the second year, it is $240 (40% of ($1,000 – $400).
- **Half-Year Convention**. Both examples above ignore the half-year convention. Under that convention, only half of the amount shown in each example ($100 or $200) is allowed.





Economic Depreciation

ALLOWS SMALL CAPITAL RECOVERY EARLY, LIKE MORTGAGE

- The depreciation methods allowed under the Code are all accelerated methods — Double declining balance is more accelerated than straight line.
- Under **economic depreciation**, the decline in value is reduced by the increase in the present value (PV) of the remaining income stream.
- *Example*.
  - Tp buys a machine for $300 which is expected to generate $200 per year of income for 3 years. Using a 5% discount rate (p. 674 of Casebook), the expected future income has a PV of $571 ($200 + $190 + $181).
  - After one year, the value of the machine has declined by $100 but the PV of $190 and $181 are now $200 and $190. Thus the depreciation deduction should be $81 ($100 – $19).

Summary of Depreciation

CHECK LIST

- Make sure the asset is depreciable — not land or inventory.
- Determine basis of depreciable asset — that is all you can depreciate.
- Determine recovery period from § 168 (e.g., 4 years)
- Forget about salvage value (see § 168(b)(4)).
- Pick depreciation method (Double declining balance is best, or straight line)
- Remember to use half-year convention — assets treated as put into serve at midpoint of first year.

Fribourg Navigation (1966)

DEPRECATION IN YEAR OF SALE

- **Facts**: Tp purchases Liberty ship for $469,000 and takes depreciation in 1955 and 1956. In 1957, it sells the ship for $1 million and also takes a depreciation deduction.
- **Issue**: Is depreciation deduction proper in year of sale?
- **Holding**: Yes. Dissent says (correctly IMHO) that depreciation in that case is "unreasonable" within meaning of IRC § 167.
- **Comment**: In 1957, prior to adoption of IRC § 1245, the deduction would reduce ordinary income, whereas the increased gain from adjustment in basis for depreciation would be a capital gain.

Harrah's Club (1981)

RESTORED ANTIQUE AUTOMOBILES

- **Facts**: Harrah's Club restores cars at great cost and displays them in its museum to get publicity for its gaming business. The restored cars have an indefinite life. Tp claims depreciation deduction for costs of restoration in excess of f.m.v. of cars.
- **Issue**: Can any depreciation be taken?
- **Holding**: No. Asset is appreciating and has no useful life.

Simon and Liddle

DEPRECIATION ON USE OF ANTIQUE VIOLIN BOWS

- **Facts**: Tp buys Tourte violin bows to use in his music business. Sound is better than with modern bow. Bow does wear out with use, but still the bow goes up in value because of its value as an antique.
- **Issue**: Can Tp take depreciation when salvage value exceeds basis?

- **Holding**: Yes.
- **Comment**: Think about depreciation on buildings when the property value is going up.

Code Section 197

Amortization of Goodwill, certain other Intangibles

- Section applies to "any amortizable section 197 intangible." § 197(a)
- Recovery period is 15 years from date acquired. § 197(a)
- Qualifying property is property "acquired" after section's adoption and held in connection with conduct of trade or business or other income-producing activity. § 197(c)
- Examples include goodwill, going concern value, patents, trademarks, business books, customer lists, covenant not to compete, etc. § 197(d)
- Generally excluded from qualifying property is property created by Tp, plus land, financial assets, etc. § 197(e)

Section 197 Intangible

IRC § 197(d)(1)

The term 'section 197 intangible' means —

(A) goodwill, (B) going concern value, (C) any of the following intangible items:

(i) work force in place . . .; (ii) business books and records . . . (including [customer] lists . . .; (iii) any patent, copyright, formula, . . .

(iv) any customer-based intangible; (v) any supplier-based intangible, and (vi) any other similar item;

(D) any license, permit,. . . granted by a governmental unit . . .

(E) any covenant not to compete . . .

(F) any franchise, trademark, or trade name.

Not § 197 Intangible

IRC § 197(e) (Exclusions)

(1) Interest in: (A) corporation, partnership, trust, or estate, or (B) under an existing futures contract . . . or similar financial contract.

(2) Land.

(3) Computer software: (i) [shrink-wrapped software] and (ii) other computer software [not part of acquisition of a trade or business]

(4) Certain interests acquired separately, including: (A) Any interest in a film . . . book, or similar property; (B) Any right to receive tangible property or services under a contract or granted by a governmental unit; (C) [Certain limited rights acquired] under a contract, etc.

(5) Interests under leases and debt instruments.

(6) Sports franchises.

(7) Mortgage fees for professional services on tax-free transactions.

Frontier Chevrolet (2003)

AMORTIZATION UNDER SECTION 197

- **Facts**: Frontier, a car dealership, redeemed 75% of its stock, causing its manager ("Menholt") to become a 100% owner. The redeemed stock had been held by an individual ("Stinton") and a company ("Roundtree") that were also in the auto business. They entered into a 5-year non-compete agreement for $22,000 per month.
- **Issue**: Should the cost of the non-compete agreement be amortized over 5 years or over 15 years (under § 197)?
- **Holding**: 15 years under § 197.

Code Section 72

ANNUITIES

IRC § 72(b). Gross income does not include that part of any amount received as an annuity … which bears the same ratio to such amount as the investment in the contract bears to the expected return under the contract.

Formula: A = amount received; I = investment; E = expected return. X = excluded amount. Then

$$X/A = I/E \text{ or } X = A \times I/E$$

Example: Tp bought an annuity for $600 that pays $100 a year for 10 years. In year 1, he receives $100. He can exclude: A($100) × I($600)/E($100 × 10) = $60

Note: Basis of $600 spread *pro rata* (S/L) over period.

Annuity Rules

A FORM OF STRAIGHT LINE CAPITAL RECOVERY

- **Annuity**. A payment that includes income (return on investment) and capital (recovery of basis). The income should be taxed, and the recovery of basis should not be taxed. Like the installment method.
- **Excluded Amount**. The Code excludes the amount of each payment that is considered a return of basis. The total amount excluded should equal basis in the contract.
- **Expected Return**. For the typical life annuity, the expected return is the annual payment multiplied by the holder's life expectancy (from IRS table).
- **Straight Line**. Annuity contracts can be a tax shelter because the S/L method is more generous than economic depreciation. That is, basis is recovered more quickly than the annuity contract declines in value.
- **Death Bonus and Penalties**. To prevent bonuses and penalties, no exclusion in excess of basis and a deduction for unused basis.

Annuity Problem

See problem on page 235 of Casebook

Facts. Tp, age 53, purchases an annuity for $90,000. It will pay $5,000 per year for the rest of Tp's life. According to Table V of Reg. § 1.72-9, Tp has a life expectancy of 30.4 years (rounded to 30 years for easy of computation).

Question. In year 1, Tp receives a payment from the annuity company for $5,000. How much is excluded, and how much is taxed?

Answer. The $90,000 of basis is spread equally over 30 years ($90,000/30 = $3,000). That $3,000 is the tax-free amount, and $2,000 ($5,000 – $3,000) is taxable.

Note 1. Tp is taxable on the full $5,000 for payments received after reaching age 83.

Note 2. If Tp dies at age 73, Tp gets a deduction for the unrecovered basis of $30,000 ($90,000 – ($3,000 × 20 years = $60,000)).

Inventory Methods

LIFO, FIFO and Average Cost

- **LIFO** (Last in, first out). On day 1, Tp buys 100 widgets for $3. On day 50, tp buys 100 widgets for $5. Tp sells 130 widgets for $10 for the year. Gross receipts = $1,300. Costs of goods sold = $5 × 100 + $3 × 30 = $590. Gross income = $1,300 – $590 = **<u>$710</u>**.
- **FIFO** (First in, first out). Same facts as above. Gross receipts = $1,300. Costs of goods sold = $3 × 100 + $5 × 30 = $450. Gross income = $1,300 – $450 = **<u>$850</u>**.
- **Average Cost**. Same facts as above. Gross receipts = $1,300. Average cost = ($5 × 100 + $3 × 100)/200 = $4. Costs of goods sold = $4 × 130= $520. Gross income = $1,300 – $520 = **<u>$780</u>**.

Thor Power (1979)

Deduction for Unrealized Loss on "Excess" Inventory

- **Facts**. Tp manufactures hand-held power tools, including replacement parts. Parts are cheap to produce initially but expensive later so Tp produces more than typically needed. As a result, it has some excess parts that it does not expect to sell but is not willing to destroy because they may be needed. But it continues to sell a few of the parts at a price well in excess of cost.
- **Issue**. Tp tries to write down (deduct) the difference between cost and estimated f.m.v. of the excess parts, contrary to Regs. Write-down is proper under GAAP (accounting rules).
- **Holding**. No deduction allowed. The loss is not realized, and tax and financial accounting are not the same.

Paccar (1988)

Tax Plan Responding to Thor Power

- **Facts**. Tp manufactures auto parts. Like Thor, it has some excess inventory of parts that it is only selling in small quantities at a price above cost. It sells the excess parts to Sajac (storage company) at salvage value, and Sajac agrees to hold the parts and sell them back to Paccar at cost plus small markup to reflect storage costs and profit. Tp takes a loss on the sale to Sajac (Sales price – basis).
- **Issue**. Is a deduction proper?
- **Holding**. Deduction disallowed because there was no *bona fide* sale, due to agreement not to sell to competitors and to resell at fixed price. In effect, Sajac was simply storing the parts for Paccar for a fee.

Sharkey v. Wernher

English Case #1

- Facts: Ran a Horse Farm with two purposes
  - Stud farm for money
  - Racing for Pleasure
  - Tp transfers colt from stud farm to racing stable. Basis in colt was $1,000 and value $5,000
- Issue: Is the transfer taxable and, if so, how much income is taxable
- Holding: Gain realized from "self-trading" and amount computed as if sold for f.m.v.

Mason v. Innes

English Case #2

- Facts: Tp wrote a novel, "The Doomed Oasis," and deducted related expenses. Then he gave copyright to his father as gift.
- Issue: Is the transfer to father taxable (f.m.v. of copyright minus adjusted basis).
- Holding: No, Rule of ***Wernher*** applies to traders but not to a "professional man."

End of Chapter 5

Next chapter is harder