In this month's column:

- The Third Circuit, reversing the Tax Court, allows banks to deduct the costs of making routine loans in *PNC Bancorp v. Commissioner*.
- The Sixth Circuit holds in *Thomas v. United States* that Ohio lottery winners did not realize an "economic benefit" before actually being paid.
- The IRS rules that paying a disputed liability to a trustee under the Section 461(f) regulations creates a complex trust.
- The IRS rules that utilities do not recognize income from "financing orders" under an electricity deregulation plan.

**DEDUCTIONS FOR LOAN ACQUISITION COSTS**

Last December, this column described the Tax Court decision in *PNC Bancorp, Inc. v. Commissioner*, which required a bank to capitalize wages and third-party outlays associated with making loans. The Third Circuit has now reversed the Tax Court, illustrating that there is still room for fairly basic conflicts about the reach of the Supreme Court's decision in *INDOPCO v. Commissioner*.

**Background**

Before 1988, banks generally reported income from loan origination fees and deducted the associated expenses at the inception of the loan. In that year, the financial accounting rules changed to require banks to amortize the fees into income over the lifetime of the loan. Direct costs of labor and third-party outlays relating to the loans (loan acquisition costs) were required to be amortized along with the related income.

For tax purposes, loan fees have to be reported immediately upon receipt under *Schlude v. Commissioner* and allied cases. The IRS, however, takes the position that the loan acquisition costs must be capitalized because they relate to "separate and distinct assets" under the Supreme Court's decisions in *Commissioner v. Lincoln Savings & Loan Association* and *INDOPCO*.

In *Lincoln Savings*, the Supreme Court required a bank to capitalize payments to a special deposit insurance reserve, noting that the payments created a "separate and distinct additional asset" for the benefit of the taxpayer. This language was sometimes read as implying that the presence of such an asset was necessary for capitalization. In *INDOPCO*, however, the Court held that capitalization could be required even in the absence of a separate and distinct asset. The key issue was whether the expenditure presented a more than "incidental" future benefit.

*INDOPCO* did not create a "talismanic" rule that all expenditures featuring any future benefit must be capitalized. Some expenditures that provide a benefit beyond the taxable year remain currently deductible, as the IRS itself has recognized in several published rulings. These rulings are based on the sensible notion that recurring expenditures should be currently deducted when the overall result will clearly reflect income.

**Attributing Costs to Assets**

The direct costs of acquiring a separate and distinct asset must be capitalized into the asset's basis. This rule applies to intangible assets as it does to any other kind of assets. Thus, in the companion cases of *Woodward v. Commissioner* and *United States v. Hilton Hotels Corp.*, the Supreme Court required capitalization of legal, accounting, and appraisal expenses incurred in buying out minority shareholders.

The problems arise when a taxpayer's routine operating costs are arguably attributable to an intangible asset. The issues are similar to those that have long faced taxpayers in connection with various kinds of

*James E. Salles is a member of Caplin & Drysdale in Washington, D.C.*
tangible property. A loan to a bank—like a widget to a manufacturer, or improvements on a lot to a real estate developer—is a routine product of day-to-day operations. A loan is also—like the widget and the lot—an asset, and clearly “capital” in the broad sense of something that belongs on a balance sheet. What expenditures should be included in the loan’s basis?

Long-standing regulations, and now the uniform capitalization (UNICAP) rules of Code Section 263A, require manufacturers and contractors to capitalize direct materials and labor and provide for allocation of overhead. The pre-UNICAP regulations did not apply to taxpayers constructing property for use in their own business, but the Supreme Court considered the issue in Commissioner v. Idaho Power Co.. Even absent regulations, the Court held that taxpayers had to capitalize not only direct costs but also overhead—specifically, equipment depreciation—into the cost of plant improvements.

Now, the spotlight has shifted to intangible assets. In Norwest Corporation v. Commissioner, discussed in the October 1999 issue of Corporate Business Taxation Monthly, the court capitalized part of corporate officers’ regular salaries into the cost of an acquisition. Wages are direct costs, but it is notable that the salaries were not attributable to the transaction on a “but for” basis, since the court found the same salaries would have been paid absent the deal. Then came PNC, and loan acquisition costs, as to which the Tax Court has come out one way, and the Third Circuit another.

The Real Issue

Both the Tax Court and the Third Circuit describe the critical issue in ways that are somewhat misleading on first glance. Both opinions discuss at some length a trilogy of pre-INDOPCO cases in which the Fourth, Eighth, and Tenth Circuits held a potpourri of expenditures associated with setting up credit card accounts to be currently deductible as ordinary expenses of carrying on the banking business. Although it did not hold these “credit card cases” vitiated by INDOPCO, the Tax Court held them inapplicable on the grounds that those courts had found no separate and distinct asset, whereas in PNC there were such assets—the loans. This analysis holds water only on the basis of a fairly technical distinction between the credit card accounts and the revolving loans that take place under their terms.

On the other hand, the Third Circuit cited the “credit card cases” as suggesting that there was no separate and distinct asset in PNC either. The courts in those cases did note, with varying emphasis, the absence of an asset, but mainly in response to the argument that the expenditures were capital because they fitted the banks to enter a “new” business. A bank loan is clearly an asset, as “separate and distinct” as any other. No one suggests a bank should deduct money it loans out. The real issue being fought over is whether, and to what extent, recurring costs should be attributed to intangible assets. There may also be a secondary question about whether different rules should apply to “one of a kind” assets like the acquired bank’s stock in Norwest than to routine assets like the bank loans in PNC.

The Third Circuit was right in suggesting the credit card cases support its broader conclusion that recurring business expenses ought to remain deductible except when directly associated with a specific intangible asset. It might have added mention of the Ninth Circuit’s decision in Moss v. Commissioner, permitting a hotel to deduct expenses relating to its program of refurbishing rooms on a rotating three- to five-year cycle. Hotel rooms are certainly assets, or parts of assets, and a three- to five-year overhaul might reasonably be argued to be capital. The court, however, held that because the expenses were routine and regularly incurred, the overall accounting clearly reflected income.

A Clouded Crystal Ball

With the Third Circuit’s decision in PNC, the IRS faces potentially hostile judicial precedent in five circuits. It is hard to predict, however, how likely the Supreme Court is to take the case, and how the case might come out if it did. Four of the five circuit opinions at issue antedate INDOPCO. The Supreme Court case most closely on point, Idaho Power, came out in favor of capitalization not merely of direct costs, but also of overhead.

On the other hand, Idaho Power itself justified capitalization in terms of the goal of matching expenses against income. In PNC, because the loan fees have to be reported at the inception of the loan under Schlude, the matching principle militates in favor of an immediate deduction. A lurking wild card in this regard is the Eighth Circuit’s holding in Johnson v. Commissioner that otherwise capitalizable expenses might be currently deductible if directly associated with
income required to be reported “prematurely” under Schlude. The Third Circuit did not discuss Johnson, probably because PNC was largely briefed before the appellate decision in Johnson was handed down. \(^28\) So far the case has attracted little attention, aside from a bit of casual vituperation in a recent field service advice. \(^29\) Courts might find its reasoning persuasive, however, on the matching question.

The IRS began asserting its position on loan acquisition costs on audit in the early 1990s, as banks’ post-1987 years came under audit, its efforts doubtless receiving a boost from the then-recent decision in INDOPCO. By April 1993, the IRS announced a moratorium on accounting method changes involving this issue. \(^30\) But PNC seems to have represented the IRS’s first opportunity to test its position in court.

PNC is thus clearly a high-profile case to the IRS, which has not been shy about citing its Tax Court victory in other contexts. \(^31\) The government may well seek certiorari, although the Supreme Court does not usually take a tax case absent a conflict among the circuits, and it is hard to identify a clear conflict here. In any event, the IRS can be expected to keep up the pressure administratively. The IRS’s 2000 business plan promises further guidance—most likely a revenue ruling—specifically on loan acquisition costs. \(^32\) Clearly the last chapter of this saga has yet to be written.

**LOTTERY WINNER DID NOT HAVE “ECONOMIC BENEFIT”**

In Thomas v. United States, \(^33\) the Sixth Circuit held that Ohio lottery winners did not realize an economic benefit from their rights before the prize was actually paid. The taxpayers in Thomas won the Ohio Super Lotto drawing on December 12, 1992. The state lottery commission verified the winning tickets twice, once when the taxpayers filed a claim in mid-December, and again on January 4, 1993, and the actual payment was made in late January.

**The “Economic Benefit” Doctrine**

A cash-basis taxpayer is taxed on receipt of an economic benefit if:

1. There is a transfer of money or property to a separate fund segregated from the transferor’s creditors; and

2. The taxpayer possesses vested rights to, or secured by, the fund.

This “economic benefit” doctrine is distinct from the doctrine of “cash equivalence,” although both are exceptions to the general rule that a cash-basis taxpayer is not taxed on the receipt of a mere promise to pay. The taxpayer’s rights need not be transferable for value for there to be an economic benefit. Indeed, they may be expressly nonassignable. \(^34\)

The economic benefit doctrine dates from Sproull v. Commissioner. \(^35\) Sproull involved a deferred compensation trust, although other cases taxed somewhat similar arrangements in connection with noninstallment sales of property. \(^36\) As far as compensation is concerned, the common-law economic benefit doctrine has been displaced by Code Section 83, although the analysis, valuation quirks aside, is largely similar. \(^37\)

One area in which the common-law rules remain potentially applicable is deferred payouts of lottery or sweepstakes winnings. \(^38\) Domestic lotteries and sweepstakes generally avoid creating an economic benefit by not setting aside funds for the benefit of a particular lottery winner. \(^39\) When the Irish Sweepstakes, less accommodating to the quirks of U.S. tax law, deposited a minor’s winnings in a court-administered fund, the IRS ruled that the minor was immediately taxable, \(^40\) and the Tax Court agreed. \(^41\)

**The Thomas Holding**

In Thomas the parties’ positions were the reverse of the usual. The taxpayers won the lottery in 1992, and were paid in 1993. In the meantime, the Omnibus Budget Reconciliation Act of 1993 took effect, and the nominal tax rate applicable to top earners rose from 31 percent to 39.6 percent. The taxpayers initially reported the lottery prize as income in 1993, but then filed a refund claim for that year on the grounds that it was properly taxed in 1992.

The taxpayers had initially argued that their economic benefit consisted of a claim against the state lottery fund, a segregated custodial account. It turned out that their award was so large that it had been paid from the state’s general revenue account. The circuit court noted, however, that even the state lottery fund would have failed to meet the requirement for a segregation of assets because it would have remained subject to other
lottery-related claims. As it was, the court had no problem brushing aside the taxpayers’ fallback argument that state law created a “constructive trust,” and finding that there had been no segregation from the state’s creditors. The court also confirmed the district court’s holding that the taxpayers’ rights remained contingent at year-end because the verification process ran over into 1993. Thus, the taxpayers met neither requirement for an economic benefit in 1992, and were taxable only when they were paid in 1993.

PAYMENT OF DISPUTED LIABILITY CREATES COMPLEX TRUST

In Private Letter Ruling 200019006, the National Office concluded that a cash-basis partnership’s payment of a disputed liability into a trust to obtain a deduction under Code Section 461(f) created a separately taxable trust under Subchapter J of the Code. The ruling’s brevity disguises its importance in the context of the complex and somewhat uncertain law that determines what tax regime applies to a settlement fund.

Code Section 461(f)

In United States v. Consolidated Edison Co. of New York, the Supreme Court essentially held that a liability could not be “paid” while its existence was disputed. The Court’s reasoning was that the taxpayer’s remittance could not qualify as an “unconditional payment” if it was uncertain whether there was any liability to pay.

Congress responded by enacting Code Section 461(f), providing that if payment is made “to provide for the satisfaction of” a contested liability that, but for the contest, would qualify for a deduction, then the deduction will be allowed on payment. Either cash- or accrual-basis taxpayers can obtain a deduction under this rule. The regulations provide that taxpayers can make payment “to provide for satisfaction of” a liability to the person asserting the liability, to an escrowee or trustee, or to a court with jurisdiction. If the taxpayer chooses to make payment to an escrowee or trustee, there must be either an agreement with the claimant or an order of a court or other government agency.

Qualified Settlement Funds

The regulations under Code Section 461(f) specifically reserve on the “[t]reatment of money or property transferred to an escrowee, trustee, or court” under that provision and the “treatment of any income attributable thereto.” Ordinarily, the absence of specific regulations under Code Section 461(f) does not matter. An accrual basis taxpayer that wants to deduct a payment against a disputed liability must satisfy the economic performance requirement as well as Code Section 461(f). For many types of disputed liabilities, economic performance occurs only on payment. Ordinarily, if payment is not made to the party asserting the liability, it will only qualify as economic performance if it is made to a qualified settlement fund.

A “qualified settlement fund” (QSF) is a creature of the regulations under Code Section 468B(g) (see below) and subject to its own specialized tax regime. Put simply, a QSF does not report contributions as income, nor deduct distributions. It does pay tax (at the maximum individual rate) on the income it earns, minus administrative expenses. Thus, QSFs are like C corporations in that income is taxed twice: once to the QSF, and again (potentially) to the recipient when it is distributed.

Because of the economic performance requirement, a QSF is frequently the only way to go for an accrual-basis taxpayer that wants an immediate deduction. There is also some advantage to the certainty provided by the QSF taxation regime. As explained above, however, there is a price, in the form of the double taxation of income. Moreover, the QSF rules do not cover every type of settlement fund. Funds to provide for the payment of certain types of liabilities are ineligible. A QSF must also be approved by, and subject to the continuing jurisdiction of, a court or other governmental authority. A QSF cannot be used in an entirely private settlement.

Non-QSF Funds

If a fund is not a QSF, then the “traditional,” pre-QSF, rules apply. A threshold question is whether the arrangement creates a trust. This basically turns on whether the escrow agent or other fund manager has sufficient investment and administrative autonomy to be considered a trustee. For example, a court, or a bank that is merely a passive stakeholder, will not be a trustee.

If the arrangement is a trust, the next issue is usually whether the trust is subject to the Code’s grantor trust rules—which tax a trust’s grantor as the owner of trust property—and if so, who, transferor or transferee(s), is to be treated as the grantor. Under sections 673 and 677 of the Code, the grantor trust rules apply to the
extent the grantor retains a 5 percent reversionary interest in trust property, or the property is “held or accumulated for future distribution” to the grantor, including being used to pay the grantor’s liabilities.54

Two old Supreme Court cases set the parameters for determining when trust property is being used to pay the transferor’s liabilities. In Douglas v. Willcuts,55 the settlor-husband of an alimony trust was taxed on the trust’s income because the Court held he remained subject to a continuing liability for which the trust only served as security. By contrast, Helvering v. Fuller56 taxed income from another alimony trust to the transferee wife when the divorce decree left the husband “no continuing obligation, contingent or otherwise,”57 and he did not have a reversion, either. On those facts, the trust property had already been applied to satisfy the husband’s obligation and now belonged to the wife.58

Code Section 682 now prescribes special rules for alimony trusts, but the principles of Douglas and Fuller continue to apply to other types of settlement trusts that remain subject to Code Section 677. The same basic principles, although not the same Code sections, apply if the arrangement does not constitute a trust. The fund usually winds up being treated as a sinking fund,59 or else the stakeholder reports as some kind of nominee or agent either for the transferor(s) or the transferee(s). The rules applicable to the two basic models—ownership by the transferor(s), and ownership by the transferee(s)—are thus fairly clear, although it is at times difficult to classify a particular arrangement as falling on one side of the line or the other.

The “Homeless Fund” Problem

The real problem arises when there is a “payment” that satisfies the transferor’s obligation but there is no transferee or group of transferees with a vested right to the property. If the arrangement does not even create a trust, there is no one to tax. In the “olden days,” courts and the IRS glumly settled on taxing the transferees of these so-called homeless funds on the accumulated income when ownership was determined.60 In 1986, Congress responded by enacting what later became Code Section 468B(g), which provided as follows:

Nothing in any provision of law shall be construed as providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

The regulations concerning QSFs were issued under authority of the last sentence quoted above. Although these rules reach much more broadly than the homeless-fund problem, they do not cover all homeless funds. If a homeless fund does not qualify as a QSF, Code Section 468B(g) makes it clear that deferring taxation is no longer acceptable, but does not say what is acceptable. The IRS has attempted to plug the gap by extending the QSF regime to an even broader category of “disputed settlement funds,”61 but these regulations remain in proposed form. Consequently, uncertainty persists.

Significance of the Ruling

Private Letter Ruling 200019006 provides much needed guidance on the taxation of non-QSF settlement funds, at least those that constitute trusts. The ruling makes explicit that a Section 461(f) “payment” is inconsistent with continuing to treat the amount paid as the property of the transferor under Code Section 677. The money or other property will be treated as already having been applied to the transferor’s liability, not as being “held or accumulated” for future application. Significantly, the ruling did not suggest that the transferor partnership might be treated as the grantor under Code Section 673, despite its presumably having a contingent right to get its money back if the appeal was resolved in its favor.

The transferor thus successfully shifted the tax burden off its back by making the “payment.” The claimant did not receive anything, and had no vested right to receive anything, and so could not be taxed. Therefore, the trust was a separately taxable trust under Subchapter J of the Code, and because current distribution of income was not required, it was a “complex trust” taxable under Code Section 661 et seq. Trusts, like QSFs, are taxable at the maximum individual rate, beyond some very compressed lower brackets.62 Trusts generally do not pose a double taxation issue, however, because they are entitled to deduct distributions.63 A complex trust may prove a workable model for taxation of a fund holding disputed property if a QSF is not needed for other reasons, such as to secure an accrual-basis transferor a deduction.
NO GROSS INCOME FROM UTILITY “FINANCING ORDERS”

In three similar letter rulings, the National Office concluded that utilities did not recognize income from “financing orders” under a state plan to deregulate the electricity market.

The relevant state deregulation statute permits regulators to issue financing orders imposing “transition charges” on area consumers. Utilities can collect these charges from all electricity consumers—regardless of their electricity supplier—to recover approved costs incurred under the regulatory regime. Each ruling involved a utility that securitized its rights under financing orders by contributing them to a tax-transparent special purpose entity (SPE) that issued debt.

The National Office’s conclusion that the utilities did not recognize income from receipt of the financing orders is natural if a financing order is to be treated as an ordinary rate order, which merely represents the regulators’ permission to charge customers money in the future. Even accrual-basis taxpayers do not recognize income from merely entering into an executory contract, however advantageous, because the projected profits are not yet paid, due, or earned.

Likewise, when a utility’s rates are reduced to “make up for” a prior windfall in a prior period—without an obligation to repay a fixed amount—the utility does not accrue a liability but simply recognizes less gross income during the period while the lower rate is in effect.

Two wrinkles in this case probably accounted for the taxpayers’ decisions to seek rulings. First, the transition charges were not confined to the utility’s customers. Although a customer’s liability might depend on buying electricity, the utility’s entitlement would not depend on selling it. Arguably, therefore, there was more involved than a simple executory contract for sale of electricity. Moreover, the utilities’ rights were transferable, at least to a limited degree, so that they might be argued to be taxable as having received a cash equivalent or some other form of property with “ascertainable market value.”

The IRS has also relied on the executory contract principle to allow taxpayers to exclude any windfall from the initial award of government licenses and privileges, such as liquor licenses, even if they can be transferred for value. The IRS has ruled on this basis that the initial issuance of emission rights, natural resource leases, airport landing slots, gasoline rationing coupons, and milk quotas is nontaxable. The National Office concluded in these letter rulings that the financing orders should not give rise to taxable income under the same principle. The utilities also did not recognize taxable income from transferring their rights to the SPEs—whose separate existence was not recognized for tax purposes—or from the SPEs’ issuance of debt.
2. 213 F.3d 927 (6th Cir. 2000).
5. 110 T.C. 349 (1999), rev’d, 212 F.3d 822 (3d Cir. 2000).
6. 212 F.3d 822 (3d Cir. 2000).
11. IRS Audit Technique Guide for Commercial Banking ch. 9 (July 1997), IRS Pos. ¶ 203,101, at 102,657-63.
12. INDOPOCO, 503 U.S. at 86-88.
22. 110 T.C. at 365.
24. 831 F.2d 833 (8th Cir. 1987).
25. See also Helvering v. Wm. H. Wm. H. McMillin, 305 U.S. 79 (1938) (refusing to permit expenses of purchasing securities purchase commissions solely on grounds of high volume, even if the taxpayer were a dealer).
26. 408 U.S. at 16.
27. 184 F.3d 786 (8th Cir. 1999).
28. Johnson was decided after both parties had filed their opening briefs. Appellant’s reply brief was filed August 5 but did not mention the case.
29. F.S.A. 200016002 (Jan. 13, 2000), discussed in last month’s column. Johnson himself was the subject of this column in the November 1999 issue.
31. E.g., T.A.M. 199952069 (Sept. 20, 1999) (capitalizing the costs of securing long-term service contracts).
35. 16 T.C. 244 (1951), aff’d per curiam, 194 F.2d 541 (6th Cir. 1952).
36. E.g., Kuehner v. Commissioner, 20 T.C. 875 (1953), aff’d, 214 F.2d 437 (1st Cir. 1954).
37. See, e.g., Minor v. United States, 772 F.2d 1472 (9th Cir. 1985).
39. E.g., Ltr. Rul. 9639016 (June 17, 1996); Ltr. Rul. 9624009 (Mar. 12, 1996); Ltr. Rul. 9315008 (Jan. 13, 1993); see also, e.g., T.A.M. 9808002 (Oct. 24, 1997).
42. 213 F.3d at __ n.5.
43. (Feb. 3, 2000).
45. 366 U.S. at 391-92.
46. Treas. Reg. § 1.461-2(c).
47. Treas. Reg. § 1.461-2(f).
48. Treas. Reg. § 1.461-4(g).
50. Treas. Reg. § 1.4608-1(g).
51. Treas. Reg. § 1.4608-1(c)(1).
54. I.R.C. §§ 673, 677; Treas. Reg. § 1.677(a)-1(d).
55. 296 U.S. 59 (1935).
56. 310 U.S. 84 (1940).
57. Id. at 75.
58. See also Rev. Rul. 63-228, 1963-2 C.B. 229 (where the trustee for a bankrupt partnership distributed property in kind to a trust for the benefit of creditors, which was thereafter treated as a grantor trust with respect to them).
62. I.R.C. § 1(e).
63. I.R.C. §§ 651, 661.
64. Ltr. Ruls. 200020043, 20020045, and 20020046 (Feb. 18, 2000).
65. See G. C. M. 37971 (June 1, 1979) and authorities cited; cf., e.g., Ewing Thomas Converting Co. v. McLaughlin, 43 F.2d 303 (3d Cir. 1930), cert. denied, 282 U.S. 897 (1931); Rockwell Int’l Corp. v. Commissioner, 77 T.C. 780, 835-36 (1981) (alternative holding), aff’d per curiam on other grounds, 694 F.2d 60 (3d Cir. 1982) (both denying taxpayers deductions for projected losses).
68. See, e.g., Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975).
72. G.C.M. 39606 (Feb. 8, 1987).
73. G.C.M. 38237 (Feb. 15, 1980).
74. G.C.M. 37971 (June 1, 1979).