TAX ACCOUNTING

BY JAMES E. SALLES

TAX COURT HOLDS FDIC FEES DEDUCTIBLE

This month's column addresses the recent decision in *Metrocorp, Inc. v. Commissioner*,[1] in which a majority of the full Tax Court held that "exit" and "entrance" fees that a bank paid to federal deposit insurance funds did not have to be capitalized. The IRS had reached the opposite result in a recent field service advice that probably involved the same case.[2]

Facts

The controversy concerned fees incurred by one of the taxpayer's subsidiaries, Metrobank, in connection with its 1990 acquisition of the assets of a failing S&L. The then-recently passed Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) left two funds providing federal deposit insurance. One was the Banking Insurance Fund (BIF), administered by the Federal Deposit Insurance Corporation (FDIC). The other was the Savings Association Insurance Fund (SAIF). The SAIF originally had been administered by the Federal Savings & Loan Insurance Corporation (FSLIC), but FIRREA brought it under the auspices of the FDIC. Insurance rates under the SAIF were more than twice as high as under the BIF, and were statutorily guaranteed to exceed the BIF rates for several more years. To preserve the integrity of the funds, FIRREA provided that when deposits ceased to be insured by the SAIF and began to be insured by the BIF, the financial institution would have to pay an "exit fee" to the SAIF and an "entrance fee" to the BIF.

Metrobank was a commercial bank insured through the BIF, while the target was insured through the SAIF. The law allowed it to choose between transferring the target's deposits from the SAIF to the BIF, paying the necessary fees, or continuing to insure those deposits through the SAIF and pay the higher premiums. Metrobank chose to transfer the deposits and pay the fees.

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Background: *Darlington-Hartsville* and *Rodeway Inns*

If a contract represents a "separate and distinct asset," then the taxpayer must capitalize all associated expenditures,[3] including the cost of terminating an earlier contract to enter into the new one.[4] A contract right to gross income is a "separate and distinct asset" to the payee. On the other side of the deal, the obligation to make a payment is not an asset, still less a "separate and distinct" one. However, the payer may still have some other property right, such as a leasehold interest in property or an option.

Whether there is a "separate or distinct asset" is usually fairly obvious. As with everything else, however, there are borderline situations, as exemplified by two controversial cases, *Darlington-Hartsville Coca Cola Bottling Co. v. United States*[5] and *Rodeway Inns of America v. Commissioner*.[6] In *Darlington*, two bottlers paid Coca-Cola to buy out an unrelated corporation that owned the exclusive bottling rights to their territory and liquidate it. The bottlers, which had previously bought syrup through this "middleman," could now buy directly from Coca-Cola at the same price. The district court and the Fourth Circuit held the bottlers' payments capital. In *Rodeway Inns*, Rodeway paid another party to surrender its rights under a previous noncancellable "territorial agreement" with Rodeway itself. The Tax Court held that the payment was an amortizable capital expenditure.

A reasonable reading of *Darlington-Hartsville* and *Rodeway Inns* is that they illustrate the rule that an otherwise deductible outlay — including a contract termination payment — will be capital if it is incurred as part of the process of acquiring a "separate and distinct asset." A contract that produces gross income, such as rents or royalties, is unquestionably a separate and distinct asset. A franchise or similar agreement logically falls into the same category, and in both *Darlington-*

Hartsville and *Rodeway Inns* the taxpayer was acquiring rights of this type.

In *Rodeway Inns* the taxpayer paid to buy out the other party's rights under the "territorial agreement," which was essentially a master franchise agreement. That Rodeway was resuming (and thus extinguishing) rights that it had itself previously granted was irrelevant. A lessor's payments to buy out a tenant are generally amortizable over the term of the former lease.[7] That the lease no longer exists as such does not change the fact that the amount was paid to acquire the lessee's rights over the property for that period, an amortizable asset. Under similar reasoning, the Tax Court determined that Rodeway had bought the other party's territorial rights — even though these had been granted by itself — and had to amortize the acquired rights over their useful life.

In *Darlington-Hartsville*, likewise, the bottlers were not obligated to buy syrup from the corporate "middleman," and did not pay to stop doing so. They paid for the prospect of future profits from buying syrup directly from Coca-Cola, which they had previously not been able to do. If the supply contract was not technically a franchise, it was something closely akin to one, and granted the taxpayers bottling rights in a territory that had previously been foreclosed. Their payments equally would have been capital had they never bought syrup from the middleman at all.[8]

The IRS Position

Numerous authorities hold that merely reducing future expenses is not the kind of future "benefit" that makes expenditures capital,[9] and that payments to get out of disadvantageous contracts may be currently deducted.[10] The court of appeals in *Darlington-Hartsville* specifically disclaimed any intent to disturb this settled law. The Tax Court in *Rodeway Inns* also distinguished these "onerous contract" cases, and specifically found that Rodeway's purpose was to "augment its income" by undertaking income-producing activities that the "territorial agreement" had reserved to the other party, not to reduce its expenses. *Darlington-Hartsville* and *Rodeway Inns* have nonetheless spawned some confusion on this score because, while the taxpayers acquired something akin to a franchise, in each case the immediate purpose of the payment was to get rid of an inconvenient middleman with a contract.

The IRS has from time to time tried to cite *Darlington-Hartsville* and *Rodeway Inns* in support of extending capital status to various supplier contracts that it can argue helped the taxpayer produce future income. The IRS is generally willing to allow a current deduction if a payment terminates the supplier relationship. If the contract is being renegotiated, however, the IRS is likely to argue that any payment is capital because it is made to obtain the new and presumably more advantageous contract. The assumption appears to be that the new contract, whether or not technically a "separate and distinct asset," provides a sufficient "future benefit" that the associated costs have to be capitalized under *INDOPCO, Inc. v. Commissioner*.[11]

This apparent IRS position fuzzes the distinction, implicit in much of the case law and explicit in some of it, between an *income-producing* contract and a contract for business inputs. Moreover its outer boundaries are uncertain. Would the IRS give capital status to any long-term contract for a business input? Would the contract have to be at a bargain price? Would it have to be for inventory (so that a lower contract price would technically produce more gross income)?

The answers to these questions remain somewhat murky. For example, in PLR 9334005,[12] a utility entered into a contract to purchase coal with a term of nearly 25 years. The contract proved disadvantageous and, as contemplated by the contract, the taxpayer sought to have the terms rewritten in an arbitration proceeding on grounds of "economic hardship." In a negotiated settlement, the taxpayer paid the supplier to terminate the original contract and the parties negotiated a new supply contract at which the taxpayer could, but did not have to, buy coal at a price based upon the spot market price at the time of negotiation, plus an inflation factor. The IRS required the payment to be capitalized as part of the cost of the new contract, citing executives' representations to state regulators that the contract price was "attractive" and furnished a desirable opportunity to hedge against possible rising prices. If the agreement is considered as a supplier contract, the IRS position looks very aggressive. Coal is not inventory to a utility[13] and the contract was not at a below-market price. On the other hand, because the utility was entitled, but not obligated, to buy at the contract price, the whole arrangement somewhat resem-

bled an option, a classic "separate and distinct asset." The IRS did not specify what factors were critical to its determination.

Tax Court: Insurance Contract Not Capital

The court did not discuss these issues expressly in *Metrocorp*. Clearly, however, the *Metrocorp* majority did not regard the right to obtain insurance from the FDIC under the same terms as everybody else as any form of "asset." The IRS argued that the taxpayer's ability to get insurance from a more stable fund at a cheaper cost and its compliance savings from only having to deal with one insurance fund and regulatory regime rather than two represented sufficient "future benefit" to require capitalization under *INDOPCO*. However, the Tax Court held that a taxpayer's "exercise of such a sound and reasonable business practice . . . to minimize its operating costs is not a significant future benefit that requires capitalization of the related nonasset-producing expenditures."

And No Prepayment

Even if the insurance contract itself is not an asset, and does not provide an *INDOPCO*-style future benefit, a payment under the contract could be capital if it constituted a prepayment for insurance. Apart from a "one-year rule" of convenience that is probably confined to cash basis taxpayers,[14] a prepayment is capitalizable in its own right because, under general matching principles, it represents an outlay allocable to future income.

The majority addressed the SAIF "exit fee" and the BIF "entrance fee" separately because it found them "diametrically different" in "use and purpose," but concluded that neither one was a prepayment. Analyzed separately, the "exit fee" could not be a prepayment because the taxpayer did not have any continuing relationship with the SAIF, so the payment could only relate to past income.[15] The "entrance fee" did not entitle the taxpayer to any insurance coverage over and beyond that which a new commercial bank could have obtained for the normal premium, nor would any part of it have been refunded had the taxpayer later ceased operations or withdrawn. Once paid, it was irretrievably gone and provided no future benefit. These factors strongly militated against the fee's being a prepayment. The court found that it was in fact simply a higher rate that Metrobank had to pay for the current year's coverage due to historical factors.

An Issue Not Considered

For procedural reasons, the Tax Court majority did not address what may have been the IRS's strongest argument in favor of capitalization, which was that the fees should have been considered part of the cost of the acquired assets. The taxpayer did not have to change insurance funds so, strictly speaking, the fees were not necessary to the transaction, but they were intimately enough connected with it that they might well have qualified for capitalization as an "ancillary expense"[16] of acquisition. (All six dissenters grounded their opinions at least in part on their view that the fees should have been capitalized as incident to the acquisition, although at least four disagreed with aspects of the majority holding.) That this issue was left for another day, however, does not detract from *Metrocorp*'s significance as an interpretation of *INDOPCO*'s "future benefit" standard.

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1. 116 T.C. No. 18 (Apr. 13, 2001).
2. FSA 200008005 (10/12/99); *see also* PLR 9348003 (Aug. 30, 1993).
3. *See* Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).
4. *See, e.g.,* U.S. Bancorp. v. Commissioner, 111 T.C. 231 (1998) ("rollover payment" under computer lease).
5. 273 F. Supp. 229 (D. S.C. 1967), *aff'd*, 393 F.2d 494, 496 (4th Cir.), *cert. denied*, 393 U.S. 962 (1968).
6. 63 T.C. 414 (1974), *acq. on another issue*, 1975-1 C.B. 3.
7. *E.g.*, Peerless Weighing & Vending Machine Corp. v. Commissioner, 52 T.C. 850 (1969).
8. *Accord, e.g.,* unnumbered field service advice (May 8, 1992), *reprinted at* 1992 WL 1354730 (newspaper's buyout of its independent carriers "effectively permitted [it] to become the sole distributor").
9. *E.g.,* T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993).
10. *E.g.,* Stuart Co. v. Commissioner, 195 F.2d 176 (9th Cir. 1952), *aff'g per curiam* 9 T.C.M. (CCH) 585 (1950).
11. 503 U.S. 79 (1992).
12. May 14, 1993.
13. Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, 551-52 (1979), *aff'd on another issue*, 633 F.2d 512 (7th Cir. 1980).
14. *See*, USFreightways Co. v. Commissioner 113 T.C. 329 (1999), *appeal docketed*, No. 00-2668 (7th Cir. 2000), previously discussed in J. Salles, "Tax Accounting," 1(7) *Corp. Bus. Tax'n Monthly* 33, 35 (April, 2000).
15. *Cf.* Steger v. Commissioner, 113 T.C. 227 (1999) (retiring lawyer's lump sum payment for malpractice insurance).
16. *Cf.* Woodward v. Commissioner, 397 U.S. 572, 576 (1970).