Tax Reduction Letter

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Technical Advice Memorandum 9645002

Code Sections 162 and 263

ISSUE

Are "Pre-opening Costs," as defined below, associated with opening new stores required to be capitalized under *§263 of the Internal Revenue Code*?

FACTS

Taxpayer is engaged in the trade or business of owning and operating retail stores. Taxpayer owned and operated x stores prior to the years at issue. These stores were located in the States.

Taxpayer ***** in Year 1. ***** owned and operated y stores in the States at the time Taxpayer *****. During the years at issue, Subsidiary opened an additional z stores in the States. The opening of the new stores was part of a long-term expansion program *****.

The stores opened during the years in issue are operationally indistinguishable from one another and from Taxpayer's other established stores. The stores sell and provide the same kinds of products and services, and the interior design of each store follows a standard theme. In addition, the stores receive various operating services from headquarters, including management information systems, accounting, financing, personnel, purchasing, inventory, management, advertising, payroll, and training services.

When a new store is completed and ready to be stocked with inventory, Taxpayer prepares the store for opening. As part of its normal business operations, Taxpayer transfers several experienced managers from its established stores to the new store to prepare and operate it. These employees normally remain at the new store after it is opened.

Opening a new store takes a very brief period of time--approximately ***** weeks. The expenses incurred during this period are similar to expenses incurred in operating established stores. These "Pre-opening" expenses incurred include (i) payroll and related costs for hiring and training new employees and managers to operate the store and service its customers, (ii) payroll and related costs for receiving, preparing, and stocking inventory for retail sale (these activities are collectively referred to as "stocking inventory" activities), and (iii) other normal and recurring store operating costs, including expenses for freight and postage, communications, incidental maintenance and repairs, utilities, incidental materials and supplies, and security.n1 These pre-opening costs are described in greater detail below.

PRE-OPENING COSTS

In this case, the following types of pre-opening costs are incurred by Taxpayer:

A. Payroll: Payroll is the most significant cost item, and represents the salaries, wages, and bonuses paid to employees for the time they perform the following activities: (a) interviewing and hiring new employees, (b) attending or providing store training, and (c) stocking inventory at

the stores. Of these activities, approximately ***** percent of payroll costs relate to stocking inventory at the stores, and the remaining ***** percent relates to hiring and training employees.

Stocking inventory is a constant and ongoing activity undertaken at all of Taxpayer's stores. Typically, inventory turns ***** times a year in Taxpayer's stores.

Payroll costs for employees to attend training are normal and recurring expenses incurred in carrying on Taxpayer's business and operating the stores. Taxpayer experiences a constant and high rate of employee turnover at all of its stores, which is characteristic of retail operations, because of resignations, terminations, promotions, and transfers. Experience indicates that employee turnover often exceeds 60 percent per year at many of Taxpayer's stores. Thus, the stores must continually hire and train new employees to replace those that have resigned or have been terminated or promoted, and train the employees that have been promoted or transferred for their new positions. In addition, Taxpayer must periodically retrain its existing employees for new store operating policies and procedures and new products sold in the stores.

B. Maintenance, Service, & Supplies: This category of pre-opening costs includes amounts incurred for incidental repairs as well as office, janitorial, selling and nonselling supplies which are normally consumed within the pre-opening phase and first few months of store operations. Maintenance and repair costs represent incidental costs incurred to maintain and make minor repairs to the store buildings and fixtures, such as cleaning the stores, maintaining the store grounds, and making minor repairs to fix damaged doors and shelves. These costs neither materially increase the value nor appreciably prolong the useful life of the property, but keep it in an ordinarily efficient operating condition.

C. Utilities & Occupancy: These pre-opening costs include amounts incurred for electricity, gas, and waste removal during the six to eight week period preceding the opening of a store. In addition this category of cost includes charges for fire & peril insurance.

D. Communication: These amounts include costs incurred for local and long distance telephone and fax services during the pre-opening period.

E. Office, Non-Selling, and Janitorial Supplies. Office supplies include store forms and paper supplies, cash register tape, and other general office supplies. Non-selling include name tags, shelf labels, and display pamphlets. Janitorial supplies include paper products, brooms, mops, towels, and cleaning supplies. Office, non-selling, and janitorial supplies are incidental supplies for which no records of consumption are kept or of which physical inventories at the beginning and end of the year are not taken by the stores. These supplies are normally consumed within a few months and must constantly be replaced.

F. Selling Supplies. Selling supplies include expenses for supplies such as paper and plastic bags, twine for packaging, forms, and other supplies used in connection with selling merchandise. These are incidental supplies for which no records of consumption are kept or of which physical inventories at the beginning and end of the year are not taken by the stores. These supplies are normally consumed within a few months and must constantly be replaced.

G. *****. Pre-opening costs also include amounts incurred for renting *****. The ***** are used to load and unload inventory and move it within the store. Taxpayer normally rents *****, in addition to the ones it owns, during the period stores are being opened, during the months immediately after the stores are opened, and during peak seasonal demand periods throughout the year. ***** rental costs are normal and recurring expenses incurred in carrying on Taxpayer's business and operating the stores.

H. Relocation. Relocation includes expenses incurred to move employees that are transferred to new store locations. Relocation costs not only are incurred when new stores are opened, but also are incurred when (i) employees are hired from distant locations to work in established stores, (ii) employees are transferred between established stores, and (iii) employees are transferred from an established store to headquarters and vice versa.

I. Recruiting. Recruiting includes costs to advertise in local newspapers and on local radio stations for employees to work in the new stores. Recruiting also includes costs paid to employment services to find qualified employees. As noted above, Taxpayer experiences a constant and high rate of employee turnover at all of its stores, which is characteristic of retail operations. Because of the constant turnover of employees, Taxpayer regularly incurs recruiting expenses to hire qualified employees. Recruiting costs are normal and recurring expenses incurred in carrying on Taxpayer's business.

J. Travel. Pre-opening costs also include amounts incurred for transportation (e.g., airline, car rental, etc.) and hotel expense incurred by employees to travel to new store locations to which they are assigned or transferred.

K. Security. Security costs during pre-opening periods include expenses for security guards to guard the stores and the inventory contained therein. Guards are required every day.

L. Freight and Postage. Freight and postage includes expenses for freight and postage services. These costs are normal and recurring expenses incurred in carrying on taxpayer's business and operating the stores.

M. Other. Taxpayer also has other types of pre-opening costs such as amounts incurred for employee relations and personnel safety supplies. Employee relations expenses include incidental expenses for coffee supplies and lunch and dinner meals provided to employees while working at the stores. *****.

These costs are normal and recurring expenses incurred in carrying on Taxpayer's business and operating the stores.

N. Personnel in Training. Taxpayer also incurs costs for employees that are receiving on-the-job training at an established, operating store and have not yet been, but are expected to be, assigned to a new store when a position becomes available. These costs for on-the-job training of employees are normal and recurring expenses incurred in carrying on Taxpayer's business and operating the stores.

LAW & ANALYSIS

In this case the field asserts that Taxpayer's pre-opening costs should be capitalized because they produce significant long-term benefits. In support of this position, the field cites *INDOPCO v. Commissioner, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992)*. Taxpayer disagrees. It argues that pre-opening costs are currently deductible under *§162*. For the reasons set forth below, the pre-opening costs in this case are deductible currently under *§162*.

A. Background.

Sections 162 and *263* together with their regulations provide the statutory and regulatory framework for analyzing the treatment of pre-opening expenses incurred in an existing trade or business. *Section 162* generally allows a deduction for all ordinary and necessary expenses paid

or incurred in carrying on a trade or business. *Section 263* requires that the cost of permanent improvements or betterments made to increase the value of property must be capitalized.

Section 161 clarifies the relationship between deductions allowable under *§162* and capital expenditures under *§263*. *Section 161* provides that the deductions allowed in Part VI of the Code, including *§162*, are subject to the exceptions set forth in Part IX, including *§263*. Thus, the capitalization rules of *§263* take precedence over the rules for deductions under *§162*, with the result that an expenditure that is otherwise an ordinary and necessary business expense deductible under *§162* must be capitalized if it is also a capital expenditure under *§263*. The Supreme Court agrees that *§263* takes precedence over *§167*. See *INDOPCO, supra at 84*; *Commissioner v. Idaho Power Co., 418 U.S. 1 (1974)*. Thus, *§263* controls if the treatment of an expenditure for tax purposes is governed by both *§263* and a section contained in Part VI such as *§162*. Further, absent an exception specifically allowing a deduction, *§263* requires capitalization of that expenditure.

B. Pre-opening Costs.

Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. An expense incurred in a taxpayer's business may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure. *Commissioner v. Tellier, 383 U.S. 687 (1966)*; Deputy v. du *Pont, 308 U.S. 488 (1940)*; *Welch v. Helvering, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112,.*

In the instant case, the field acknowledges that the pre-opening costs are ordinary and necessary expenditures within the meaning of *§162*. Rather, this request for technical advice raises the issue of whether Taxpayer's pre-opening costs must be capitalized under *§263* even though they are admittedly ordinary and necessary business costs within the meaning of *§162*. The field asserts that capitalization is appropriate and cites INDOPCO in support of this position.

The INDOPCO decision focuses on the relationship between *§§162* and *263* and notes that through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income. *503 U.S. at 84*. Further, the presence of future benefits is important, although not determinative, in determining whether an amount may be deducted or must be capitalized. According to the Court:

Although the mere presence of an incidental future benefit-- "some future aspect"--may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization ... Indeed, the text of the Code's capitalization provision, *§263(a)(1)*, which refers to "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.

503 U.S. at 87-88; See *Colonial American Life Insurance Co. v. Commissioner, 491 U.S. 244, 252-253 (1989)* (the important point is whether the taxpayer is investing in an asset or economic interest with an income-producing life that extends substantially beyond the taxable year); *United States v. Mississippi Chemical Corp., 405 U.S. 298, 310 (1972)* (expense that is of value in more than one taxable year is a capital expenditure). After comparing the taxpayer's case to others involving changes in capital structure, the Court concluded that the expenses in

INDOPCO bore the indicia of capital expenditures and should be treated as such. INDOPCO affirmed the Service's position that expenditures creating significant long-term benefits must be capitalized even if they do not result in a separate asset.

In this case, the field reasons that the pre-opening costs produce significant long-term benefits to Taxpayer by allowing it to open new stores which will produce income for an indefinite number of years. In addition, the field asserts that the pre-opening costs, by definition, do not produce current income but rather produce only future income. Accordingly, the field would require the pre-opening costs to be capitalized under *§263*.n2

However, for the reasons described below, the pre-opening costs in this case are not subject to capitalization under *§263*. Capitalization is not required for every expenditure that produces a future benefit. This proposition was explicitly stated by the Supreme Court in INDOPCO when it noted that the mere presence of an incidental future benefit may not warrant capitalization. *503 U.S. at 87*. Further, the logical extension of requiring capitalization of all costs that produce future income is that almost every business expenditure is capitalizable. That this position proves too much was acknowledged by the court in *Encyclopedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982)* (cost of editorial services in developing a new book held to be capital), rev'g T.C. Memo. 81-255 (1981). In that case, the court started with the proposition that where income is generated over a period of years, the expenditures should be classified as capital. *685 F.2d at 214*. But the court went on to note the practical difficulties in using this approach which would result in practically every expenditure being capitalized.n3 *685 F.2d at 217*. The court reasoned that the distinctions between recurring expenditures and nonrecurring expenditures provides a crude demarcation in determining whether an expenditure should be capitalized or deducted currently. Id. Based on these distinctions, the court held that the royalties at issue were capital. See also *Mountain Paper Products Corp. v. Commissioner, 287 F.2d 957 (2d Cir. 1961)* (nonrecurring nature of expenditures a factor in determining that capitalization was appropriate); *Rev. Rul. 89-23, 1989-1 C.B. 85* (recurring or nonrecurring nature of costs is an important factor in distinguishing capital expenditures from currently deductible costs). Although a capitalization result was ultimately reached, Encyclopedia Britannica is important because the court acknowledged that not every cost producing future income must be capitalized and that the recurring nature of expenditures helps distinguish between items that are deductible under *§162* and those that must be capitalized under *§263*.

The recurring nature of the costs at issue supports allowing Taxpayer a current deduction for the pre-opening costs. As noted above, "the distinctions between recurring expenditures and nonrecurring expenditures provides a crude demarcation in determining whether an expenditure should be capitalized or deducted currently." *Encyclopedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 214 (7th Cir. 1982)*; see also *Rev. Rul. 89-23*, supra. In this case, the pre-opening costs are recurring costs that Taxpayer incurs in operating all its stores. These costs include the cost of stocking the stores with inventory and supplies, staff training, store promotional costs, utilities, rent and other related miscellaneous expenses for goods and services already provided to Taxpayer. The recurring nature of these costs suggests that they should not be capitalized under *§263*.

Further support for not requiring pre-opening costs to be capitalized under *§263* is found in the fact that the costs appear to generate predominantly short-term benefits. In general, expenditures to produce current income are deductible currently even though some incidental future benefit may result. See *Rev. Rul. 92-80, 1992-2 C.B. 57* (advertising costs generally deductible); *Iowa-Des Moines National Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979)*,

aff'g *68 T.C. 872 (1977)*; *Three-in-One Oil Co. v. United States, 35 F.2d 987 (Ct. Cl. 1929)* (advertising that increases sales is not a capital expenditure); *A. Finkenberg's Sons, Inc. v. Commissioner, 17 T.C. 973 (1951)*; *Rev. Rul. 74-318, 1974-2 C.B. 14* (advertising to sell cars deductible); *Rev. Rul. 69-510, 1969-2 C.B. 23* (cost of cars given to customers as a prize deductible); *Rev. Rul. 56-181, 1956-1 C.B. 96* (advertising as part of opening new sales territories deductible). In A. Finkenberg's Sons, an installment dealer was required to currently deduct promotion and advertising costs to obtain new customers because there was a direct relationship between amounts expended and income. Current deduction was required as "[a] substantial part of the thrift club expenses produced immediate results which are impossible to segregate from prospective results." *17 T.C. at 982-983*. Thus, expenditures that result in immediate sales generally are deductible currently even if some incidental future benefits also result.

The importance of current sales is also demonstrated by two cases decided after INDOPCO. Fidelity Associates, Inc. v. Commissioner, T.C. Memo. 94-142 (1994); Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 93-467 (1993). Commissions paid to salespersons for obtaining sponsors were held to be currently deductible in Fidelity. The Tax Court reached this result even though the sponsorship agreements were for two-year periods and sponsors could elect to pay the taxpayer over two years. The court reasoned that the contractual right to receive payments over two years, standing alone is not a sufficient reason to classify the commissions as capital expenditures. In reaching this result, the court noted that dealers are specifically authorized to deduct commissions by §1.263(a)-2(e). Similarly, in Sun Microsystems, the Tax Court allowed a current deduction for the cost of stock warrants issued to the buyer of computer workstations as an incentive to induce the purchase of the workstations. The court reasoned that the possible development of a long-term customer relationship was an "incidental future benefit" when compared with the immediate benefits of selling the workstations. Fidelity and Sun Microsystems show that whether immediate sales result from an expenditure remains an important factor after INDOPCO in determining whether the expenditure is deductible currently under *§162* or must be capitalized under *§263*.

In this case, Taxpayer incurs various costs to open new stores during the ***** weeks immediately preceding store opening. These pre-opening costs result in short-term benefits primarily related to producing income in the near term. For example, the fact that Taxpayer's inventory turns ***** times a year indicates that shelf stocking costs produce income over a short time period. In addition, Taxpayer's high rate of employee turn-over ***** demonstrates that employee training costs produce short-term benefits. Further, it is worth noting that the cost of training employees generally is deductible under *§162*. See *Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253, 271 (1991)* aff'd. *17 F.3d 684 (4th Cir. 1994)* (the costs of training employees are deductible); *Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220, 234 (1985)* (costs of training employees to operate new machinery in existing business are deductible). However, the costs of training employees in connection with a new business are capital expenditures. See *Cleveland Electric Illuminating Co. at 228-229*. In this case, Taxpayer trains its new employees to perform the same functions as its existing employees. The training is not related to a separate capital transaction such as construction or acquisition of the new store. Accordingly, the short-term benefits produced by stocking shelves and training argue against requiring those costs to be capitalized.

The short-term nature of the benefits resulting from pre-opening costs indicates that these costs are not capital expenditures. See *INDOPCO, supra*; Sun Microsystems, Inc., supra. The

combination of these short-term benefits and the recurring nature of the costs leads to the conclusion that Taxpayer's pre-opening costs need not be capitalized under *§263*.

CONCLUSION

Taxpayer's pre-opening costs associated with opening new stores are not required to be capitalized under *§263*.

A copy of this technical advice memorandum is to be given to the taxpayer. *Section 6110(j)(3) of the Code* provides that this memorandum may not be used or cited as precedent.

FOOTNOTES:

n1

"SF Pre-opening costs do not include amounts paid for fixtures, leasehold improvements, rolling stock, EDP and cash register equipment, and display items. Taxpayer capitalizes these expenditures. "EF

n2

"SF The instant case does not raise the issue of whether costs to expand into new geographic markets must be capitalized as Taxpayer's new stores were opened in the States where Taxpayer already had existing stores. "EF

n3

"SF Similar practical difficulties were noted by the Tax Court in *Denise Coal Co. v. Commissioner, 29 T.C. 528 (1957)* aff'd in part and rev'd in part, *271 F.2d 930 (3d Cir. 1959)*. In that case, the court in allowing the taxpayer a deduction for advertising costs stated that it would be a very difficult task in cases involving advertising expenditures if it had to delve into the question of how soon immediate increases in sales resulted from a particular advertisement. *29 T.C. at 554*. "EF