

MEMO# 3662

April 1, 1992

TAX COURT RULES THAT COMMISSIONS PAID ON SALE OF BOOKS OVER TWO YEARS NEED NOT BE CAPITALIZED

April 1, 1992 TO: TAX COMMITTEE NO. 13-92 12b-1 AD HOC COMMITTEE RE: TAX COURT RULES THAT COMMISSIONS PAID ON SALE OF BOOKS OVER TWO YEARS NEED NOT BE CAPITALIZED _____ The attached U.S. Tax Court decision, *Fidelity Associates, Inc. v. Commissioner*, T.C. Memo. 1992-142 (March 10, 1992), concerns the deductibility of commission expenses paid and accrued in one year with respect to sales, some of the income on which will not be accrued or reported in the same year. The case concerns Internal Revenue Code section 446, which grants the Commissioner authority to change a taxpayer's method of accounting if it does not clearly reflect income. In *Fidelity Associates*, the taxpayer paid commissions to its sales representatives for their procurement of sponsorship contracts with respect to certain types of books. While commissions were paid within days of the procurement of a valid sponsorship contract, the contract lasted for two years and *Fidelity Associates* could receive payments over this entire period. The Commissioner asserted that the potential lag in payment meant that the taxpayer's accounting treatment did not clearly reflect income. As part of her analysis, the Commissioner claimed that the payment of the commissions resulted in the acquisition of certain intangible contract rights (a finite income stream) having a useful life substantially beyond the close of the taxable year. The Court rejected the Commissioner's arguments, holding that the commissions were ordinary and necessary expenses under Code section 162, and that the right to receive payments over the two-year period of the sponsorship contracts was not a sufficient reason, standing alone, to classify the commissions as capital items. The Commissioner's argument in this case is essentially the same argument being made for capitalization in the proposed Internal Revenue Service coordinated issues of which the Institute has previously informed you. (See Institute Memoranda to Tax Committee No. 10-91 and Members - One Per Complex No. 16- 91, dated April 15, 1991; and to 12b-1 Ad Hoc Committee, dated February 27, 1991.) - 1 - The significance of the *Fidelity Associates* case to the proposed coordinated issues is unclear, in part because the specific Internal Revenue Code sections at issue are different and in part because the Tax Court's opinion does not mention *Indopco, Inc. v. Commissioner*, the recent Supreme Court case on expensing or capitalization of expenses incurred in a friendly takeover, even to distinguish it. (See Institute Memorandum to Tax Members No. 11-92, Accounting/Treasurers Members No. 7-92, and 12b-1 Ad Hoc Committee, dated March 2, 1992.) Nonetheless, it may be instructive of the Tax Court's general attitude toward the capitalization versus expense issue. We will keep you informed of developments. David J. Mangefrida Jr. Assistant Counsel - Tax Attachment DJM:bmb

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