

OVERVIEW TO FEDERAL DOMESTIC TAX CONSIDERATIONS FOR AN INTERNET COMPANY¹

Professor Annette Nellen
San José State University

Presentation Outline

- I. Introduction **[page 2]**
 - A. Definition of Internet Company
 - B. Sizing Up Internet Business Activity
 - C. Why Internet Companies Generate Tax Issues
 - D. Guidance
 - E. Focus of This Presentation and Outline
- II. Issues for Both Internet Start Up and Bricks and Clicks Companies **[page 5]**
 - A. Treatment of Web Site Development Costs
 - 1. Nature of Web Site Development Costs and Tax Treatment Alternatives
 - 2. Informal IRS Position
 - 3. GAAP Guidance
 - B. Treatment of Intangibles
 - 1. Transfer of a Domain Name
 - 2. Other Intangibles
 - 3. Transfers of Intangibles to a Corporation
 - C. Start Up Costs
 - 1. New Line of Business
 - 2. When Does Business Start
 - 3. Included and Excluded Expenses
 - D. Barter Transactions
 - E. Selected Tax Accounting Considerations
 - 1. Timing of Commissions
 - 2. Hosting Arrangements
 - 3. Subscription Income
 - 4. Service vs. Goods
- III. Issues for Internet Start Up Companies **[page 29]**
 - 1. Use of Stock to Entice Customers
 - 2. Efficient Use of Net Operating Losses
 - 3. Importance of Tax Return Filing
 - 4. Research Tax Credit
 - 5. Tax Incentives
 - 6. Worker Classification Considerations
 - 7. Compensation Considerations
- IV. Appendix: Letter from SEC to FASB on Internet Accounting Issues **[page 33]**

¹ This outline was used at an ABA Tax Section program on January 13, 2001 in Scottsdale, AZ.

I. Introduction

A. Definition of an Internet Company

Many different types of businesses might be labeled as an “Internet Company.” Generally, conducting some operations – whether sales or purchases or customer relations, over the Internet is the key feature. Some Internet companies only came into existence along with the creation of broader access to the World Wide Web a few years ago. These companies include Yahoo!, E-Bay, and Amazon.com. Other Internet companies began before commercial use of the Internet. Typically these established companies are using the Internet to supplement their traditional methods of selling goods and services, purchasing goods and supplies, interacting with customers and suppliers, and advertising. Many retailers, such as Walmart, K-Mart, Barnes & Noble, Borders, and Macy’s, have expanded their traditional “bricks and mortar” operations to become so-called “bricks and clicks” or “clicks and mortar” operations. A few companies that sell items that can be digitized and thus, transferred over the Internet, such as Egghead, have closed their bricks and mortar operations and become solely web-based businesses. In addition, various manufacturers, such as Intel and Cisco, have moved much of their sales and purchasing activity to a web-based model (so called “B2B”). Various service providers are also using the Internet to maintain and grow markets. These include many newspapers and consulting firms. Finally, the term “Internet Company” includes companies providing a key part of the Internet backbone – telecommunications companies.

A 2000 report on the Internet economy, released by the University of Texas at Austin and Cisco uses a “4-layer” model to describe the roles Internet companies play in the Internet Economy.²

Layer 1 – Internet Infrastructure Layer: This layer consists of companies that make the Internet function. It includes telecom companies, PC and peripherals manufacturers, networking software and hardware companies, and security vendors.

Layer 2 – Internet Applications Layer: This layer is made up of companies that enable the Internet to perform business activities. It includes software developers, search engines, databases, multimedia applications and Internet consultants.

Layer 3 – Internet Intermediary Layer: This layer makes the electronic marketplaces efficient and facilitates interactions between buyers and sellers. It includes online businesses and web portals.

Layer 4 – Internet Commerce Layer: This layer includes companies that sell goods and services to consumers and businesses.

B. Sizing Up Internet Business Activity

- In March 2000, the U.S. Census Bureau released its first figures to measure e-commerce separately from other retail figures. Online sales of about \$5.3 billion for the fourth quarter of 1999 represented about 0.6% of overall retail sales.³ In August 2000, the Department of Commerce reported that U.S. retail e-commerce sales for the second quarter of 2000 had increased 5.3% from over the first quarter of \$5.240 billion. E-commerce sales in the second quarter accounted for 0.68% of total retail sales.⁴
- Internet growth has been rapid relative to that for radio and television. To reach 50 million users, it took 38 years for radio, 13 years for television and 4 years for the Internet.
- Most of the dollars (about 80%) are currently in business-to-business (B2B) transactions, and this segment is expected to continue to be the largest e-commerce market.
- Cisco Systems receives about 80% of its orders from its web site.⁵
- In November 1998, Intel reported that it was receiving \$1 billion a month in orders over the Internet, mostly from existing customers, and on a system that it had only begun in July 1998.⁶

² See <http://www.internetindicators.com/>.

³ Remarks of Secretary of Commerce William M. Daley, February 5, 1999, <http://204.193.243.2/public.nsf/commerce-ftc-online-shopping-briefing>. See March 2, 2000 Department of Commerce press release at <http://www.census.gov/Press-Release/www/2000/cb00-40.html>.

⁴ Department of Commerce, “Retail E-Commerce Sales in Second Quarter 2000 Increased 5.3 Percent from First Quarter 2000, Census Bureau Reports,” August 31, 2000.

⁵ Cisco’s 1999 Annual Report.

⁶ Jim Carlton, “Intel’s Online Orders Reach \$1 Billion a Month,” *Wall Street Journal*, November 16, 1998, page B4.

- Amazon.com offers over 2.5 million book titles and has sold to over 17 million customers in over 160 countries since it began business in July 1995.⁷
- Approximately 400,000 jobs related to e-commerce were added in 1999, representing a 78% increase over 1998.⁸
- Forrester Research predicts that by 2004, 50% of software sales, 40% of hardware sales, 16% of book sales and 11% of general apparel sales will be online.⁹
- Forrester Research predicts that e-commerce will make up almost 9% of worldwide sales of goods and services in 2004. This market will mainly be constituted in 12 countries that would comprise about 85% of worldwide e-commerce.¹⁰
- Forrester Research predicts that in 2003, Internet activity will account for 5% of the world's gross domestic product (GDP).¹¹
- In April 2000, Forrester Research predicted that losses, increased competition and investor concerns would “drive most of today’s Dot Com retailers out of business by 2001.”¹²

C. Why Internet Companies Generate Tax Issues

E-commerce represents a new business model. As such, it creates some challenges to tax systems that were designed with a different model in mind. Some of the key reasons why e-commerce raises tax issues include the following:

1. Location—Existing tax systems tend to determine tax consequences based on where the taxpayer is physically located. The e-commerce model enables businesses to operate with very few physical locations. Location factors primarily raise tax issues at the international and state and local levels, rather than at the federal level.
2. Nature of Products—E-commerce allows for some types of products, such as newspapers and music CDs, to be delivered in digitized (intangible) form, rather than in tangible form. Digitized products raise issues at the state level as to whether sales tax applies and in which state income is generated for state income tax purposes. It can also raise federal issues regarding the type of revenue generated and how it is to be reported, as well as whether digitized products are subject to traditional inventory accounting rules.
3. New Marketing Techniques—The Internet has allowed for new ways of selling and buying goods and services. For example, individuals can offer their unwanted items to a worldwide group of potential buyers via auction sites, such as E-Bay. The Internet can also be used to easily link business buyers and sellers through exchange web sites where buyers post what they have to sell and sellers match up with them, or vice versa. Such sites can almost operate without human intervention for the matching function. In addition, the Internet has increased the use of bartering, most notably with respect to exchange of web banners that serve as advertisements. These new techniques raise various tax issues at all levels. At the federal domestic level, issues include whether an exchange intermediary or broker should be accounting for inventory, and what amount of information reporting should be required for low-value bartering transactions.
4. New Types of Assets—Some of the new assets created by commercial use of the Internet are domain names (URLs) and web sites. At the federal tax level, issues exist as to how to treat the costs of creating or acquiring such assets, as well as the characterization of any gain or loss generated upon disposition of the asset.
5. Making Optimal Use of the Internet May Challenge Old Rules—One area where use of the Internet has potentially raised some tax issues involves how some tax-exempt organizations are using the Internet. For example, a tax-exempt organization might allow donors to be listed on the organization’s Web site. This may cause the entity to face issues as to whether the listing is merely an acknowledgement or whether it is advertising that may result in unrelated business taxable income (UBTI) for the organization. Another issue may exist where an organization that primarily operates on the web, such as a non-profit information

⁷ See <http://www.amazon.com/exec/obidos/subst/misc/company-info.html>.

⁸ *Measuring the Internet Economy*, an October 1999 report by Cisco Systems and the University of Texas. See <http://www.internetindicators.com>.

⁹ “Brick-and-mortar retailers still standing,” *Red Herring*, July 2000, page 84.

¹⁰ Forrester, “Global eCommerce Approaches Hypergrowth,” October 27, 2000.

¹¹ Neil Winton, “Electronic Commerce Must Jump Regulation Obstacle,” Reuters, Yahoo! News, June 7, 1999.

¹² Forrester Research Press Release of April 11, 2000; <http://www.forrester.com/ER/Press?release/0,1769,270.FF.html>.

exchange, meets the tax definition of a tax-exempt organization. Also, the Internet may allow for more efficient interactions between a tax-exempt organization and its donors, yet existing rules were not written with such interactions in mind. For example, a receipt is required for certain donations in order for the donor to be entitled to a deduction. Will a receipt generated by and printable from a Web site constitute an appropriate acknowledgement for tax purposes? In October 2000, the Service issued Announcement 2000-84, 2000-42 I.R.B. 385, which lists various issues that tax-exempt organizations may face related to the Internet. The Service is seeking input from interested parties as to whether additional guidance is needed for tax-exempt organizations.

6. Nature of Transactions—The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concerns for the Internal Revenue Service as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed. In a speech entitled, “Tax Administration in a Global Era,” Treasury Secretary Summers stated:

“The Internet provides new ways for tax administrations, such as the IRS, to improve the ease and transparency of tax collection. But new technology also raises certain problems. In a world where cyber-transactions are growing at a rapid pace, tax administrations face the challenge of adapting existing tax systems to an economy that increasingly ignores physical borders.

In such a world, it will be easier for companies to avoid tax collectors by operating worldwide through web-sites based in jurisdictions that are unwilling to share taxpayer information.”¹³

D. Guidance

The only guidance issued by the Service in response to an Internet transaction is Notice 2000-6 on information reporting for certain bartering transactions (discussed later). There have been a few news reports of a research project conducted by the Upstate New York (Buffalo) IRS District; a report is expected to be released soon. Initial reports on the study indicate that the Service reviewed thousands of commercial Web sites with about 1,600 selected for additional study. Approximately 400 small businesses were selected for formal examination. The Service discovered that for roughly 9% of the 1,600 sites, the beneficial owner could not be identified. Of the sites audited, the Service found a tax gap of \$6.2 million for 1997. About 91% of the tax gap was due to understatement of taxable income and 7% with failure to file a return. Approximately 10% of the commercial Web sites examined did not file a 1997 tax return; the rate was 16% for Internet Service Providers (ISPs).¹⁴

E. Focus of This Presentation and Outline

Over the past few years, there has been much discussion about various tax issues raised by e-commerce. Most of these discussions have focused on the application of sales and use taxes, telecommunications taxes, and various international tax issues, such as whether a computer server can be a permanent establishment. One might easily think that there are no federal domestic issues for Congress and the Service to deal with. However, this is not true. As noted above, there are federal domestic issues, such as the tax treatment of web site development costs and costs to purchase a domain name from another party, character of a domain name, exchanges of web banner ads, and accounting for revenue and inventory.

This presentation and outline focuses on federal domestic tax issues that an Internet Company – whether an Internet Start-up or a Bricks and Clicks operation, may face (see list of topics on page 2). A discussion of relevant law is also included and where unanswered questions remain.

The Financial Accounting Standards Board (FASB) and SEC are moving more quickly than Congress and the Service in addressing many of the types of issues raised in this outline. In October 1999, the SEC issued a letter to FASB describing 20 accounting issues related to Internet transactions for which the SEC desired guidance. Several significant pieces of guidance have been issued by the Emerging Issues Task Force (EITF) since October 1999. Because several of the issues noted by the SEC are also tax issues, some of the FASB guidance is discussed in this outline along with the discussion of tax issues. The complete text of the October 1999 SEC letter is included as an appendix to this outline.

¹³ From a speech to the 34th General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.

¹⁴ See George Guttman, “IRS Studying E-Commerce Tax Problems,” 1999 TNT 206-7, and “Executive Summary of IRS Electronic Commerce Report Available,” 2000 TNT 219-66.

II. Issues for Both Internet Start Up and Bricks and Clicks Companies

A. Tax Treatment of Web Site Development Costs

I. Nature of Web Site Development Costs and Tax Treatment Alternatives

Web site development may include such activities as creating content and a strategy for how the site fits into sales and advertising goals, developing software, using templates to assemble content and certain functionality into HTML format, testing, redesign, and updating of content. The web site may be only for internal use (intranet) or also for external use. The sponsor's purpose in creating the site may be solely for advertising, or the site may constitute the company's primary business operation, for example, soliciting sales from customers.

The treatment of the costs to develop a web site will depend on the nature of the activity. Common activities of web site development and their likely tax treatment are described next.

Initial Planning: The treatment of costs incurred in deciding upon the purpose, content and use of a web page, may vary depending on the particular circumstances for incurring the costs. If the costs are viewed as an integral part of the development costs, they likely should be treated in the same manner as such costs are treated. If the planning can be viewed as a separate activity, an *Indopco* analysis may be warranted.¹⁵ If the future benefit is speculative, capitalization is not warranted.¹⁶ Also, if the primary benefit is to current year activities, the costs should be deductible under §162.¹⁷

Acquisition of a Domain Name: Typically, a business obtains a domain name by registering with a registrar¹⁸ and paying a nominal fee (generally \$35 per year with the first two years required to be paid upon registration). Registrants may be able to make a payment to secure a domain name for up to a ten-year period. Although the cost of even a 10-year registration is small, since there is no de minimis rule under §263, the multiyear fee should technically be capitalized and amortized. While some domain names may have market value significantly higher than the registration fee amount, that should not affect the tax treatment of the yearly registration fee. If a domain name is not renewed, it might be lost. For example, in June 2000, J.P. Morgan failed to renew the domain "jpmorgan.com" and its web site became inaccessible until the renewal fee was paid.¹⁹

The treatment of the costs to purchase a domain name from someone who has already registered it is covered in a separate section of this outline.

Software Development: Per Revenue Procedure 2000-50 (formerly Revenue Procedure 69-21),²⁰ software development costs may be treated similarly to §174 expenditures thereby allowing the taxpayer to currently expense the costs or to elect to amortize them over 60 months under §174(b) or under the 167(f) depreciation rule (36 months). Under Revenue Procedure 2000-50, a taxpayer who buys software would be able to amortize the cost ratably over 36 months per §167(f)(1), unless the software was acquired as part of the hardware without the cost being separately stated (in which case it is depreciated along with the hardware).

It is important to note that Revenue Procedure 2000-50 does not state that software development expenditures are per se R&E expenditures. Instead, it states that software development costs "in many respects so closely

¹⁵ *Indopco*, 503 U.S. 79, 92-1 USTC ¶50,113, 69 AFTR2d 694 (1992): An expenditure need not create or enhance a separate and distinct additional asset to be capitalizable; other characteristics of an expenditure may indicate that it is a capital expenditure. "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."

¹⁶ *Sun Microsystems, Inc.*, T.C. Memo 1993-467 and Revenue Ruling 2000-4, 2000-4 I.R.B. 331.

¹⁷ Revenue Ruling 2000-4, 2000-4 I.R.B. 331 (current deductibility of ISO certification costs); *Goodwyn Crockery Co.*, 37 TC 355 (1961), PLR 7906011, Revenue Ruling 92-80, 1992-2 C.B. 57 (advertising, even if it creates goodwill, is deductible under §162); and *RJR Nabisco Inc. v. Comm'r.*, T.C. Memo 1998-252, nonacq. 1999-40 I.R.B. 2, AOD 1999-012.

¹⁸ A list of accredited and accreditation-qualified registrars can be found at <http://www.icann.org/registrars/accredited-list.html>.

¹⁹ Patrick McGeehan, "For Want of \$35, J.P. Morgan Loses Its Web Site and E-Mail," *New York Times*, Technology Section, June 14, 2000.

²⁰ Rev. Proc. 2000-50, 2000-52 I.R.B. 601 and Rev. Proc. 69-21, 1969-2 C.B. 303.

resemble the kind of research and experimental expenditures that fall within the purview of §174 as to warrant similar accounting treatment."

In PLR 9709041 (12/3/96), the Service granted a taxpayer permission to change its accounting method for software development costs. This ruling includes the following statement: "it should be understood that the responsibility for making determinations as to whether the expenditures for the development of computer software paid or incurred by the taxpayer in connection with the taxpayer's trade or business are costs similar to research and experimental expenditures is a matter to be considered by the district director upon examination of the taxpayer's return." This "similar to" language is slightly different from that of Revenue Procedure 69-21 (now Revenue Procedure 2000-50) which states that software development costs so closely resemble R&E expenditures to warrant *accounting treatment similar* to that accorded such costs under §174. In the PLR, the Service is stating that the software development costs be *similar to* R&E expenditures.²¹

Revenue Procedure 2000-50 and its predecessor do not define software development or the types of costs involved in software development. In *Norwest Corp., et al. v. Comm'r.*, 110 T.C. 454 (1998), one of the Service's experts discussed the difference between software development and research. Per this expert, software research involves a search for information, use of test data, and the presence of technical risk. Software development involves the production of code, use of production data, and failure is more likely to be due to people and project management risks, rather than technical risk.

Section 197(e)(3)(B) defines computer software as "any program designed to cause a computer to perform a desired function." Treas. Reg. §1.197-2(c)(4)(iv) further provides that computer software is "any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software."

Queries: 1) Does the Service agree with the definition of software development offered by their expert in the *Norwest* case?

2) Does use of a software program to produce an HTML document constitute the production of code and therefore, software development?

3) Does the §197 definition of software only encompass creation of a program language, or also use of a program language to create code that a computer reads?

4) Does software development include initial design activities, testing and other non-coding activities necessary to the development of software?

Research and Experimentation (R&E): Section 174 allows for the current deduction of research or experimental expenditures incurred in connection with a trade or business.²² The "in connection with" language differs from the §162 "carrying on" language. The U.S. Supreme Court has held that the "in connection with" language allows taxpayers to deduct R&E expenditures before they are carrying on a business.²³ However, the taxpayer must be engaged in a trade or business at some time—there must be some actual and honest objective of making a profit.²⁴

²¹ Relevance to the §41 research credit: In *Norwest v. Commissioner*, 110 T.C. 454 (1998), the court stated that for purposes of software development expenditures qualifying for the credit, they must meet the definition of R&E under §174. "We believe that the phrase 'the research expenditures may be treated as expenses under section 174' is meant to require the taxpayer to satisfy all the elements for a deduction under section 174."

²² If a taxpayer does not want to current expense its R&E expenditures, it may elect to instead capitalize them and then begin to amortize them when it first realizes benefits from the expenditures. The amortization period under §174(b) may be no shorter than 60 months. If the R&E results in an item that is depreciable under §167, that life is used. For example, if a software developer has capitalized its R&E (software development costs), the amortizable life is under §167(f)—36 months. See Treas. Reg. §1.167(a)-14(b)(1) and §1.174-4(a)(4).

²³ *Snow v. Commissioner*, 416 U.S. 500 (1974).

²⁴ *Brown v. Commissioner*, 58 T.C.M. (CCH) 850 (1989).

Research and experimentation costs are defined as R&D costs incurred in the experimental or laboratory sense, for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.²⁵ Uncertainty exists if information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. One is to look to the nature of the activity, not to the nature of the product or improvement being developed. R&E expenditures include costs of obtaining a patent, including attorney fees in making and perfecting the application.²⁶ Quality control testing does not constitute R&E. However, the regulations clarify that "quality control testing does not include testing to determine if the design of the product is appropriate" (validation testing).²⁷

Section 174 only applies to R&E expenditures if they are reasonable in amount under the circumstances. Generally, expenditures are reasonable in amount if the amount "would ordinarily be paid for like activities by like enterprises under like circumstances."²⁸ Depreciable property is not a §174 expenditure, but the depreciation on equipment used in R&E falls under §174.²⁹ A product includes "any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license."³⁰

In TAM 9538008, redesign of existing home appliances or components was held to qualify as R&E. Projects were undertaken to 1) produce better and more competitive products, 2) to increase reliability, 3) to increase general product safety, or 4) to respond to new federal restrictions.

If the expenditures for developing a web site meet the definition of R&E under §174 and the taxpayer has adopted the §174(a) expensing method, the costs are deductible. In order to potentially claim a research tax credit under §41 for the web site development costs, such costs will have to meet the definition of R&E under §174 (in addition to other requirements under §41).³¹

Purchase of Software: If instead of developing the software, a taxpayer purchases software designed by someone else, the taxpayer must capitalize the software costs (assuming the software has a useful life exceeding one year). To determine if the software designed by a third party constitutes a §174 expenditure or should instead be treated as the acquisition of a software program, a determination must be made as to who was at risk for the development. If R&E expenditures are incurred in the creation of depreciable property by another person, they are only deductible under §174 if "made upon the taxpayer's order and at his risk."³²

Creation of an HTML File from a Template: Various software programs exist, such as Microsoft's FrontPage^R, which provide the template and software to enable someone to create an HTML file (web page). It is unclear whether this type of activity constitutes software development. The file created with the program does not by itself enable a computer to do something. However, the file may also include some code created by the designer that does have some functionality on its own. Does software development mean creation of a new program language, or is it also the writing of code based on existing program language, such that use of a tool to help write that code would also be software development? The question of whether use of a software program to create an HTML document constitutes software development is one in need of guidance.

If the creation of an HTML file from a template is not treated as software development, then the costs to create this item must be examined under §162 and §263. Generally, if the item will provide a significant benefit beyond the current year, the costs to create it will have to be capitalized. Otherwise, the costs should be expensed when incurred. If the costs are to be capitalized, the next issue would be to determine if the asset has a

²⁵ Treas. Reg. §1.174-2(a).

²⁶ This definition differs from that in Financial Accounting Statement No. 2, Accounting for Research and Development Costs, which specifically states that costs to obtain a patent do not constitute R&D expenditures.

²⁷ Treas. Reg. § 1.174-2(a)(4).

²⁸ Treas. Reg. § 1.174-2(a)(6); based on I.R.C. § 174(e) added by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110, 103 Stat. 2106.

²⁹ See §174(c) and Treas. Reg. §1.174-2(b)(1).

³⁰ Treas. Reg. §1.174-2(a)(2).

³¹ §41(d)(1)(A) and *Norwest Corp., et al. v. Comm'r.*, 110 T.C. No. 34 (1998).

³² See Treas. Reg. §1.174-2(b)(3), TAM 9449003 (Aug. 25, 1994), and FSA 199930016.

determinable useful life, and if so, what that life is. In addition to the costs of creating the file, related costs of planning what the site should look like should be included with the other costs of creating the site.

Continual Updating: The content of a web page will most likely be updated frequently in order to provide useful information to visitors. These recurring costs do not provide a significant benefit beyond the current year and so, should be deducted under §162 as incurred.³³ Also, if the updating process involves training of employees, such costs should be deductible under §162. In Rev. Rul. 96-62, the Service held that the *Indopco* decision does not affect the treatment of training costs (such as the "costs of trainers and routine updates of training materials") as business expenses deductible under §162, even though there may be some future benefit from the costs. Training costs only need to be capitalized in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. See, e.g., *Cleveland Electric*, 7 Cl. Ct. at 227-29 (capitalization of costs for training employees of an electric utility to operate a new nuclear power plant, which were akin to start-up costs of a new business).³⁴

Additional Tax Considerations Pertaining to Development of a Web Site

Creation of an Asset with a Long Useful Life: As a general rule, no deduction is allowed for amounts paid for new buildings or permanent improvements or betterments that increase the value of any property. In addition, amounts spent to restore property or in making good the exhaustion thereof for which a depreciation allowance was taken are not currently deductible. Additional examples of capital expenditures include the cost of acquiring and constructing property, defending or perfecting title to property, commissions paid in purchasing securities, and the cost of goodwill in connection with acquiring assets of a going concern.³⁵ In 1992, the U.S. Supreme Court attempted to clarify the demarcation between ordinary and capital expenditures in the *Indopco* decision.³⁶

Per the Court, an expenditure need not create or enhance a separate and distinct additional asset to be capitalizable; other characteristics of an expenditure may indicate that it is a capital expenditure. "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."

The *Indopco* decision has not necessarily made the capitalization versus expensing analysis any easier. We continue to see IRS rulings and court cases. In 2000, two cases at the appeals level overturned Tax Court decisions to find certain expenditures to be currently deductible. In *PNC Bancorp*³⁷ the Third Circuit held that costs incurred by a bank in creating loans (such as salaries and credit check fees) did not have to be capitalized because they were everyday-type expenditures and were merely associated with origination of the loans and did not become part of the loan balance. In approving a loan, including performing credit checks and appraisals, the bank did not "step out of its normal method of doing business." The court noted that there is a "fundamental distinction between business expenses and capital outlays."

In *Wells Fargo*³⁸ the Eighth Circuit held that officer salaries incurred in determining whether a company was a suitable merger target were only indirectly related to the acquisition and therefore did not have to be capitalized. If the cost is only "incidentally connected" with a long-term benefit, capitalization is not warranted. The court also noted that these indirect costs originated from the company's obligations to pay a salary due to the employment relationship, rather than the capital transaction.

With respect to web site development costs, many companies have hired or trained employees to maintain web sites. Would the above two cases support the treatment of such costs as currently deductible because they are a fundamental business expense (marketing, customer relations, etc.)? Or, if web site development costs are to be capitalized, would the *Wells Fargo* case suggest that the salary costs are direct costs tied to a long-term asset?

³³ *Encyclopedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982) and TAM 9645002.

³⁴ Rev. Rul. 96-62, 1996-53 I.R.B. 6.

³⁵ IRC §263(a), and Treas. Reg. §1.263(a)-1(a) and §1.263(a)-2.

³⁶ *Indopco*, 503 U.S. 79, 92-1 USTC ¶150,113, 69 AFTR2d 694 (1992).

³⁷ *PNC Bancorp Inc. et al. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000).

³⁸ *Wells Fargo & Co., et al. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000).

Of course, if any costs incurred in developing a web site fall under §174 or Rev. Proc. 2000-50 they can be expensed under such provisions without the need to consider §162 versus §263.

Creation of a New Trade or Business: Typically, creation of a web site by a business will not constitute the creation of a new trade or business. If a business decides to create a web site in order to serve customers, it has merely used a tool to reach customers for its existing trade or business. A web site should be viewed as enabling the company “to carry on an old business in a new way.”³⁹ Where a web site is created as part of the creation of a new trade or business, such costs must be capitalized if they are of a nature that would have to be capitalized if incurred by an existing trade or business.⁴⁰ If such costs are otherwise deductible and are not §174 expenditures, they should be treated as §195 start-up expenditures.

Advertising: One function of many web sites is to advertise the company’s products and services. Generally, all advertising costs are deductible under §162. Per Rev. Rul. 92-80,⁴¹ “the *Indopco* decision does not affect the treatment of advertising costs under section 162(a) of the Code. These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. ... Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized.”

In *Cleveland Electric Illuminating Co.*,⁴² mentioned in Rev. Rul. 92-80 as the “unusual” case, the court held that advertising costs incurred to educate the public about nuclear energy had to be capitalized. This type of advertising was distinguished from “goodwill” advertising performed to keep the taxpayer’s name in the public’s mind and to attract future patronage. The advertising with respect to the nuclear power plant was related more to the costs of obtaining the permit to build the plant and the operating license, which were long-lived assets. Similarly, the taxpayer had to capitalize the employee training costs associated with the nuclear power plant. Also, in Rev. Rul. 68-283, the Service held that costs incurred to promote products at a fair, which operated for six-month periods during two years, had to be capitalized and amortized over the two years.

In the *RJR Nabisco* case,⁴³ the Tax Court broadly defined advertising, finding that graphic design costs were advertising and could be currently deducted under §162. In 1982, RJR deducted graphic design and package design expenditures of about \$2.2 million. The parties identified \$1.8 million of this amount as the “litigated expenses” for which the court’s conclusion would enable the parties to settle the treatment of the remaining amount.

RJR incurred the costs for its cigarettes, which the court described as “image” products. That is, “imagery significantly influences consumers’ decisions about which brand to smoke.” RJR’s marketing activities required completion of three steps—“(1) determining product position, (2) developing a marketing strategy, and (3) deciding on the tactics to implement the marketing strategy.” Marketing strategy for cigarettes included selecting the product name, physical characteristics of the product, the price, the advertising campaign, and developing appropriate promotions. Specific steps were needed to implement the marketing strategy, including “developing executions for the advertising campaign,” the media to use, and the types of promotions (such as coupons and direct mail promotions).

RJR developed graphic designs for its cigarette products including cartons, packages, tipping (the printed wrap around the filter), foils, and the closure seal. RJR also had an advertising strategy for its products which entailed creation of the campaign, the advertising “executions” (the specific individual ads that implement the advertising campaign themes), and determination of media placement.

³⁹ *Colorado Springs National Bank v. U.S.*, 74-2 USTC ¶9809, 34 AFTR2d 74-6166 (10th Cir.) where the court held that establishment of a credit card system by a bank was similar to its typical lending operations. “A new method is distinguishable from a new business.” Similarly, see *NCNB Corp v. U.S.*, 684 F.2d 285, 82-2 USTC ¶9469, 50 AFTR 2d 82-5281 (4th Cir. 1982); and *First National Bank of South Carolina v. U.S.*, 558 F.2d 721, 77-2 USTC ¶9526, 40 AFTR2d 77-5291 (4th Cir. 1977). In contrast, in TAM 9331001 (April 23, 1993), the Service ruled that the activities involved in operating a retail store were substantially different from those of a manufacturer and distributor and thus, constituted a new line of business. Similarly, in *Cleveland Electric Illuminating Co. v. U.S.*, 7 Cl. Ct. 220 (Cl. Ct. 1985), the court held that a nuclear power plant operated by a utility was a new business relative to the utility’s existing fossil fuel plant.

⁴⁰ IRC §195(c)(1)(B).

⁴¹ Rev. Rul. 92-80, 1992-2 C.B. 57.

⁴² *Cleveland Electric Illuminating Co. v. United States*, 7 Cl. Ct. 220, 85-1 USTC ¶9128 (1975).

⁴³ *RJR Nabisco Inc. v. Commissioner*, T.C. Memo 1998-252, nonacq. 1999-40 I.R.B. 2, AOD 1999-012.

No one can determine the time period that graphic designs and advertising campaigns will be used. The Service argued that these costs must be capitalized—the advertising campaign expenses "provide an intangible benefit to [RJR] over the economic lives of the brands to which they attach" and are not "recurring, day-to-day expenditures nor are they deductible under section 174." On the other hand, RJR argued that all of the costs were for ordinary business advertising.

The court reviewed case law, §1.162-20(a) and Rev. Rul. 92-80 to find advertising expenditures deductible under §162, even if they are designed to generate goodwill. "[N]otwithstanding certain long-term benefits, expenditures for ordinary business advertising are ordinary business expenses if the taxpayer can show a sufficient connection between the expenditure and the taxpayer's business." The court also did not accept the Service's argument that the expenditures created "brand equity." Also, the court did not agree with the Service that the costs had to be capitalized because they contributed to trade dress or involved copyrighted materials.

"We have found that the litigated expenses are advertising expenditures.⁴⁴ Respondent classifies the litigated expenses as advertising campaign expenditures and would have us distinguish between such expenditures and advertising execution expenditures on the basis that the later give rise principally to short-term benefits while the former give rise only to long-term benefits. The experience of our predecessor, the Board of Tax Appeals, and other courts in an earlier era lead us to doubt the sharpness of that distinction. [footnote omitted] Moreover, no case distinguishes between advertising execution and campaign expenditures, and the long-term, short-term distinction respondent would draw is incompatible with section 1.162-1(a) and 20(a)(2), Income Tax Regs., and Rev. Rul. 92-80, 1992-2 C.B. 57. Respondent's distinction will not hold; the litigated expenses are advertising expenditures that are ordinary business expenses."

Business Reengineering Costs: A business may develop its web site concurrently with the design or redesign of order fulfillment, manufacturing techniques, payment systems, and customer relations functions as part of a redesign or reengineering of the business. Often, this work may be part of an implementation or redesign of Enterprise Resource Planning (ERP) systems. In a situation where web site development is part of a larger business activity, the Service might argue that the entire process provided a long-term benefit to the business and capitalization is warranted for all project costs (other than costs that fall under §174 or Rev. Proc. 2000-50).

While the Service has not issued any formal guidance on the tax treatment of costs involved in implementing ERP systems, the large case data processing industry group of the IRS has informally stated some theories. First, revenue agents will tend to label this type of work as management consulting which does not qualify as an R&E deduction under §174. They will also likely argue that Rev. Proc. 2000-50 does not apply because no software development is taking place. Instead, templates are used and pre-set programs. In addition, agents will categorize the expenditures as capital under §263 because of the long-term benefits expected by the taxpayer.

The Spring 2000 *ISP Digest Data Processing*, a quarterly publication of the Data Processing ISP explains the Service's audit position (an informal one) on ERP expenditures. The audit focus appears to be to distinguish between software development and other costs, which have to be capitalized because they provide a long-term benefit. The Digest notes that ERP software implementation is "template driven" and that at least "one major vendor discourages doing much change to the underlying source code, for fear that it might mess up the whole system." "The dominant nature of these ERP systems is that they are template driven; that is why companies are buying them. Otherwise, they would be designing their own programs from scratch." The Service does not view use of templates as software development and thus, cannot be currently expensed under Rev. Proc. 69-21 (replaced by Rev. Proc. 2000-50). The Digest offers the following advice to agents: "Let the taxpayer establish that he is truly doing work that involves writing source code. If he cannot, then the whole project should be capitalized."

In a 1995 private ruling involving costs of a quality improvement initiative, the Service held that the costs had to be capitalized because of the expectation of a long-term benefit. TAM 9544001 involved the treatment of costs to reconfigure manufacturing facilities and train personnel to adopt just-in-time manufacturing (JITM). JITM was defined as a "radical redesign of existing manufacturing processes" that eliminated waste, added flexibility, allowed existing equipment to be used more efficiently and even per statements made by the taxpayer, would provide long-term benefits. The costs involved in the TAM were only the implementation costs, not the on-going improvement of JITM once implemented. The implementation costs included moving costs for existing equipment; electrical and plumbing modifications; materials and supplies, such as signs with a useful life

⁴⁴ Footnote 9 of the *RJR Nabisco* case states: "Neither party has asked us to address separately the small portion (approximately 1.5 percent) of the litigated expenses that were package design expenditures. Indeed, it is only petitioner that, in its opening brief, drew our attention to the distinction between graphic design and package design, and respondent has not alleged that we should afford them different treatment."

extending beyond one year; employee training at all levels, including costs of sending senior management to Japan to observe JITM and to develop 11 JITM training manuals and videos; and costs of a consultant.

While the Service acknowledged that moving and employee training costs were generally deductible under §162, exceptions existed and each situation must be "judged on its particular facts and circumstances bearing in mind that distinctions between current deductions and capital expenditures are often a matter of degree and not of kind." "The cost of physically reconfiguring Taxpayer's facilities are capital because they are part of an overall plan to convert to JITM and that plan, in itself, is capital in nature." The Service relied on *True, Jr.*, 894 F.2d 1197 (10th Cir. 1990) where the taxpayer was required to capitalize costs of moving manufacturing equipment to a new site as part of an overall plan that was capital in nature. The Service also noted that while costs to increase future operating efficiencies are not capital per se, such a benefit is to be taken into account in distinguishing capital expenditures from ordinary ones.

The materials and supplies were capitalizable because the items were not consumed during the year or consumed in the manufacturing process. Costs to produce training manuals are capitalizable even if they are continuously modified.⁴⁵ The employee training costs were held to be capitalizable, in part, based on *Cleveland Electric Illuminating Co.*, *supra*, that involved training utility company employees to operate a nuclear power plant where only a coal plant was used before. "The differences between Taxpayer's old manufacturing process and the new JITM process are similar to those in the Cleveland ... case. ... the JITM process represents a fundamental change in Taxpayer's operations and is a radical redesign of its manufacturing operations. ... [it] involves a "New Technician" who no longer operates just one piece of equipment, but is trained to operate many different types of equipment and given substantial new responsibilities." The Service did acknowledge though, that on-going training costs would fall under §162.⁴⁶

In contrast, in Rev. Rul. 2000-4,⁴⁷ the Service ruled that costs to obtain, maintain and renew ISO 9000 certification are deductible under §162. The Service concluded that the benefits derived from ISO 9000 certification are incidental and similar to current benefits of training, advertising and expenditures incurred to retain existing customers or to just improve the overall quality or attractiveness of the taxpayer's business operations. Per the Service, "these future benefits are incidental to the primary benefit of current sales" and are therefore currently deductible. The Service also referred to the *Briarcliff Candy* and *Sun Microsystems* cases⁴⁸ to support its §162 conclusion in that the "mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits." In addition, the Service stated that ISO 9000 certification is not like obtaining a license or certification that is necessary for market-entry (which would most likely be capitalizable). Finally, the Service noted that if any asset with a life greater than one year, such as a quality manual or equipment, was created or acquired in the certification process, the cost of such item would have to be capitalized.

2. Informal IRS Guidance

The Spring 2000 *ISP Digest Data Processing*, an informal publication of the Service's Data Processing ISP, includes an analysis of the tax treatment of web site development costs. The paper points out that if the taxpayer does not bear the economic risk of the project, then software is being purchased and capitalization is warranted. The *Digest* notes that if a purchased software tool is used to create the web page, then templates are being used and software development is not occurring. The *Digest* also suggests that web site development costs are not deductible advertising because they are more like a package design. Also, the *RJR Nabisco* holding (T.C. Memo. 1998-252) will not help a taxpayer's deductibility argument because the Service nonacquiesced to this decision (1999-40 I.R.B. 2; AOD 1999-012). Finally, the *Digest* discusses *Alabama Coca-Cola Bottling Co.*, T.C. Memo. 1969-124, which held that the cost of creating a billboard had to be capitalized, while periodic changes to the billboard display constituted deductible advertising. The *Digest* analogizes the billboard to the initial creation of the web site. The *Digest* concludes that the web site is a form of purchased software and the capitalized costs can be depreciated over three years under §167(f).

⁴⁵ *Domestic Management Bureau*, 38 BTA 640 (1938), acq. 1939-1 C.B. 10.

⁴⁶ A January 1996 article on Danaher's ruling in *Forbes* noted that the Service and taxpayer settled the issue by allowing the capitalized costs (\$9 million) to be amortized over 5 years. The article also notes that Danaher's tax director suggested to the Service that the costs might qualify for the research tax credit; an argument that apparently was not pursued after the offer of 5-year amortization. Saunders, "How to fight the IRS," *Forbes*, January 22, 1996.

⁴⁷ Rev. Rul. 2000-4, 2000-4 I.R.B. 331.

⁴⁸ *Briarcliff Candy*, 475 F.2d 775 (2d Cir.) and *Sun Microsystems*, T.C. Memo 1993-467.

In an outline presented at the 16th Annual SJSU/TEI High Technology Tax Institute in November 2000, Robert L. Rible, Team Manager – Communications, Technology and Media, Large and Mid-Size Business Division of the IRS, states: “To consider web site design similar to research and development under section 174 is stretching the human imagination beyond its normal limits.”

Queries – (1) Isn’t it inconsistent to refer to certain developed web sites as purchased software, yet take the position that the costs of creating web pages using a software tool (such as Adobe PageMill) is not software development? (2) If the costs of creating the web page that are analogous to building a billboard do not constitute software development and/or R&E and provide a more than incidental future benefit, thus warranting capitalization, how should such costs be segregated from deductible costs? (3) Will the Service issue guidance on the tax treatment of web site development costs so as to avoid settling the matter over the next ten years in the courts?⁴⁹

3. GAAP Guidance

(1) EITF Issue 00-2, *Accounting for Web Site Development Costs*

In March 2000, the Emerging Issues Task Force completed discussion on EITF Issue 00-2, *Accounting for Web Site Development Costs*. The consensus reached by the EITF provides that consistent with SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, not all web site development costs should be expensed. Generally, the EITF calls for the following treatment of costs:

Activity/Stage	Treatment
Planning – develop a business plan, determine functionalities of the site, conceptually formulate and/or identify graphics* and content, identify hardware and software needs, evaluate alternatives, select external vendors, address legal considerations	Expense
Web Application and Infrastructure Development Stage	Capitalize
Graphics Development Stage – initial graphics	Capitalize
Graphics Development Stage – enter initial content into the web site	Expense
Operation Stage – train employees, create updates, create new links, verify links, perform routine security reviews and usage analysis	Expense
Operation Stage – addition of new functionalities and features	Capitalize

* The EITF concluded that graphics are part of software and the cost of developing the initial graphics should be accounted for as under SOP 98-1 and FASB #86.

⁴⁹ Attorney Douglas W. Schwartz has written an extensive analysis calling for the Treasury Department and Service to issue a revenue procedure on the accounting treatment of web site development and modification costs. Mr. Schwartz recommends that the government accept the premise that that web site development costs are most closely analogized to software development costs, but should not necessarily be expensed under Rev. Proc. 69-21 and §174(a) as a web site is more than software development – it is more of a graphic document. Mr. Schwartz recommends that taxpayers be allowed a choice of two different accounting methods for web site development costs: 1) a pool-of-costs capitalization and 36-month amortization or 2) a site-by-site capitalization and 36-month amortization method. These methods would operate similarly to those provided for package design costs (Rev. Proc. 97-37). See Douglas W. Schwartz, on behalf of the 2000 Washington, D.C. delegation co-sponsored by the Tax Sections of the Los Angeles County and California Bar Associations; “Tax Accounting for Costs of Developing or Modifying Internet Web Sites;” pending publication in *The California Tax Lawyer*, Spring/Summer/Fall 2000. Also see 2000 TNT 208-65 (May 16, 2000).

The EITF does not address accounting for costs of web site content. These costs will be addressed in a separate document.

(2) SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

When FAS #86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, was issued in 1985, FASB decided not to address the treatment of costs of developing internal use software. However, given the "growing magnitude" of such costs and the fact that treatment varied among businesses, SOP 98-1 was issued.

SOP 98-1 defines internal-use software as "acquired, internally developed, or modified solely to meet the entity's internal needs" and "during the software's development or modification, no substantive plan exists or is being developed to market the software externally" [¶12]. The SOP lists four types of software: 1) software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process (costs to be treated per FAS #86), 2) software for use in R&D (costs to be treated per FAS #2 and FAS Interpretation #6), 3) software developed for others under a contract (costs to be treated per contract accounting rules), and 4) internal-use software (costs to be treated per SOP 98-1) [§6]. The appendix to SOP 98-1 contains 13 examples of internal-use software, as well as 8 examples of software that is not for internal use. The focus of the SOP definition of internal-use software is on whether the software is to be marketed to customers, rather than whether customers might use it in some manner. Example 10 in the SOP Appendix provides that a software database developed by a broker-dealer entity which then charges for financial information distributed through the database is internal-use software.

Generally, SOP 98-1 provides that software costs incurred in the Preliminary Project Stage are to be expensed as incurred. Costs incurred during the Application Development Stage should be capitalized. Capitalized costs (such as external direct costs, payroll and related costs for employees directly associated with the project, and interest costs, but not G&A and overhead costs) should generally be amortized using a straight-line method. Generally, capitalization ends when the software is "ready for its intended use after all substantial testing is completed." Costs incurred during the Post-Implementation/Operation Stage should be expensed as incurred. Costs of upgrades and enhancements generally should only be capitalized if it is probable that such expenditures will result in additional functionality (but see EITF 96-14 on Y2K costs). Special rules cover R&D costs, arrangements for multiple-element software, impairment, later marketing of internal-use software, and disclosures.

The stages of software development are described as follows in SOP 98-1:

<u>Preliminary Project</u>	<u>Application Development</u>	<u>Post-Implementation/ Operation</u>
(expense)	(capitalize)	(expense)
Conceptual formulation of alternatives	Design of chosen path, including software configuration and software interfaces	Training
Evaluation of alternatives		Application maintenance
Determination of existence of needed technology	Coding	
	Installation to hardware	
Final selection of alternatives	Testing, including parallel processing phase	

(3) EITF 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*

This EITF provides guidance on the accounting treatment of costs of implementing ERP and business process reengineering activities. Whether performed internally or by a third party, the EITF consensus as identified for four categories of costs involved in projects covered by the EITF is to treat costs as described in the following chart. The consensus gives consideration to SOP 98-1 on the treatment of internal use software costs.

Activity	Treatment
Business process reengineering and information technology transformation – preparation of request for proposal, assessment of current state, process reengineering, workforce restructuring	Expense
Preliminary software project stage– conceptual formulation and evaluation of alternatives, technology needs assessment, final selection of alternatives	Expense
Application development stage – software design and configuration, coding, installation to hardware, testing, development or acquisition of software that allows old data to be accessed by the new system	Capitalize
Application development stage –data conversion, training	Expense
Post-implementation/operation stage – training, application maintenance, ongoing support	Expense
Acquisition of fixed assets – computer equipment, office furniture, reconfiguration of work areas (architect fees and hard construction)	Capitalize

(4) SOP 93-7, *Reporting on Advertising Costs*

Generally, all advertising costs are to be treated as expenses in the periods in which the costs are incurred or the first time the advertising taxes place. However, for “direct-response advertising” designed to elicit sales from customers who can be documented as having responded specifically to the advertising and where the advertising results in “probable future benefits as assets” should be capitalized and amortized using a cost-pool-by-cost-pool method over the estimated useful life of the benefits. If tangible assets, such as billboards are created, the costs of such assets should be capitalized and depreciated. For purposes of SOP 93-7, production of film or videotape to communicate advertising is not a tangible asset.

B. Treatment of Intangibles

1. Transfer of a Domain Name

Typically, a business obtains a domain name by registering with a registrar⁵⁰ and paying a nominal fee (\$35 per year; first two years must be paid upon registration). Other times, a business may acquire a domain name that has already been registered by someone else.⁵¹ Some of these purchases have been quite newsworthy due to the dollar amount involved. For example, in January 2000, the name “loans.com” sold at auction for a reported \$3 million and in November 1999, the name “business.com” sold for \$7.5 million.⁵² Also, it was estimated that Compaq Computer paid \$3.35 million to AltaVista Technology, Inc. in 1998 to acquire the rights to the domain name “altavista.com.”⁵³ These types of situations raise the tax question for the buyer of how to treat the acquisition costs, and for the seller as to how to characterize the gain. Large amounts may also be allocated to a domain name when a taxpayer acquires another business in a taxable acquisition.

Some non-tax cases are useful to gain an appreciation of some of the factors that may exist to help the buyer determine the tax treatment and for the seller to classify the domain name asset.

⁵⁰ A list of accredited and accreditation-qualified registrars can be found at <http://www.icann.org/registrars/accredited-list.html>.

⁵¹ Domain names are also traded on the web, such as on E-Bay.

⁵² The Associated Press, “Loans.com Domain Name Sells for \$3 Million,” *New York Times*, Technology Section, January 31, 2000.

⁵³ Tom Diederich, “AltaVista domain name deal due soon,” *Computerworld’s Online News*, July 31, 1998; www.computerworld.com/home/news.nsf/all/9807315altav. For a site with news on domain name transfers, see www.igoldrush.com/.

In *Panavision Int'l v. Toeppen*,⁵⁴ T, an Illinois resident, had registered the domain name panavision.com and posted a picture of Pana, Illinois at the site. When P notified T that Panavision was a registered trademark, T tried to sell the name to P. P brought action against T in California on the basis that T had violated the Federal Trademark Dilution Act of 1995 and similar California law. The District Court held for P and T appealed. The Ninth Circuit affirmed. T's argument that California had no jurisdiction over him failed.

The court noted that where the only presence is through a web site, jurisdiction would only likely be found if there was "something more to indicate that the defendant purposefully (albeit electronically) directed his activity in a substantial way to the forum state." The court found that T had directed his activity (trying to obtain money from P) to California where P is headquartered. The court also stated that while T's burden of litigating in California is significant, it was not so great such as to deprive him of due process. The district court had even stated that due to fax machines and discount travel, litigating in California was not constitutionally unreasonable. The court also found with respect to the trademark dilution issue, T did make commercial use of the mark because he was in the business of registering trademarks as domain names and then selling them to their rightful owners.

In contrast, in *K.C.P.L., Inc. v. Nash*,⁵⁵ the court held that New York did not have jurisdiction over an individual. While the plaintiff referred to the defendant as a cyber-pirate, the court noted that the defendant did not compare to Toeppen. Toeppen had registered over 100 domain names most of which were trademarks of others, while Nash had only registered four with just one of them a trademark, although the court noted it was not a famous one. Thus, the court could not find that Nash had transacted business in New York. The court also noted that the long-arm statute of California was not as restrictive as that of New York.⁵⁶

Nature of the Asset for the Buyer: If Panavision had purchased the domain name from a third party, what type of asset would it be for tax purposes? Unlike the small registration fee, which might be viewed as having only a two-year life because failure to re-register will result in loss of the name, the amount paid to the third party lasts as long as the name remains registered with the owner. Could such a payment be expensed as extortion? Does such a payment fall within the definition of a §197 intangible (as a trademark protection expense per Treas. Reg. §1.197-2(f)(4)(i))? If not related to a trademark, does the asset fit within some other §197 category? What effect do renewals have on categorizing the asset? If not a §197 intangible, what is the depreciable life of the domain name asset?

Reg. §1.197-2(b)(1) defines a trademark as including "any word, name, symbol, or device, or any combination thereof, adopted and used to identify goods or services and distinguish them from those provided by others. ... A trademark or trade name includes any trademark or trade name arising under statute or applicable common law, and any similar right granted by contract." Is a domain name a "similar right granted by contract?" While domain names and trademarks appear to share some similarities, there are also some differences. Both domain names and trademarks serve to identify a business and may have distinctive characteristics. However, the purpose of a domain name is really to represent a series of numbers to locate a web site. Domain names are only unique in terms of the word comprising the name and do not have any distinctive shape, color, font, etc. Also, unlike a trademark, domain name can be issued as long as no one else has registered it,⁵⁷ there is no need to show that it will be used in commerce. Also, some things are can be registered as domain names, such as loans.com, cannot be trademarks because they are common words.

An article by David Hardesty suggests that a domain name derives its value from two key sources: 1) the name's association with a company or product (such as "Amazon.com"), and 2) inherent value that is not part of the trademark value, but the value from registration of the name (such as "drugs.com"). Hardesty argues that the value

⁵⁴ *Panavision Int'l v. Toeppen*, 141 F.3d 1316 (9th Cir. 1998).

⁵⁵ *K.C.P.L., Inc. v. Nash*, 1998 U.S. Dist. LEXIS 18464 (SD NY 1998).

⁵⁶ The non-tax cases dealing with jurisdiction in cyberspace raise an interesting nexus/due process issue for tax purposes (which is noted here because it is illustrated by such cases as *Toeppen* and *K.C.P.L.*, it does not pertain to issues under the Internal Revenue Code). While the *Quill* case (504 U.S. 298 (1992)) has already held that efforts to sell in a state (such as by mailing catalogs to residents) satisfies the due process requirement for sales and use tax jurisdiction, this may not be enough for all types of e-commerce businesses. For example, if a web site is selling regionalized merchandise (such as something related to a college or sports team in the area), yet anyone could order a product, has the business purposefully directed its activities to residents of the state? How many sales outside of the region would be necessary for a state not located in the region to make the business comply with state tax laws? Or is setting up a web site that does not prohibit customers in any particular state constitute directing activities to Internet users in all states?

⁵⁷ The Anticybersquatting Consumer Protection Act (P.L. 106-113, 11/29/99) which amends the trademark statute (15 U.S.C. § 1125(d)) may deter individuals from registering domain names intended to be similar to trademarks.

associated with the company or product can be treated as a trademark under §197, but that the inherent value cannot be treated as such.⁵⁸

Queries – (1) Isn't the inherent value of a domain name, as described by Hardesty, part of the broad definition of a trademark as provided in the §197 regulations? Some domain names that cannot be trademarked because they are a common name, such as *pets.com*, can still serve to identify a certain company (or mascot) on the web and is a registered right. Thus, isn't it a "similar right" granted by contract?

(2) Will Congress or the Service clarify whether a domain name should be treated as a §197 intangible? Arguably, this result would best meet the intent of §197 for simplicity

Characterization of Gain for the Seller: With respect to the seller, the domain name is not a capital asset if held by someone who is in the business of buying and selling domain names (as in the *Toeppen* case). That is, the asset likely falls within §1221(1) as property held primarily for sale to customers in the ordinary course of a trade or business. If a domain name was purchased for investment and the level of activity does not rise to the level of a trade or business,⁵⁹ then it must be determined if the name is a copyright, artistic composition, or similar property under §1221(3). Per §1.1221-1(c)(1), "similar property" refers to something that is eligible for copyright protection. The issue then falls under copyright law. Generally, words and phrases are not copyrightable because they do not have the minimal level of creativity.⁶⁰ But, if the owner's purpose of obtaining the domain name was the creativity of the name, might it be copyrightable? Resolution of this issue will likely first come from copyright cases, rather than tax cases.

If the domain name meets the definition of a trademark, §1253(a) provides that if the transferor retains any significant power, right, or continuing interest in the trademark, the transfer is not treated as a sale or exchange of a capital asset.

Purchase of an Existing Web Site: If instead of purchasing an already registered domain name, a taxpayer purchases an operating web site, the treatment described for the buyer and seller above may be different. Unlike a domain name, a web site might be a trade or business. If a buyer purchases a web site that is a functional trade or business or as part of a trade or business, §§197 and 1060 will likely apply to determine the tax treatment. The character of any gain or loss to the seller depends on how the asset was created and used.

2. Other Intangibles

Besides a domain name and trademark, other intangibles that an Internet start up or bricks and clicks company might have are copyrights and patents. A patent obtained on a company's R&D project is a §174 cost and accounted for using the taxpayer's §174 method (expensing or capitalization).⁶¹

An acquired interest in a patent or copyright is not a §197 intangible if the acquisition does not involve assets constituting a trade or business or substantial portion thereof (thus, "separately acquired rights"). Allowable deductions for such assets are to be determined under other rules. Congress directed that such deductions would be determined under regulations to be provided by the Service.

If the purchase price for a separately acquired interest (including an interest as a licensee) in a patent, patent application, or copyright is payable at least annually, as a fixed amount per use or a fixed percentage of revenue derived from use, the payor may deduct each payment in the year paid or incurred.⁶² In other situations, the cost of the patent or copyright (or an interest therein) is depreciated ratably over its remaining useful life. In addition, the regulations provide that if the patent or copyright becomes valueless prior to its legal expiration, its adjusted basis is deductible in that year.⁶³

⁵⁸ David Hardesty, "Taxation of Internet Domain Names – Can They Be Shoehorned into the 15-Year Amortization Rules?" *Journal of Taxation*, December 2000.

⁵⁹ There are several dealer versus investor cases under §1221(1), such as *Drummond v. Comm'r.*, T.C. Memo 1997-71 and *Guardian Ind. v. Comm'r.*, 97 T.C. 308 (1991), aff'd. without published opinion 21 F.3d 427 (6th Cir. 1994).

⁶⁰ See *CMM Cable Rep., Inc. v. Ocean Coast Properties, Inc.*, 97 F.3d 1504 (1st Cir. 1996), *Salinger v. Random House, Inc.*, 811 F.2d 90 (2d Cir. 1987), and cases cited therein.

⁶¹ Reg. §1.174-2(a)(1).

⁶² This suggestion came from Congress (H.R. Rpt. 111, *supra*, 1993-3 CB 345).

⁶³ Reg. §1.167(a)-14(c)(4) and §1.197-2(c)(7).

3. Transfers of Intangibles to a Corporation

Some bricks-and-mortar businesses have established Internet operations by forming a separate entity. Assuming that the Internet business will use the trade name, trademarks, customer data, goodwill, and other intangibles of the bricks-and-mortar business, consideration must be given to exactly what was transferred to the new entity to determine whether §351⁶⁴ applies or whether the shareholder(s) will have a gain from the items transferred in exchange for stock.

Existing guidance on the application of §351 where intangibles or other patent rights are transferred provides that whether such items or rights qualify as property is to be determined on a case-by-case basis. Generally, a patent right transferred to a corporation is considered property for §351 purposes.⁶⁵ The Service has held that the term property includes "secret processes and formulas" per §§861(a)(4) and 862(a)(4) and other secret information as to devices or process, whether or not a patent has been applied for. The item should be something that is subject to legal protection against unauthorized disclosure and use. Recording the idea on paper does not alone make it property.⁶⁶ If an item is not subject to protection from unauthorized use and rights to use under the law, it will likely not be viewed as property.⁶⁷

Where a transfer involves all substantial rights in the property, it will likely be viewed as a transfer of property under §351.⁶⁸ The IRS has ruled that to constitute a sale or exchange, all substantial rights to the patent must be granted to the corporation.⁶⁹ However, in *E.I. Du Pont de Nemours* case,⁷⁰ the court held that a non-exclusive license under a patent to manufacture, use and sell a particular product was property for §351 purposes even though the transferor kept certain rights in the patent. The Service argued that a transaction must qualify as a "sale or exchange" in order to be considered a "transfer" of property "in exchange" for §351 purposes. The court pointed out, however, that §351 is not involved with "true severance of control and true flow of gain." The sale or exchange language pertinent for capital gains transactions stresses a complete disposition by the taxpayer. On the other hand, §351 is "grounded in the taxpayer's continuance in control." The court ruled that the concept of sale and exchange is not relevant under §351. After reaching this conclusion, the court ruled that a non-exclusive license of "substantial value" which was "commonly thought of in the commercial world as a positive business asset" constituted property under §351.⁷¹ Similarly, in another case, the court stated that the term property "encompasses whatever may be transferred."⁷²

Case law has also addressed whether the item transferred to an entity in exchange for an ownership interest in the entity must constitute an enforceable property right. For example, a letter of intent was held to constitute property even though it was not legally enforceable.⁷³ The court pointed out that unpatented know-how, even though not enforceable, could be considered to be property, as could an exclusive right to use a trade secret.⁷⁴ Generally, if the item transferred encompasses a "sufficient bundle of rights" it is likely to be viewed as constituting property.⁷⁵

⁶⁴ IRC §351 provides that no gain or loss will be recognized if *property* is transferred to a corporation by one or more persons solely in exchange for stock and immediately afterwards, such person(s) are in control (80%) of the corporation (emphasis added).

⁶⁵ Treas. Reg. §1.351-1(a)(2).

⁶⁶ Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, 134.

⁶⁷ Rev. Rul. 79-288, 1979-2 C.B. 139.

⁶⁸ Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, 135; *amplified by* Rev. Rul. 71-564, 1971-2 C.B. 179.

⁶⁹ Rev. Rul. 69-156, 1969-1 C.B. 101, the ruling makes reference to I.R.C. § 1235 to determine whether all substantial rights to the patent were transferred. Also see Rev. Proc. 83-59, 1983-2 C.B. 575.

⁷⁰ *E.I. Du Pont de Nemours and Company v. U.S.*, 471 F.2d 1211 (Ct. Cl. 1973).

⁷¹ IRS reaction to the *Du Pont* case: Although in GCM 36,922 (11/16/76) the Chief Counsel recommended that Rev. Rul. 64-56, *supra*, be modified and Rev. Rul. 69-156, *supra*, be revoked, in light of the decision in the *Du Pont* case, such actions were never taken. Also see GCM 37,178 (6/24/77) and 38,114 (9/27/79).

⁷² *Stafford, supra*, referring to *Hempt Bros., Inc. v. U.S.*, 453 F.Supp. 1172, 1175 (M.D. Pa 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974).

⁷³ *Stafford, supra*.

⁷⁴ *Id.* at 1052, with reference to Rev. Rul. 64-56, *supra*, Rev. Rul. 71-564, 1971-2 C.B. 179, and Rev. Rul. 70-45, 1970-1 C.B. 17.

⁷⁵ *Stafford, supra*, at 1052.

If an item was developed solely for the corporation, the stock received may be viewed as provided for services. This may be a concern where the existing company will be involved in development of the web site for the new entity. The Service provides an example where a taxpayer was viewed as receiving payment for services for a plan he developed for selling insurance. If services are to be performed in connection with a transfer of property, the services are merely ancillary to the transfer, and consideration is received for both, §351 treatment can still result for the property. Whether services are considered ancillary and subsidiary to a transfer of property is a question of fact.⁷⁶

Also relevant in distinguishing a property contribution from the contribution of services is the content of any agreements related to the "transferor's" activities. For example, if the "transferor" is under an agreement with the transferee entity to perform services, the contribution of the results of such services in exchange for an interest in the entity will likely be viewed as given for payment for the services, and taxable to the recipient ("transferor"). If instead, the transferor works on his own behalf and then contributes the results of his activities to the entity, such contribution will likely not be viewed as for services.⁷⁷

Finally, even if the transferor contributes property in exchange for an interest in a corporation or partnership entity, it must be established that the interest is transferred in exchange for the property, and not for services, or some combination of property and services.⁷⁸

Procedures exist whereby taxpayers may obtain advance rulings from the Service under §351. Rulings may also be obtained as to whether a transfer of software is a transfer of property under §351.⁷⁹

C. Start Up Costs

A taxpayer may not deduct "start-up expenditures." Instead, if a timely election is made, §195 allows a taxpayer to amortize capitalized start-up expenditures ratably over a period no shorter than 60 months beginning with the month the active trade or business begins.

I. New Line of Business

Section 195 applies not only to an entirely new business and taxpayer, but also to an existing business that creates a new line of business. In the later situation, an issue is likely to arise as to whether the taxpayer has actually created a new business (for which §195 would be pertinent) or has instead expanded its existing business (for which §195 would not apply and the costs would likely be deductible under §162). Three recent rulings are described below to help explain the distinction between expansion of an existing business and creation of a new business.

In TAM 9310001 (11/4/92), the taxpayer was in the hospitality business and then entered a consulting and data gathering business to provide services to service-oriented companies. The Service stated that whether this was an expansion of the taxpayer's current business or a new business was a question of fact. The Service looked at whether the pursuit or activity was one for which the original business was established. It also looked at whether the new activity was within the compass of the taxpayer's existing trade or business. If the two activities were related such that an average business in that field would likely involve both activities, then under the Service's approach, the new activity would not be a new trade or business. If instead, the new activity required substantial amounts of new skills or expertise, then it would likely be viewed as a new business.⁸⁰ The Service concluded that the new activities constituted a new trade or business. The Service also held that the taxpayer's involvement in various industry trade associations, without compensation, was not sufficient for the taxpayer to be considered in

⁷⁶ See Rev. Rul. 64-56, *supra*, and cases cited therein.

⁷⁷ See *Stafford, supra*, at 1050.

⁷⁸ For example, in *Stafford, supra*, at 1054, after concluding that the letter of intent constituted property, the court noted that it must still determine whether the partnership issued *Stafford* an interest in the partnership as compensation for services to be rendered, or for contributing the letter of intent, or both.

⁷⁹ Rev. Proc. 74-36, 1974-2 C.B. 491 and Rev. Proc. 69-19, 1969-1 C.B. 301. The procedures for obtaining rulings under I.R.C. §351 are at Rev. Proc. 83-59, 1983-2 C.B. 575.

⁸⁰ Also see GCM 36,116 (11/14/72). Although the GCM predates §195, it can be viewed as helpful authority because in many §195 rulings, the Service refers to *Richmond Television Corp. v. U.S.*, 354 F.2d 410 (4th Cir. 1965), and other pre-§195 cases which involve when a new business begins. For example, see TAM 9310001.

an active consulting business and thus not enough to find that the taxpayer was expanding a business rather than starting a new one.

The Service also held that the new business had not yet started during the years under examination. Therefore, the taxpayer could not begin amortization of start-up expenditures under §195. The Service followed *Richmond Television*, 354 F.2d 410 (4th Cir. 1965), in determining when a new business begins. Under this approach, an active trade or business begins when it first functions as a going concern and performs the activities that it was organized to perform. During the years under examination, the taxpayer was still developing his service assessment system and trying to obtain customers, thus, he did not yet have a going concern.

The Service did not rule on whether the §195 election erroneously made by the taxpayer in year a (erroneous because his business did not start in year a) would allow him to instead begin amortization in later years. The Service did not rule on this matter because it held that the taxpayer's new business did not start in any of the tax years under examination. If the taxpayer failed to attach a §195 election statement to his tax return for the year his new business started (because he thought it started in an earlier year), it is not clear whether the earlier election will protect him for the later year.⁸¹

In TAM 9331001 (4/23/93), the taxpayer manufactured and sold cosmetics and clothing through a wholesale distribution network. At a later date, the taxpayer began a retail business for its goods. When the taxpayer began its retail operations, it elected to treat its start-up expenditures as amortizable over 60 months under §195. After opening its first retail store, the taxpayer opened ten more in different cities. All stores were set-up and operated similar to the first store.

In determining the proper treatment of pre-opening expenses under §§195, 162 and 263, the Service stated that it is "appropriate to look for a change in the nature of the activities that a taxpayer is engaged in" to determine whether a taxpayer has expanded an existing business or created a new one. In a footnote, the Service referred to the *Cleveland Electric Illuminating* case⁸² where the opening of a nuclear power plant by a utility was viewed as a new business relative to the utility's existing fossil fuel plant. The Service ruled that the activities involved in operating a retail store were substantially different from those of a manufacturer and distributor. Thus, when taxpayer opened its first retail store, it created a new business; it did not expand its old business. The opening of subsequent retail stores represented expansion of the taxpayer's business and §195 would not apply to the costs incurred in the expansion.

The Service raised the issue, but did not respond to it, as to whether the costs of expanding a business should be capitalized in light of the holding in *Indopco*. The IRS National Office suggested to the revenue agent that the Income Tax & Accounting branch be contacted if the agent wanted to pursue treatment of the expansion costs as not currently deductible.

In FSA 1999-1105, T deducted costs incurred to develop a new type of life insurance policy. The costs included wages, travel, training, and legal and accounting fees to obtain SEC approval, develop underlying actuarial assumptions, enhancing software and preparing training and marketing materials. Under the policy, the build-up is invested in mutual funds and thus, can only be sold by insurance agents who are also licensed stockbrokers. The Service described T's situation as expansion of a business, which creates a significant long-term benefit, thus requiring capitalization of the expenditures. The Service also noted that it did not matter whether T was trying to improve service to its existing market or to tap a completely new market. Relying on *Central Texas Savings & Loan*, 731 F.2d 1181 (5th Cir. 1984) and *Cleveland Electric Illuminating Company*, 7 Cl. Ct. 220 (1985), the Service stated that "expenses to establish a new product are capital if the new product is vastly different from existing products." The Service distinguished *Briarcliff Candy*, 475 F.2d 775 (2d Cir. 1973) which held that a taxpayer could expense costs of finding new ways of selling its existing product. "*Briarcliff Candy* can be distinguished on the grounds that it involved expenses incurred to market the company's existing products differently." There was no discussion in the TAM as to the application of §195 (presumably because T did not make a §195 election).

2. When Does a Business Start

Section 195(c)(2)(A) provides that the determination of when an active trade or business begins is to be made in accordance with the regulations. However, such regulations have never been issued. Section 195(c)(2)(B) provides a more specific guideline with respect to an acquired business by stating that an acquired active trade or

⁸¹ See final §195 election regulations issued in December 1998 (T.D. 8797) on the election procedures under §195.

⁸² *Cleveland Electric Illuminating Co. v. U.S.*, 7 Cl. Ct. 220 (Cl. Ct. 1985).

business is treated as beginning when the taxpayer acquires it; thus, such a taxpayer clearly knows when to make a §195 election. However, a taxpayer that is starting a new business from scratch, needs to know when business begins for §195 purposes so that it will know when to make the §195 election and what expenditures fall under §195.

The legislative history to §195 states:

Generally, it is anticipated that the definition of when a business begins is to be made in reference to the existing provisions for the amortization of organizational expenditures (Code Secs. 248 and 709). Generally, if the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.⁸³

Regulations under §248 provide that generally a corporation begins business "when it starts the business operations for which it was organized."⁸⁴ The corporation begins business when it has advanced to the point where the nature of its business operations is established such as by acquiring its operating assets. The §248 definition of when business begins may produce an unfavorable result for some taxpayers because the point that a corporation begins business for §248 purposes might be before it meets the definition of "carrying on" a trade or business for §162 purposes. The result of such an interpretation would be that expenditures incurred between the business starting date for §248 purposes and the carrying on date for §162 purposes would not fall under either §162 or §195 and would instead be permanently capitalized. The Service has recognized this problem in private letter rulings under §195 and has used §162 as the definition of when a business begins.⁸⁵

In PLR 9047032, the Service relied on the rule set out in the *Richmond Television* case⁸⁶ for when a business begins. This case predates §195, but is the seminal case to address when a new business may begin to treat expenditures as deductible under §162. This standard is referred to as the "going concern" standard. To have begun business for §162 purposes, the taxpayer must not only have acquired its operating assets, but must also be using them to conduct actual business operations. Generally, a business is considered to have begun when it is ready to receive revenue. In the *Richmond Television* case, the court held that training employees did not constitute start of a business. Instead, business did not start until the taxpayer received its broadcasting license and began to broadcast. In PLR 9047032, the Service stated that it was not enough to have acquired the necessary operating assets, but that they must also be put to productive use in the business; "actual business operations must commence."

In TAM 9027002, the Service stated that an active business did not begin for §195 purposes until it started to market the works for which it went into business to market. It did not matter that the taxpayer had made a firm decision to enter the particular business and had spent a large amount of money preparing to enter the business.

Election Procedure: Final regulations were issued in December 1998 (T.D. 8797) to address the election procedure under §195. The election statement is to be filed no later than the date for filing the return (including extensions) for the tax year in which the active trade or business begins. "The statement may be filed with a return for any taxable year prior to the year in which the taxpayer's active trade or business begins, but no later than the date prescribed in the preceding sentence." [§1.195-1(b)] The election statement is to describe the trade or business and a description of each start-up expenditure and the month the active trade or business began or was acquired. A revised statement may be filed to include start-up expenditures that were not included in the original election, "but the revised statement may not include any expenditures for which the taxpayer had previously taken a position on a return inconsistent with their treatment as start-up expenditures."

3. Included and Excluded Expenses

"Start-up expenditure" means amounts paid or incurred in connection with i) investigating the creation or acquisition of an active trade or business, ii) creating an active trade or business, or iii) any activity engaged in for

⁸³ S. Rpt. No. 96-1036, 96th Cong., 2d Sess. (1980), *reprinted in* 1980 U.S.C.C.A.N. 7293, 7304. I.R.C. § 195 was added by the Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 102, 94 Stat. 3521..

⁸⁴ Treas. Reg. §1.248-1(a)(3). Beginning business is to be distinguished from being in existence. A corporation is in existence on its date of incorporation.

⁸⁵ Additional support for the Service's use of the §162 standard for when a business begins, rather than the §248 standard perhaps also exists from the addition of the word "active" to §195(b) by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 94(a), 98 Stat. 494. The Service confirmed this interpretation in PLR 9047032 (Aug. 27, 1990).

⁸⁶ *Richmond Television Corp. v. Comm'r.*, 354 F.2d 410 (4th Cir. 1965).

profit and the production of income prior to when an active trade or business begins, in anticipation of the activity becoming an active trade or business. The expenditure must be one that would be allowable as a current deduction if incurred in connection with the operation of an existing active trade or business. Start-up expenditures do not include deductions allowed under Sections 163(a) (interest), 164 (taxes) or 174 (R&E). An Internet start-up company must not only distinguish between §§ 195 and 162, but must also consider what expenditures fall under §174.

“Common types of start-up expenses (which are distinguishable from investigatory costs insofar as start-up expenses are incurred AFTER the decision to acquire a business is made but BEFORE actual operations begin) include advertising costs; salaries and wages paid to employees and their instructors for training; travel and related expenses incurred in the course of finding potential distributors, suppliers and customers; salaries and fees paid to executives and consultants, as well as for professional services; and, other pre-opening expenses which if paid or incurred in the operation of an existing trade or business would be allowable as a deduction.”⁸⁷

Investigatory versus acquisition costs: Rev. Rul. 99-23, 1999-20 I.R.B. 3, explains when expenditures incurred in acquiring the assets of an active trade or business qualify as "investigatory" costs eligible for amortization as start-up expenditures under §195. The Service based its conclusion on Rev. Rul. 77-254, which is mentioned in the legislative history to §195. Under this ruling, expenses incurred in a general search for, or an investigation of, a business that pertain to whether to purchase a business and which business to purchase are investigatory costs. "Once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital." The "final decision" mentioned in the §195 legislative history in describing when costs are no longer considered "investigatory" "is the point at which a taxpayer makes its decision whether to acquire a business, and which business to acquire, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction." Since any non-investigatory costs are incurred for a long-term benefit, they must be capitalized. All facts and circumstances are to be considered in determining whether expenditures related to acquisition of a business are "investigatory" costs.

Similarly, see TAM 199901004 (released prior to issuance of Rev. Rul. 99-23) where the Service held that the "whether and which" decision constituted a final decision under §195. Also see TAM 9825005 where the Service stated that the expenses incurred by taxpayer in acquiring a bank indicated that it had "gone beyond a general search or preliminary investigation of Bank 1 and had decided to acquire Bank 1." Thus, the costs had to be capitalized under §263 as acquisition costs, and therefore, cannot be §195 start-up costs.

D. Barter Transactions

In IR-2000-03 and Notice 2000-6, 2000-3 I.R.B. 315, the Service announced that it was eliminating the reporting requirement (1099-B) for barter exchanges with respect to transactions involving property or services worth less than \$1.00. This change is effective for transactions reportable on or after January 5, 2000. The rationale is that there is "a growing number of barter exchanges that, through the use of electronic or Internet services, engage in millions of transactions daily involving property or services with very low fair market values" and the burden of filing will outweigh the usefulness of the information for revenue purposes. The Service also seeks comments on how new bartering reporting regulations (§6045) should address whether a per-transaction exception should apply only in situations where an aggregate annual limit is not exceeded, whether annual reporting of certain property or services bartering should be required rather than reporting each transaction separately, and whether any special rules are needed for bartering of electronic or Internet services. Comments were requested by April 4, 2000.

Observation: The types of electronic service that the IRS *seems* to be addressing with the new reporting exception are banner ad exchanges of an inconsequential amount and ones where each impression is viewed as a separate advertising transaction. However, it would be helpful to know how these nominal value exchanges should be valued (since \$.99 and less is almost the equivalent of \$0). For examples of the type of exchanges the Service might be addressing with the exemption, visit (no endorsement intended):

<http://www.pegasoweb.com/pwbanners/banners.html>

<http://www.bannerexchange.com/>

http://www.adbility.com/ba_exchange.htm

⁸⁷ Field Service Advice (FSA) 1998-438.

With respect to low value ad impressions, a survey released in August 2000 found that the average cost for 1,000 ad banners was \$30 to \$31, or about 3¢/banner.⁸⁸

More Information: A barter exchange is defined at §6045(c)(3) as "any organization of members providing property or services who jointly contract to trade or barter such property or services." Regulations clarify that an exchange "does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis." Per Reg. §1.6045-1(e)(2)(ii) reporting is not required if the barter exchange has fewer than 100 exchanges during a calendar year. Note that bartering done outside of a bartering exchange may still need to be reported on Form 1099-MISC (rather than 1099-B), such as where it is the equivalent of a business paying a contractor with non-cash property totaling \$600 or more for the year. When required, Form 1099-B is due to payees on or before January 31 of the following year.

The penalty for failure to timely file Form 1099-B or to file a 1099-B with incorrect or missing information is provided in §6722. The penalty is \$50 per missed payee 1099-B, with a \$100,000 cap. If the failure is due to intentional disregard, the penalty is the greater of \$100 or 5% of the aggregate amount of the items required to be reported correctly; there is no dollar limitation.

Queries: Why is the de minimis amount so low? Is there more value in processing 1099s for \$1.00 versus \$0.99? Even interest income only needs to be reported on a 1099 if it is \$10 or more. How should these swaps be valued?

Potential Timing Issue: While the exchange values are presumed to be equal (assuming arm's length transactions are involved), the timing of the revenue and expense may not match which would then make a "tax difference" that would necessitate valuing and properly reporting the swap.

Example: Small.com and Big.com are accrual method businesses. Small.com uses a calendar year as its tax year, while Big.com uses a year ended June 30. These entities enter an agreement to allow each to display a banner ad on the other's web site. The parties acknowledge that Small.com will get more "hits" per day on Big.com's web site than will Big.com get on Small.com's site. So, this fact is factored into the exchange agreement. Small.com will get to display its ad for 30 days, while Big.com will get to display its ad for 90 days. The start of both periods is December 15, 2000. Small has never actually sold banner space for cash (only barter), but Big.com has sold banner space for \$15,000 cash for a 30-day period.

Small.com appears to have incurred \$7,500 of advertising expense in 2000 (15/30 of \$15,000). However, Small.com has only earned \$2,500 of advertising revenue in 2000 (15/90 of \$15,000). Thus, because the timing of the income and expense does not match, Small.com cannot merely report \$0 revenue and expense for this exchange. Also, it will be important for the parties to be able to place a value on the transaction. Big.com's advertising expense and related advertising revenue both fall within the same tax year (year ended June 30, 2001).

GAAP Guidance: In response to the SEC's request for guidance on the treatment of banner ad exchange, the Emerging Issues Task Force released EITF 99-17, *Accounting for Advertising Barter Transactions*, in January 2000. The EITF concludes that revenues and expenses associated with advertising barter transactions should only be recognized when the entity has an historic practice of receiving or paying cash for similar transactions. Historic practice refers to the six months prior to the date of the barter transaction, unless such transactions are not representative of the current value of ads, in which case a shorter period should be used. "Similar" transactions refers to those in the same media and within the same advertising vehicle as the bartered advertising. In addition, the characteristics, such as circulation, timing and viewer demographics must be similar.

E. Selected Tax Accounting Considerations

1. Timing of Commissions

Some Internet vendors broaden their presence on the Internet by entering into contracts with web site hosts who will display the vendor's icon with a link to the vendor's web page. Typically, when a person (other than the web site host) links to the vendor's page from the web site host's page and buys something, the web site host earns a commission. For example, Amazon.com has an "Associates Program" under which individuals and organizations may earn money through sales made at Amazon.com's site when it was linked to from the organization's web page. The relationship is started when the host submits an application that is accepted by Amazon.com. Amazon.com provides some assistance with the linking arrangement for the host's site. A link can be provided that leads to a

⁸⁸ Susan Stellin, "A Short Life for Ads at Top of Web Pages," *New York Times*, Technology Section, August 28, 2000; survey by AdRelevance.

letter from the president of Amazon.com stating that they are pleased to have "host" in the "family of Amazon.com associates" and that they will ship books and provide customer service for the orders. Amazon.com is solely responsible for processing all orders. The agreement spells out the terms for calculating referral fees that are paid on a quarterly basis based on products shipped, although fees of less than \$25 are deferred to a subsequent quarter. The agreement states that no agency relationship is created and that the host does not have any authority to make or accept any offers or representations on behalf of Amazon.com. Bn.com has a similar program called the "Affiliate Network." Borders.com has a similar program called the "Friends & Associates Program."

The commonly raised issue with the "associates" arrangement is whether the vendor has nexus in the states where it has hosts. This issue is not discussed here; instead, the federal domestic tax issues are explored.⁸⁹

For a cash method host, revenue from an associates program is reported when earned. For an accrual method host, the "all events test" of Treas. Reg. §1.451-1(a) governs when revenue is to be reported. Under this test, items are includible in gross income when,

- 1) all events have occurred which fix the right to receive such income, and
- 2) the amount thereof can be determined with reasonable accuracy.

Rev. Rul. 74-607 provides that all events are fixed at the earliest of (1) required performance occurs, (2) payment is due, or (3) payment is made. In *Hallmark Cards v. Commissioner*, 90 T.C. 26 (1988), the court stressed that the date that the legal rights to the income arise is the income accrual date.

Thus, an accrual method host will need to review its operating agreement with the vendor to determine when the legal right to the revenue arises. For example, the Amazon.com operating agreement states: "For a Product sale to be eligible to earn a referral fee, the customer must follow a Special Link from your site to our site, select and purchase the Product using our automated ordering system, accept delivery of the Product at the shipping destination, and remit full payment to us."⁹⁰

For an accrual method taxpayer, it would seem that revenue is earned when the books are shipped, even though the commission won't be paid until the end of the quarter (or later under some arrangements where payment must be of a certain amount before a check is mailed). The shipping date is likely the key date because most orders are not sent until payment is made by the customer (usually by credit card) and it is unlikely that most orders don't get delivered. Thus, the accrual method taxpayer needs some way of knowing when products are shipped on which it has earned a commission. The three Internet booksellers noted above provide such information to their hosts via the web site. If a vendor does not provide such information, then arguably, the second prong of the all events test is not satisfied. That is, the amount cannot be determined with reasonable accuracy until the host receives some type of shipping report or actual payment.

2. *Hosting Arrangements*

E-commerce has likely expanded or accelerated the various innovative ways that software can be transferred to and used by customers. For example, there has been a recent trend for so-called ASP arrangements. ASP refers to *application service provider*. ASPs host software on servers that can be accessed by customers, usually through a rental or lease arrangement, sometimes with an option to buy. The key advantage to users is ease of access and maintenance of the software.⁹¹ The myriad of ways that software can be transferred raises tax issues as to the nature of the revenue (royalty, sale of goods, service, etc.). The nature of the revenue is important for the following tax reasons:

- (1) Character of the resulting income: If the transferred item is a capital asset that is sold, capital gain will result; if it is not a capital asset, or is licensed or constitutes service income, ordinary income will result. It is also important (for both parties) to distinguish what has been transferred—an intangible (such as a copyright) or a copyrighted item. For certain transfers of a patent, special capital gain treatment of §1235, *Sale or exchange of patents*, may be available to the transferor.

⁸⁹ For a discussion of the state nexus issues, see "Background Outline" at www.cob.sjsu.edu/facstaff/nellen_a/e-links.html.

⁹⁰ See article 4 of the Amazon.com operating agreement at www.amazon.com/exec/obidos/subst/associates/join/operating-agreement.html.

⁹¹ For more on ASPs, see http://www.eserver.com/businesses/asp/what_is_an_asp.asp.

- (2) Timing of income recognition: If the transferred item is licensed, income is likely earned by an accrual basis taxpayer ratably over the license period; if the item is sold, income is recognized upon sale, unless the installment method applies.⁹²
- (3) Passive versus active income: Under some tax provisions, royalty income from licensing can produce adverse tax consequences, such as personal holding company status, passive investment income of an S corporation, or possibly constitute income from a passive activity under §469.
- (4) Various foreign provisions: Sourcing—royalty income is generally sourced where the property is used, while sale of goods income is sourced per the residence of the seller. Also relevant for foreign tax purposes, withholding on royalties, and per the regulations under §1.861-18 (explained later)—sale versus license versus services can be relevant under §§367, 404A, 482, 551, 679, 842, 845, 1057, and 1059A.

Sale versus Lease versus License

- Rev. Rul. 55-540, 1955-2 C.B. 39⁹³—For tax purposes, whether a transaction is a lease or a sale depends on the intent of the parties as evidenced by the terms of the transaction. A transaction will most likely be classified as a sale if one or more of the following conditions exists:
 - a) A portion of each periodic payment made by the customer is specifically to acquire an equity interest in the property.
 - b) The customer will acquire title to the property once they make a stated amount of payments.
 - c) The total amount to be paid by the customer for a relatively short period of use is an "inordinately" large proportion of the total amount to be paid to obtain title to the property.
 - d) The periodic payments materially exceed the fair rental value.
 - e) The agreement includes a purchase option that allows the customer to obtain the property for a nominal amount relative to the total amount of periodic payments to be made.
 - f) A portion of each periodic payment made by the customer is designated as interest.

A transaction may be classified as a sale even if title does not transfer, provided at least one of the above factors is present.

- TAM 9231002—The Service applied Rev. Rul. 55-540 (and other guidance) to hold that updates for off-the-shelf software should be treated as goods, rather than as services. The Service also held that the deferral provisions of §1.451-5 could apply to the amount received in advance for the maintenance agreement (to provide updates).

Example: Taxpayer receives \$100x for a five-year extended maintenance contract and reports \$20x income per year for financial reporting purposes. Under §1.451-5, taxpayer would generally report the \$100x in year 3. However, since \$20x is reported for books each year, taxpayer's deferrals for tax purposes may not be greater than the book deferrals, thus the taxpayer would report \$20x in both years 1 and 2 of the contract and \$60x in year 3.

- *Grodt & McKay Realty v. Comm'r.*, 77 T.C. 1221 (1981)—8 factors are relevant in distinguishing a lease from a sale:
 - (i) Whether legal title passes;
 - (ii) How the parties treat the transaction;
 - (iii) Whether an equity was acquired in the property;
 - (iv) Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;
 - (v) Whether the right of possession is vested in the purchaser;
 - (vi) Which party pays the property taxes;
 - (vii) Which party bears the risk of loss or damage to the property; and

⁹² Whether the installment sale method of §453 can apply to payments received over more than one tax year for the transfer of software depends on whether the item transferred is considered inventory or dealer property in which case the installment sale method is not allowed.

⁹³ Also see Rev. Rul. 75-21, 1975-1 C.B. 715.

(viii) Which party receives the profits from the operation and sale of the property.

- Sale - transfer of title, or transfer of benefits and burdens of ownership may be sufficient. Seller gives up all substantial rights.
- Final regulations providing guidance on the classification of revenues from transactions involving computer programs under certain international provisions of the Code were issued at §1.861-18 (T.D. 8785; 10/2/98; replacing proposed regulations at REG-251520-96; 11/13/96). The rules contained in these regulations enable taxpayers to categorize transactions involving computer programs as being either: sales, licenses, leases, the provision of services, the provision of know-how, or some combination of these transactions. The regulations only apply for purposes of IRC §§861 through 999, 367, 404A, 482, 551, 679, 1059A, 1441 through 1465, 1491 through 1494, 842 and 845 (to the extent involving a foreign person) and for transfers to foreign trusts not covered by section 679.⁹⁴

The chart below summarizes the six types of transactions described in the regulations. The regulations contain 18 examples to help illustrate their application; these examples are referenced in the chart.

Transaction	Regulation §1.861-18
<p>Transfer where transferee (TE) acquires one or more of the following rights:</p> <ul style="list-style-type: none"> (i) to make copies of CP to distribute to the public by sale or other transfer of ownership, or by rental, lease or lending; (ii) to prepare derivative CP based upon the copyrighted CP; (iii) to make a public performance of the CP; or (iv) to publicly display the CP. <p>CP = computer program⁹⁵</p>	<p>Transfer of © rights, that is either:</p> <ul style="list-style-type: none"> (1) a sale or exchange of property (©) - if, based on the facts and circumstances, all substantial rights in the © have been transferred (per the principles of §1222 and §1235, as well as case law (even cases not specifically addressing §1222 and §1235)); [Income to be sourced per §865(a), (c), (d), (e), or (h) as appropriate.] [Example 5] <p>or</p> <ul style="list-style-type: none"> (2) a license of a © generating royalty income - if not all substantial rights have been transferred. [Income to be sourced per §861(a)(4) or §862(a)(4) as appropriate.] [Examples 6 and 8] <p>© = copyright</p>

⁹⁴ §1.861-18(a)(1).

⁹⁵ Per §1.861-18(a)(3), a computer program is defined as a "set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result." A computer program includes "any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program."

Transaction	Regulation §1.861-18
<p>TE acquires copy of CP, but does not acquire any of the rights (i) - (iv) listed above (or only acquires a de minimis grant of such rights), and either no services or a de minimis amount of services are involved, or a de minimis amount of know-how is involved.</p>	<p>Transfer of copyrighted article,⁹⁶ that is either:</p> <p>(3) a sale or exchange of a copyrighted article if the benefits and burdens of ownership have been transferred; [Income to be sourced per §861(a)(6), §862(a)(6) §863, §865(a), (b), (c), or (e), as appropriate.] [Examples 1, 2, 7, 9, 10, 11, 13, 14, 17, and 18]</p> <p>or</p> <p>(4) a lease of a copyrighted article (generating rental income), if insufficient benefits and burdens of ownership have been transferred. [Income to be sourced per §861(a)(4) or §862(a)(4), as appropriate.] [Examples 3, 4, and 12]</p>
<p>Provision of services for the development or modification of a CP. Provision of services is to be distinguished from other transactions by considering "all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties." [§1.861-18(d)]</p>	<p>(5) Provision of services. [Example 15]</p>
<p>Provision of information with respect to a CP that:</p> <ol style="list-style-type: none"> 1) relates to computer programming techniques; 2) is furnished under conditions preventing unauthorized disclosure; and 3) is considered property subject to trade secret protection. 	<p>(6) Provision of know-how relating to computer programming techniques. [Example 16]</p>
<p>Transaction involving more than one category above.</p>	<p>Treat as separate transactions, with appropriate provisions applied to each transaction. "However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction."⁹⁷</p>

⁹⁶ Per §1.861-18(c)(3), "copyrighted article" includes "a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium."

⁹⁷ §1.861-18(b)(2).

3. *Subscription Income*

Some Internet companies may be selling content with delivery made via the Internet. Also, some Internet Service Providers are also providing content, such as AOL. Also, some publishers deliver newspapers and magazines, not only in tangible form, but also via the Internet. These types of companies should consider whether existing favorable tax rules on subscription income apply to them. Of course, these decades-old rules were not written with the Internet and E-commerce in mind. Two of these old provisions that may apply to some Internet “publishers” are §455, *Prepaid subscription income*, and §458, *Magazines, paperbacks, and records returned after the close of the taxable year*.

Section 455 allows eligible taxpayers to defer prepaid subscription revenue to the period in which the taxpayer’s liability to furnish or deliver the periodical arises. “Prepaid subscription income,” is defined as any amount “received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received, and which is income from a subscription to a newspaper, magazine, or other periodical.” Neither the statute nor regulations define “other periodical.” Rev. Rul. 71-139, 1971-1 C.B. 143, held that §455 applied to certain publications of a taxpayer who generated income from looseleaf services providing legal and business information and training materials. The looseleaf services were updated at stated intervals with new releases relating with prior releases. However, the training materials were not updated and could be purchased at any time. The Service referred to Webster’s dictionary to define periodical as “published or appearing with a fixed interval (more than one day) between the issues or numbers.” Based on this definition, the Service found that the looseleaf services were “other periodicals” under §455, but that the training materials were not. “A subscription for a series of books contemplates a sale of specifically described volumes, each complete in and of itself with no inherent continuity and no contemplation that it will be updated or supplemented in any way. Such a subscription would not qualify for deferral under section 455 of the Code.”

Arguably, a publisher of a newspaper or magazine that now also distributes its periodicals via the Internet will still be entitled to the benefits of §455 as the product would still meet the definition of a “periodical” regardless of how distributed. However, an on-line content provider may not be delivering a periodical as defined in Webster’s dictionary. There may be no expectation of regular delivery and it may not be connected to prior distributions. However, the particular facts of a situation should be evaluated.

Section 458 allows an accrual method seller of magazines, paperbacks, and records to exclude from gross income amounts from returns received within a specified period following year end. In 1992, regulations under §458 were issued that also address new items that the Service believed should be covered by §458. An excerpt from the preamble to T.D. 8426 (8/26/1992) regulations under §458 provides:

“Definition of Magazine and Record - In response to suggestions from commentators, changes were made in the definitions of “magazine” and “record.” First, the definition of magazine was revised to reflect the treatment of “annuals” or “oneshots”-supplements to monthly or weekly periodicals that are issued annually-as magazines. These annual supplements are issued in basically the same format and appearance as magazines issued at regular intervals. To be treated as a magazine under section 458 of the Code, the annual publications must relate by title or subject matter to a magazine and must otherwise qualify as a magazine under section 458. Second, the definition of “record” was expanded to include video cassettes in response to commentators’ concerns that the definition of “record” was unduly restrictive by its exclusion of items that also contain a visual recording. There is no evidence of any Congressional intent to exclude video cassettes at the time of the enactment of section 458 and commentators indicated that the distribution of recordings with visual content is the same as for recordings without visual content. Finally, compact discs and laser discs are specifically included as examples of ‘records.’”

A recent ruling from the Service analyzed the potential broadness of §458 in a situation involved subscriptions to video games. In TAM 9730006 the Service held that a video game cartridge qualified as a “record” per §458 and §1.458-1(b)(3) because its pre-recorded sound was a “relatively substantial and an integral part” of the item and sufficiently material compared to the non-audio components of the cartridge. Thus, a taxpayer who distributes such games could elect to exclude from gross income amounts returned within a specified time after year-end. Unfortunately for the taxpayer in the TAM, it had not properly elected to use the §458 method and had not actually used it. Thus, the Service required it to use the normal accrual method, rather than the §458 method.

4. Services versus Goods

Inventory rules represent another area where the rules were written for the industrial era, rather than the information era. Practitioners are likely to encounter businesses engaged in new ways of delivering items to customers (particularly digitized products) and new types of intermediaries assisting in matching buyers and sellers where issues will arise as to whether the intermediary is subject to the inventory and accrual accounting rules.

Example 1: Ostrich Software is a sole proprietorship that develops and transfers educational software. OS only sells to customers via the Internet—both the software and payment (by credit card) are transferred via the phone lines. The software is not customized, but is off-the-shelf type software. OS expenses its software development costs under §174 and has no §263A costs. Is OS required to use the accrual method of accounting? Is it subject to §471 on the premise that it is selling "something"? If the software is considered inventory, is it de minimis?

Example 2: This example is taken verbatim from EITF 99-19, *Recording Revenue Gross as a Principal versus Net as an Agent*.⁹⁸ “Company A facilitates the sale of home furnishing products. Each product marketed has a unique supplier and that supplier is identified in product catalogs distributed to customers. Company A maintains no inventories of products in advance of customer orders. Company A takes title to the products ordered by customers at the point of shipment from suppliers. Title is passed to the customer upon delivery. The gross amount owed by a customer is charged to the customer’s credit card prior to shipment and Company A is the merchant of record. Company A is responsible for collecting the credit card charges and must remit amounts owed to suppliers regardless of whether that collection occurs. Suppliers set product selling prices. Company A retains a fixed percentage of the sales price and remits the balance to the supplier. Written information provided to customers during marketing and included in the terms of sales contracts states:

Company A manages ordering, shipping, and billing processes to help you purchase home furnishing products. Company A does not buy, sell, manufacture, or design the products. When you use Company A, you are purchasing the products from the Suppliers. Company A has no control over the quality or safety of the products listed. Orders will not be binding on Company A or the Suppliers until the applicable Supplier accepts them. Company A will process your requests for order changes, cancellations, returns, and refunds with the applicable Supplier. All order changes, cancellations, returns, or refunds are governed by the Supplier’s policies, and you agree to pay additional shipment costs or restocking charges imposed by the Supplier. You agree to deal directly with the Supplier regarding warranty issues. Company A will not be liable for loss, damage, or penalty resulting from delivery delays or delivery failures due to any cause beyond reasonable control.”

Is Company A required to account for inventories and use the accrual method of accounting?

⁹⁸ EITF 99-19 addresses the accounting issue as to when a sale should be reported as gross (as if the business was the seller) or at net (as if the business only earned a commission for facilitating a sale). The SEC’s concern with the varied accounting treatment it was seeing among some Internet companies was that if a company reported at gross when it should have been net, it had artificially inflated its revenues, and likely its stock price. For a discussion of the tax issues in this area, see the Appendix to this outline. The situations described in EITF 99-19 also raise potential tax issues as to who is liable to collect sales tax on the sale.

EITF 99-19 provides a list of factors that are to help in determining whether a company should report revenues at gross or net. None of the indicators are to be considered presumptive or determinative. Per EITF 99-19 a company should report revenue at gross if it: (1) is the primary obligor of the arrangement, (2) has general inventory risk, (3) has latitude in setting prices, (4) changes the product or performs part of the service, (5) has discretion in selecting suppliers, (6) is involved in determining product or service specifications, (7) has physical loss inventory risk, and (8) has credit risk. A company should report revenue at net if: (1) the supplier is the primary obligor in the arrangement, (2) the amount earned by the company is fixed, and (3) the supplier has credit risk. EITF 99-19 includes 13 examples to help illustrate application of the indicators.

III. Issues for Internet Start Up Companies

Listed below, in no particular order are some issues and considerations for start-up companies, such as planning for optimal use of accounting methods and usage of any net operating loss (NOL).

1. Use of Stock to Entice Customers

In recent years, there have been two court decisions that have addressed the use of stock warrants as a volume discount for customers. Both cases held that the company was entitled to a deduction for the spread that existed in the stock warrant upon its eventual exercise by the customer (this spread would also constitute income to the customer). These cases, summarized below, are interesting examples of how a high technology company may consider using its stock to preserve cash, the tax issues raised, and the need for legal documentation for the transaction.

*Sun Microsystems, Corp. and Subsidiaries:*⁹⁹ In 1983, Sun Microsystems (SMS) entered into various agreements with Computervision Corporation (CV), an unrelated taxpayer. A 3-year purchase agreement gave CV a 40 percent discount on all purchase orders during the first six months and thereafter a maximum volume discount of 40 percent off the list price of workstations, as well as a 5 percent cash discount for prompt payment. The parties also entered into an investment agreement whereby SMS agreed to issue two stock warrants to CV as part of the overall agreement. The first stock warrant allowed CV to purchase 10,000 shares of Series F preferred stock at \$120 per share, exercisable once CV purchased \$20 million of products within 36 months of SMS's first shipment to CV. The second warrant allowed CV to purchase 10,000 shares of Series G preferred stock at \$150 per share, exercisable when CV's purchases exceeded \$30 million within the 36 month period. The purchases amount included royalties payable by CV to SMS pursuant to a joint development agreement. The parties also agreed that SMS would borrow from CV by way of \$1.5 million convertible debenture and a \$1 million note. The last part of the agreement was a technology exchange whereby the parties would contribute to the design of "superseding generations of intelligent workstation products which would be jointly owned by CV and SMS."

The goal of SMS in the agreements was to try to establish a relationship with a large company in order to increase sales and obtain the credibility SMS needed to become a major company in the computer industry. CV's goal in entering the agreements was to obtain workstations that it needed in selling its CAE/CAD/CAM products at a very low price. CV realized that the stock option could potentially result in a zero cost for acquiring the workstations.

In 1986, SMS made its initial public offering of common stock. Pursuant to the SMS and CV agreements, the preferred stock covered by the warrants was converted into 15 shares of SMS common stock. This changed the warrants from exercisable for 10,000 shares of preferred stock to 150,000 shares of common stock. The first warrant was exercised on November 24, 1986 (during SMS's June 30, 1987 tax year) when the exercise price was \$8 per share and the fair market value was \$19.375 per share. The warrant was exercised by an underwriter to whom CV sold its rights. CV also sold its rights in the second option to an underwriter; at the date of exercise (during SMS's same tax year), the exercise price was \$10 per share and the fair market value was \$31.375 per share.

On its tax return for the year ended June 30, 1987, SMS deducted \$4,912,500 representing the difference between the fair market value and the exercise price for the two warrants exercised during that tax year. This amount was not treated as an expense on SMS's financial statements. Upon audit, the Service disallowed the deduction.

SMS's position was that the excess of the fair market value of the stock over the exercise price was a sales discount because that was the purpose of issuing the warrants to CV; therefore the amount should be excluded from gross income. Alternatively, SMS argued that the amount was deductible under §162. The Service, on the other hand, argued that issuance of the warrants was an investment opportunity for CV and should be capitalized by SMS. Both SMS and the Service did agree though, that any tax consequence would fall into SMS's tax year ended June 30, 1987 because that was when all contingencies were settled. Also, the parties agreed that §1032¹⁰⁰ did not deny any tax benefit claimed by SMS.

The Tax Court stated that the treatment of the excess of the fair market value over the exercise price (i.e., the value of the warrants) depended upon the proper analysis of all the facts and circumstances surrounding the relationship of SMS and CV, including a determination of the intent of the parties. The court held that the \$4,912,500 value of

⁹⁹ *Sun Microsystems Corp. and Subs. v. Comm'r.*, 66 T.C.M. (CCH) 997 (1993).

¹⁰⁰ Section 1032 provides that no gain or loss is to be recognized to a corporation when it receives money or other property in exchange for its stock.

the warrants was a sales allowance or discount, rather than a §162 deduction or a capitalizable amount. The court stated that inclusion of the provision for the warrants in the "investment agreement" between the parties did not mean that the value of the warrants should be capitalized. The Service's form over substance approach was not valid based on the facts and circumstances that indicated that all of the agreements were a single agreement structured to deal with the requirements of federal and state securities laws. In addition, the court stated that it was not necessary to have a specified dollar amount at the outset in order to have a sales discount. Instead, it was sufficient if a mechanism existed to ultimately determine the amount of the discount. Also, the potentially large amount did not preclude treatment as a sales discount. The court also stated that the facts did not indicate that the issuance of the warrants was specifically related to either the joint technology agreement or to the favorable financial terms of the debenture and note. Thus, the existence of these parts of the total agreement did not require that the value of the warrants be capitalized. It is also important to note that the court did not find that an *Indopco* type argument¹⁰¹ required capitalization of the value of the warrants. The court agreed with SMS that the potential long-term benefits to SMS from a relationship with CV were "softer" and speculative, relative to the immediate benefits to be derived by selling the workstations to CV. Finally, the court noted that testimony and other evidence of SMS indicated that the warrants were issued as an incentive for CV to buy workstations. CV also indicated that it did not intend to buy and hold SMS stock and the warrants were sold very shortly after they became exercisable.

Convergent Technologies, Inc.:¹⁰² Convergent Technologies (CT), a manufacturer of workstations, entered into a purchase agreement with NCR with a stock warrant option, which was NCR's idea. The agreement did not state a minimum volume of workstations that NCR had to buy and did not preclude NCR from buying workstations from other companies. The purchase agreement gave NCR the right to buy 250,000 shares of CT common stock for \$20 per share once NCR's purchases from CT exceeded \$30 million and within four years of the agreement. CT had not yet become publicly-traded when the agreement was entered into. To help ensure that NCR would not reduce its purchases should the value of CT stock decline, the agreement also included the following clause. "NCR understands and acknowledges that CT's willingness to grant NCR a warrant under the Agreement hereinafter set forth and to sell its common stock to NCR upon the exercise of the warrant does not constitute additional consideration by CT for NCR's purchase of CT's products under the OEM Agreement, and that this Agreement is entirely separate and independent from the OEM Agreement." CT also entered into a similar arrangement with Burroughs. The stock warrant agreements did not involve any exchange for technological information. Both sets of warrants were exercised in 1983.

In 1986, CT filed amended returns to reduce its gross income by \$31,374,804, which was the spread, or value, of the NCR and Burroughs warrants exercised in 1983. The Service disallowed the reductions, arguing that the value of the warrants should have been capitalized, rather than treated as a reduction to gross income (sales discount) or as a §162 deduction.

The Tax Court held for CT, in part, based on its similar holding in *Sun Microsystems, Inc., supra*. The court found that the two "critical findings" from the *Sun Microsystems, Inc.* case, "that the warrants were an incentive for the purchase of workstations and that the warrant holder did not intend to hold the underlying stock," were both present in the *Convergent Technologies* case. For example, neither NCR nor Burroughs held onto the stock after exercising the warrants.

In deciding when CT was entitled to a deduction for the spread on the warrants, the court held that the first part of the all events test was met when the warrants became exercisable because it was unlikely that they would not be exercised, based on the size of the spread and the actual exercise was a ministerial act. However, the court held that the amount was not determinable with reasonable accuracy until the exercise date and noted that, unlike the situation in the *Sun* case, the value of the CT warrants declined in value between the exercisable date and the exercise date.

¹⁰¹ *Indopco v. Commissioner*, 503 U.S. 79, 87 (1992). The holding of the *Indopco* case is that an expenditure need not create or enhance a separate and distinct additional asset to be capitalizable; other characteristics of an expenditure may indicate that it is a capital expenditure. "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."

¹⁰² *Convergent Technologies, Inc. v. Comm'r.*, 70 T.C.M. (CCH) 87 (1995).

2. Efficient Use of Net Operating Losses

Like any new business, Internet start-ups will likely have greater expenses than revenues in early years and generate NOL carryovers. Section 172 allows NOLs to be carried back two years and forward 20 years. If a company with an NOL carryover is acquired or merged with another company, usage of the NOL carryover may be limited under §382. There are a variety of techniques a start-up company should consider to defer expenses rather than to generate large NOLs that may be limited in the future.

For example, an Internet start-up company should consider electing to capitalize its research and experimentation expenses and amortize them over no shorter than 60 months under §174(b) once it first realizes benefits from the R&E. Alternatively, the company could adopt the §174(a) expensing method, but make an election under §59(e) each year to instead capitalize and amortize the R&E over a period of 10 years beginning with the year the R&E was incurred.

An election under §59(e) is to be made by the return filing date (timely filed) and would only apply to R&E expenditures for that tax year. Section 59(e) does not appear to constitute a method of accounting requiring permission from the Service to use or not use for the R&E expenditures of a particular tax year. Thus, a taxpayer that is properly using the §174(a) expensing method could decide by the filing date for its return that it wishes to instead amortize all or a portion of that year's R&E expenditures over ten years. Although this choice results in a long amortization period, it does not require permission from the Service, filing of a ruling request under §1.174-3 or 1.174-4 or Revenue Procedure 99-49 (automatic accounting change procedure), and it does not require that a decision be made by the last day of the tax year, but instead allows for additional time.

In addition, because §59(e) does not specify the time and manner for making the election, arguably, a taxpayer who expensed R&E under §174(a) could file an amended return to make an election under §59(e). However, the Service has taken the position in TAM 9607001 and TAM 9848003 that a taxpayer may not modify the amount of costs capitalized and amortized under §59(e) from what was elected on the original return without first obtaining permission to revoke the original election.

3. Importance of Tax Return Filing

As with any other new taxpayer, an Internet start-up will want to carefully consider the types of accounting methods available to it before it files its first tax return. The selection of accounting methods on the first tax return is binding assuming proper methods are adopted. If a taxpayer later wants to change its method, it will first need to obtain permission from the Service.

Some elections, such as the capitalization and expensing election under §174(b) and the election to amortize start-up expenditures under §195 must be made on a timely filed tax return.

4. Research Tax Credit

Start-up companies receive certain benefits under §41 which allows for a research tax credit for increasing research activities. Generally, for research expenses to qualify for the credit, they must be incurred in *carrying on* a trade or business. However, an exception exists at §41(b)(4) such that the trade or business requirement is relaxed if at the time the in-house research expenses are paid or incurred, the taxpayer's principal purpose in incurring the expenses is to use the research results in the active conduct of a future trade or business. However, this exception only applies to in-house research expenses (wages and supplies), not to contract research expenses. Thus, if a start-up company hires a contractor to perform research prior to the point at which the company is carrying on a trade or business, the expenses will not constitute QRE.

Generally, the calculation of the fixed base percentage used in computing the amount of the credit involves amounts from tax years beginning after December 31, 1983 and before January 1, 1989. A company that comes into existence during or after that time period will not have the appropriate data. To address this situation, a special rule for start-up companies is provided at §41(c)(3)(B). Under this rule, a taxpayer's fixed base percentage for its first five tax years is 3% (for its sixth and subsequent tax years, special determinations are provided for).¹⁰³ This 3% rule applies to taxpayers if

- i) the first tax year in which it has both gross receipts and qualified research expenses begins after December 31, 1983, or

¹⁰³ See §41(c)(3)(B)(ii).

- ii) there are fewer than 3 tax years beginning after December 31, 1983 and before January 1, 1989, in which the taxpayer had both gross receipts and qualified research expenses.

5. Tax Incentives

High technology businesses typically involve high-paying jobs. Cities, counties and states often seek these types of enterprises to locate in their area. Thus, various tax incentives exist that business owners and their tax advisers should investigate, seek out and utilize, such as research tax credits and sales tax exemptions for manufacturing and R&D equipment. Some states also have enterprise zones that entitle companies located in them to special tax breaks such as on sales tax and income tax credits. While location decisions involve much more than tax considerations, the availability of special tax incentives should not be overlooked as they may help maintain the company's cash.

6. Worker Classification Considerations

Worker classification rules will generally apply in the same manner to high technology start-up companies as they will to other businesses.¹⁰⁴ The topic is mentioned here because high technology companies often need specialized expertise on a short-term basis and thus, use independent contractors. Companies should be familiar with the 20 common law factors¹⁰⁵ and have procedures in place to document how and why a worker was classified as either an employee or a contractor. In addition, legal counsel should be consulted where the contractor will be involved in the development of intellectual property so that the service-recipient can properly protect its rights in such property. The liabilities for misclassification can be substantial. For example, in December 2000, Microsoft settled a class action lawsuit begun several years earlier by workers reclassified by the Service from contractors to employees. The employees won lawsuits over several years holding that they should have been entitled to employee stock purchase plan (ESPP) participation. The suit was settled for \$97 million.¹⁰⁶

7. Compensation Considerations

This topic is covered in Sunday's program, *How to Compensate the E-Commerce Executive*.

¹⁰⁴ One notable exception to this statement is where a company uses technical service specialists through a third party arrangement. In such an arrangement, the taxpayer may not use the safe harbor provisions of "section 530" of the Revenue Act of 1978, Pub. L. No. 95-600, § 530, 90 Stat. 1520, to determine the status of the workers. See Rev. Rul. 87-41, 1987-1 C.B. 296.

¹⁰⁵ See Rev. Rul. 87-41, *supra*.

¹⁰⁶ Steven Greenhouse, "Microsoft Temp Workers Win Suit," New York Times, December 13, 2000. See *Vizcaino v. Microsoft Corporation*, 120 F.3d 1006, 97-2 USTC ¶50,572, 80 AFTR2d 5594 (9th Cir.), reh'g of 96-2 USTC ¶50,553, 78 AFTR2d 6690 (9th Cir.); *Vizcaino v. Microsoft*, 82 AFTR2d 98-6569 (DC WA); *Vizcaino v. Microsoft*, 82 AFTR2d 98-6573 (DC WA) and *In re Vizcaino v. U.S.*, 84 AFTR2d 99-____ (9th Cir. 6/24/99).

Appendix

Letter from SEC to FASB on Internet Accounting Issues

[Following is the full text of the letter obtained from <http://www.sec.gov/offices/account/calt1018.htm>. A discussion of tax issues (by Annette Nellen) has been inserted in the letter and appear in shaded boxes. The status of actions by the FASB and EITF can be found at <http://www.rutgers.edu/Accounting/raw/fasb/tech/index.html> and <http://www.us.deloitte.com/us/news/AR/taskforce/default.htm> and <http://www.us.deloitte.com/us/news/AR/taskforce/default.htm>]

Letter From the Chief Accountant:
Accounting Issues Related to
Internet Operations

October 18, 1999

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Lucas:

As we discussed at the EITF meeting on September 23, the SEC staff has been developing a list of issues that have arisen in internet businesses. We have finished preparing that list, and it is attached to this letter.

The list includes those issues that we believe warrant consideration by the EITF (or another standard-setting body). As discussed at the EITF meeting, we have also suggested priority levels for addressing each of the issues (priority levels 1-3). It would be helpful if the level 1 items could be dealt with first. However, we believe that all of the issues should eventually be addressed.

As you may recall, at the EITF meeting I expressed support for setting up a working group to focus on internet issues. We hope to be able to discuss the issues in the attached list and the possible formation of a working group with the EITF Agenda Committee before the November EITF meeting. As you will note, there are several issues that we believe can best be addressed by staff announcements. If the working group (or the EITF Agenda Committee, if a decision is reached not to form a working group) agrees that staff announcements are an appropriate way to resolve these issues, we hope that such announcements can be made at the November EITF meeting. Other issues could be added to the EITF Agenda (or the agendas of other standard-setting bodies) for discussion at the November and subsequent meetings.

After you have had a chance to review the issues, please let us know your thoughts about setting up a working group. If you have any questions about the issues in the attached list, please contact Scott Taub in the Office of the Chief Accountant at 202-942-4409.

Sincerely,

Lynn E. Turner
Chief Accountant

Issues in Accounting for Internet Activities

This memo describes accounting issues the SEC staff is aware of that have arisen in companies with internet activities. The list has been compiled based upon a review of issues the SEC staff has dealt with in registrant filings, as well as issues identified through input from accounting firms. The issues discussed are all issues in which 1) there appears to be a diversity in practice, 2) the situation does not appear to be addressed in the accounting literature, and/or 3) the SEC staff is concerned that the developing practice may be inappropriate under generally accepted accounting principles.

Some of the issues arise due to the new business models used in internet operations, while others are issues that also exist in businesses with no internet operations. For example, advertising partnerships, coupon and rebate programs, and complex equity instruments, while perhaps more common in internet businesses, were in use long before the internet. As a general rule, the SEC staff believes that internet companies engaging in transactions that are similar to transactions entered into by traditional companies should follow the already established accounting models for those transactions.

We believe that all of the issues discussed warrant further consideration by the accounting and financial reporting community. Each issue represents an area in which investors would benefit from the improved financial information and consistency that would come out of providing additional guidance on the issue. In order to maximize the benefits of providing such guidance, we believe it is important that any guidance address not only recognition and measurement questions, but also classification and disclosures.

For each issue, we have added comments from the SEC staff regarding the issue, and an assessment of the priority of addressing the issue.

Gross vs. Net – Some of the more significant issues facing internet businesses surround whether to present grossed-up revenues and cost of sales, or merely report the net profit as revenues, similar to a commission. The significance is enhanced due to the importance often placed on the revenue line in the valuation of internet stocks.

1. The question of gross vs. net revenue and cost display has arisen several times in connection with an internet company that distributes or resells third party products or services. Because the internet is a new distribution model, and can be used in the distribution of tangible assets, intangible assets, and services, the existing practices used for making this determination are not always sufficient.

SEC Staff Comments: This seems to be a key issue. Priority level 1.

Tax Considerations

A primary accounting concern with the gross vs. net issue is whether revenues have been overstated which may artificially inflate stock prices. There is no corresponding tax concern. One possible tax issue pertains to small companies that need to determine whether their gross receipts are below a threshold such that §448 (required use of accrual method of accounting), UNICAP, and AMT rules may not apply.

Another potential tax issue is whether the taxpayer has inventory. If a business is only receiving a commission and does not have title to the goods (even if momentary) and does not have the benefits and burdens of ownership, generally, inventory accounting is not required. [*Addison Distribution Inc., et al. v. Comm'r.*, T.C. Memo 1998-289; *Epic Metals Corp & Subs v. Comm'r.*, T.C. Memo 1984-322; TAM 8510003]

2. Many internet companies enter into advertising barter transactions with each other, in which they exchange rights to place advertisements on each others' websites. There is diversity in practice in accounting for these transactions. The staff believes a prerequisite to reflecting these transactions in the accounting records is that the value of the transaction must be reliably measurable. In addition, the staff believes registrants should be making transparent disclosure that will clearly convey to investors the accounting being used.

SEC Staff Comments: There have been a number of press articles on this issue, illustrating its importance. Priority level 1.

Tax Considerations

See discussion in main text of outline.

3. ISP's and PC retailers are currently offering a \$400 rebate to purchasers of new PC's who contract for three years of internet service. It appears that most of the rebate cost is borne by the ISP while a portion is borne by the PC

retailer, that the retailer provides advertising and marketing for the arrangement, and that the rebate, or a portion thereof, must be returned by the consumer to the ISP if the consumer breaks the contract with the ISP. Some ISPs and retailers believe their portion of the cost of the rebate should be a marketing expense, as opposed to a reduction of revenues. The SEC staff generally believes that such rebates should be considered a reduction of revenues.

SEC Staff Comments: The SEC staff believes that a staff announcement indicating that discounts like these should be accounted for as reductions of revenue is appropriate.

Tax Considerations

Revenue Ruling 76-96, 1976-1 C.B. 23, provides that a rebate is not income to the buyer. Extending this logic to the seller indicates that the seller should treat the rebate as a reduction of revenues.

4. Shipping and handling costs are a major expense for internet product sellers. Most sellers charge customers for shipping and handling in amounts that are not a direct pass-through of costs. Some display the charges to customers as revenues and the costs as selling expenses, while others net the costs and revenues. The staff believes that practice for non-internet mail-order companies is to net the revenues and expenses, although diversity may exist. In either situation, we note that companies generally do not provide any separate disclosure of shipping revenues and costs (e.g., by reporting shipping revenue and costs as separate line items, or by providing footnote disclosure of the gross shipping revenues and costs).

SEC Staff Comments: There is diversity in practice that should be eliminated. However, because the issue relates to a smaller portion of revenues and costs than some others in this section, it can be addressed after some of those issues. Priority level 2.

Tax Considerations

If the shipping and handling costs are liabilities of the seller, they should be reported as expenses with the amounts charged to buyers treated as revenue. [*Alleghany Corporation v Comm'r*, 28 TC 298 (1957); *The Electric Tachometer Corp. v Comm'r*, 37 TC 158 (1961), acq. 1962-2 C.B. 4; and TAM 7506309970A.]

5. Some internet companies have concluded that a free or heavily discounted product or service, as is provided in introductory offers (e.g. free month of service, 6 CDs for a penny) should be accounted for as a sale at full price, with the recognition of marketing expense for the discount. The staff notes that an AICPA Technical Practice Aid (Section 5100.07, "One-Cent Sales") addresses this issue, concluding that "The practice of crediting sales and charging advertising expense for the difference between the normal sales price and the "bargain day" sales price of merchandise is not acceptable for financial reporting."

SEC Staff Comments: The SEC staff believes that a staff announcement indicating that discounts like these should be accounted for as reductions of revenue is appropriate.

Tax Considerations

A taxpayer will not be able to report revenue at an amount that exceeds the amount owed by the customer.

6. Several internet-based businesses have experienced service outages recently. Related costs may include refunds to customers/members, costs to correct the problem that caused the outage, and damage claims. Issues could include when to accrue the refunds and costs, whether refunds that are not required but are given as a gesture of goodwill are reductions of revenues or a marketing expense, etc.

SEC Staff Comments: The facts and circumstances surrounding these situations are likely to be very diverse, making the development of general guidance difficult. Priority level 3.

Tax Considerations

An accrual method taxpayer may deduct expenditures when all events have occurred to establish the fact of the liability, the amount can be determined with reasonable accuracy, and economic performance has occurred. For refunds and damage claims, economic performance occurs when the payment is actually made to the claimant. For costs of correcting problems, economic performance occurs as services are provided to the taxpayer. [§461, §1.461-1, and § 1.461-4]

Definition of Software – We have noted several issues that relate to whether websites themselves and files or information available on websites should be considered software, and therefore be subject to the provisions of SOPs 97-2 and 98-1 and/or SFAS 86.

7. In EITF Issue 96-6, the SEC staff expressed its view that the costs of software products that include film elements should be accounted for under the provisions of SFAS 86. As such, revenue from the sale of such products should be accounted for under the provisions of SOP 97-2. By analogy, the staff believes that guidance should be applied to software with other embedded elements, such as music. However, EITF 96-6 did not discuss accounting for the costs of computer files that are essentially films (e.g., mpeg, realvideo), music (e.g., mp3), or other content. A number of questions may arise with relation to these files, including whether a company purchasing the rights to distribute music in the .mp3 format should account for those costs under SFAS 50 or 86. Similarly, it is not clear whether the revenue from the sales of .mp3 files falls under SOP 97-2.

SEC Staff Comments: As the areas of software, film, music, etc continue to converge, it is important to be able to identify which accounting models apply to various transactions. In addition, resolving this issue may be necessary in order to resolve issue 8 below. Priority level 2.

Tax Considerations

For federal income tax purposes, distinction between a sale, a license, a lease and the provision of services can be relevant in the following contexts (only federal domestic tax issues are discussed):

(1) Character of the resulting income: If the transferred item is a capital asset that is sold, capital gain will result; if it is not a capital asset, or is licensed, ordinary income will result. It is also important to distinguish what has been transferred: an intangible, such as a copyright, or a copyrighted item. For certain transfers of a patent, special capital gain treatment of §1235, *Sale or exchange of patents*, may be available.

(2) Timing of income recognition: If the transferred item is licensed, income is likely earned by an accrual basis taxpayer ratably over the license period; if the item is sold, income is recognized upon sale, unless the installment method applies.

(3) Passive versus active income: Under some tax provisions, royalty income from licensing can produce adverse tax consequences such as personal holding company status, passive investment income of an S corporation, or possibly constitute income from a passive activity under §469.

8. Costs of developing a website including the costs of developing services that are offered to visitors (chat rooms, search engines, e-mail, calendars, etc.) are significant costs for many internet businesses. The SEC staff believes that a large portion of such costs should be accounted for in accordance with SOP 98-1, as software developed for internal use. The staff notes that SOP 98-1, paragraph 15 states that "If software is used by the vendor in providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP."

SEC Staff Comments: This is a key issue, given that it is the largest cost for many internet businesses. Priority level 1.

Tax Considerations

See discussion in main text of outline.

Revenue Recognition – As with any new business model, issues exist regarding the recognition of revenue for various types of internet activities.

9. Auction sites usually charge both up-front (listing) fees and back-end (transaction-based) fees. The staff understands that the listing fees are being recognized as revenue when the item is originally listed, despite the requirement for the auction site to maintain the listing for duration of the auction. In addition, some auction sites recognize the back-end fees as revenue at the end of the auction despite the fact that the seller is entitled to a refund of the fee if the transaction between the buyer and seller doesn't close (Note: the auction house is merely a facilitator and takes no part in assisting in closing the transaction). Given that many popular sites have recently started up auction sites, this issue may become more prevalent.

SEC Staff Comments on Front-end: The SEC staff believes that a staff announcement indicating that fees like this should be recognized over the listing period, which is the period of performance, is appropriate.

SEC Staff Comments on Back-end: The facts and circumstances of the agreements between the auction site, the buyers, and the sellers may vary significantly, making it difficult to provide applicable guidance. Priority level 3.

Tax Considerations

The "all events test" of reg. §1.451-1(a) governs when an accrual basis taxpayer is to include items in gross income. Under this test, items are includible in gross income when,

- 1) all events have occurred which fix the right to receive such income, and
- 2) the amount thereof can be determined with reasonable accuracy.

Rev. Rul. 74-607 provides that all events are fixed at the earliest of (1) required performance occurs, (2) payment is due, or (3) payment is made. In *Hallmark Cards v. Commissioner*, 90 T.C. 26 (1988), the court stressed that the date that the legal rights to the income arise is the income accrual date.

In TAM 9823003, the Taxpayer operated several retail stores and used the accrual method. Most stores provided film processing to customers. Customers dropped off their film, it was processed and returned for the store for customer pick-up. Customers were not obligated to purchase their photos if they were not completely satisfied. Also, if the photos were not picked up after a certain period of time, they were discarded and the customer was not charged. Taxpayer only reported revenue from film processing when a customer purchased his prints. Upon audit, the revenue agent took the position that the revenue should be reported earlier when the prints are delivered to the store for customer pick-up. The revenue agent position is premised on the interpretation of §451 that Taxpayer has a fixed right to receive income at that time because its required performance has occurred because the film has been developed.

The IRS National Office disagreed with the revenue agent and held that the film processing revenue was not reportable until the customer actually purchased the prints. "[F]or accrual method taxpayers, it is the right to receive an amount and not the actual receipt that determines the inclusion of the amount in gross income. ... In the case of a taxpayer selling goods, the taxpayer's inventory is reduced and a claim of the purchase price arises at the time the sale is made. ... Until a sale occurs, the required performance has not occurred to fix a taxpayer's right to receive income under the first part of the all-events test under section 1.451-1(a). Therefore, a taxpayer selling goods generally accrues income from the sale of goods at the time of the sale."

Based on the tax law summarized above, the up-front listing fee should be reported by an accrual method auction house when the listing is made. If a completed sale is a condition precedent to the auction house earning the back-end fee, then that fee does not seem to be includible in income by an accrual method taxpayer until the transaction is completed.

10. Some purchasers of software do not actually receive the software. Rather, the software application resides on the vendor's or a third party's server, and the customer accesses the software on an as-needed basis over the internet. Thus, the customer is paying for two elements – the right to use the software and the storage of the software on someone else's hardware. The latter service is often referred to as "hosting." When the vendor also provides the hosting, several revenue recognition issues may arise. First, there may be transactions structured in the form of a service agreement providing internet access to the specified site, without a corresponding software license. In such instances, it may not be clear how to apply SOP 97-2. Second, when the transaction is viewed as a software license with a service element, it isn't clear how to evaluate the delivery requirement of SOP 97-2.

SEC Staff Comments: This type of arrangement seems to be growing in popularity, although it is not all that common at this point. Priority level 2.

Tax Considerations

If in substance, the user does not own the software, no depreciation can be claimed. If the arrangement is a lease of software or a service fee, revenue should be recognized as earned over the period, unless a prepayment is received. If the arrangement can be viewed as the provision of services, an accrual method taxpayer should be able to defer any prepayment provided the services are to be provided by the end of the next tax year (Rev. Proc. 71-21).

11. An internet business may provide customers with services that include access to a website, maintenance of a website, or publication of certain information on a website for a period of time. Certain companies have argued that because the incremental costs of maintaining the website and/or providing access to it are minimal (or even zero), this ongoing requirement should not preclude up-front revenue recognition. The staff has historically objected to up-front revenue recognition in these cases, even with an accrual of the related costs.

SEC Staff Comments: The SEC staff believes that a staff announcement indicating that fees like this should be recognized over the performance period, which would be the period over which the company has agreed to maintain the website or listing, is appropriate.

Tax Considerations

See tax discussion under #10.

12. Many internet companies enter into various types of advertising arrangements (sometimes with other internet companies) to provide advertising services over a period of time. These arrangements often include guarantees on "hits," "viewings," or "click-throughs." It isn't clear how the provider of the advertising takes progress towards these minimums into account in assessing revenue recognition. This issue could show up in various other industries as well (sales reps who guarantee they will reach a certain level of sales, advertising in other kinds of media, etc).

SEC Staff Comments: The terms of these arrangements vary somewhat from contract to contract. The issues that arise in some, but not all, of these contracts may be addressed in the planned Staff Accounting Bulletin on revenue recognition issues. Once the SAB is released, consideration of this issue would be appropriate. Priority level 3.

Tax Considerations

See discussion in main text of outline.

13. There are a growing number of "point" and other loyalty programs being developed in internet businesses (similar to the airline and hotel industry programs). There are several well-known companies whose business model involves building a membership list through this kind of program. In some cases, the program operator may sell points to its business partners, who then issue them to their customers based on purchases or other actions. In other cases, the program operator awards the points in order to encourage its members to take actions that will generate payments from business partners to the program operator. Several issues related to these programs have arisen.

- a. The program operators believe that their customers are the companies for whom they provide advertising and marketing services. They view the redemption of the points or other reward as the "cost of sales," not as a revenue-generating activity. Therefore, they do not believe the fact that delivery under the reward occurs later should require revenue deferral. The staff has accepted this argument only when the contracts with the business partners do not require the issuance or offer of any award, and speak merely to performing the advertising, marketing, or customer acquisition activities. In other cases, the staff has required that some amount of revenue be deferred until the points are redeemed to reflect that the substance of the arrangement involves multiple elements, one of which has not yet occurred. The same issue could also exist in customer acquisition programs. For example, offers exist where an ISP offers 6 months of free service to people who open accounts at certain on-line brokerages.
- b. When revenue is recognized up front with an accrual of the redemption costs, a question arises as to whether companies should estimate "breakage" (the amount of rewards that will expire unused). Many web-based businesses have loyalty programs that would also face this issue. For example, many sites issue rewards that can be used towards future purchases at the site. In recording the liability for those rewards, some argue that the gross amount of the rewards issued should be recorded, while others believe that the recorded amount should be reduced for an estimate of the rewards that will not be used, if this "breakage" can be reliably estimated.

SEC Staff Comments: Priority level 2.

Tax Considerations

Gold Coast Hotel & Casino, et al. v. U.S., 98-2 USTC ¶50,800, 82 AFTR2d 98-6714 (9th Cir.)—Gold operated a slot club that allowed members to accumulate points when they used slot machines. The points could be redeemed for prizes, such as coffee mugs, vacations, and appliances, once they accumulated 1,200 points. Gold tracked the points using a computerized data bank. Members could redeem the points directly from Gold, or from a redemption center who would then bill Gold for the previously agreed upon amount. Gold treated points accumulated during the year, but not redeemed at year end as a deduction. It also recaptured an amount into income representing accumulated points in accounts for which there have been no activity for over a year. The Service denied the deduction. The district court allowed Gold to deduct the liability only for members who had

accumulated over 1,200 points. The Service continued to challenge the deduction. The parties stipulated that the value of each point was \$0.0021.

The Ninth Circuit affirmed the lower court finding that the liability was both fixed and determinable with reasonable accuracy. The court applied the holding of *Hughes Properties*, 476 U.S. 593 (1986) to find that the last event that fixed the Gold's liability was the accumulation of the 1200th point. The possibility that a 1,200 point member won't redeem his points is equivalent to the possibility of nonpayment inherent in any accrued expense, and does not affect the fact of the liability. Also, like *Hughes*, Gold's liability is unavoidable under state gambling law. The court also held that *General Dynamics*, 481 U.S. 239 (1987), was not similar because a club member's demand for payment is not equivalent to admitting to a medical claim, but instead, is a technicality (a ministerial act). Also, unlike in *General Dynamics*, there is no third party involved. "[D]emand for payment is not a condition precedent to fixing Gold Coast's liability for the value of accumulated slot club points."

The economic performance (EP) requirement was not applicable in this case per §1.461-4(k)(3) that makes the rule for "payment" liabilities effective for tax years beginning after December 31, 1991.

For liabilities arising when the EP rule is in effect, a taxpayer should consider applicability of the recurring item exception given that its first requirement—the all events test, is met for some of the points by year end. The other requirements would also be met for prizes actually paid on or before the earlier of the date the return is filed or 8 1/2 months after year-end. However, for the recurring item exception to apply, the liability must be either a prize or rebate type of payment liability. If it doesn't meet either of these categories, but instead is an "other payment liability," the recurring item exception would not apply (§1.461-5(c)). It would appear though, that this liability could be considered a rebate – a term that is not defined in the economic performance regulations.. (It doesn't seem to be a prize because unlike most prizes that are won unexpectedly, slot club members can easily determine if they will "win" a prize (assuming points accumulate based on dollars gambled)).

Prepaid/Intangible Assets vs. Period Costs – Internet businesses often make payments to obtain members or customers or to obtain advertising space, distribution rights, supply agreements, etc. In some cases, the questions of whether to capitalize or expense such costs and of assessing impairment of the rights obtained is not straightforward. Although similar payments are made by companies that do not have internet operations, the frequency with which this issue arises is higher in internet companies.

14. Businesses often make payments for long-term contractual rights (e.g., internet distribution rights) that are intended to be exploited only through internet operations. The contractual rights meet the definition of an asset, but the measurement of the probable economic benefits is difficult. Some companies have asserted that these rights are immediately impaired, as their best estimate of the expected cash flows would indicate the asset is not recoverable. The SEC staff has objected in these situations, and believes impairment should not be recorded unless it can be shown that conditions have changed since the execution of the contract. The evaluation of impairment of these kinds of assets is complicated because, as discussed above, the contractual rights purchased may be covered by different accounting standards, depending on the subject of the rights.

SEC Staff Comments: EITF Issue 99-14 discusses whether impairment of such contracts should be assessed, but not how. Guidance on how to assess impairment is critical, and should be provided either as implementation guidance to Issue 99-14 or in a separate issue. Priority level 1.

Tax Considerations

If the right meets the definition of an asset for tax purposes and the costs of acquiring that right have been capitalized, no write-off is allowed unless the right becomes worthless or is abandoned. Treas. Reg. §1.165-1 and §1.167(a)-8.

15. Many internet companies enter into various types of advertising arrangements (sometimes with other internet companies) in which one entity pays the other an up-front fee (or guarantees certain minimum payments over the course of the contract) in exchange for certain advertising services over a period of time. The payers in these arrangements have at times recognized an immediate loss on signing the contract, arguing that the expected benefits are less than the up-front or guaranteed payments. The staff has indicated that it views these payments as being similar to payments made for physical advertising space, and that any up-front payment should be treated as prepaid advertising costs. This issue was discussed in Paul Kepple's speech last December.

SEC Staff Comments: Guidance on these arrangements can be provided along with guidance on Issue 14 above.

Tax Considerations

No loss is allowable for tax purposes because no loss has been realized. A taxpayer receiving such advertising fees in advance may be able to apply Revenue Procedure 71-21 to defer reporting of the revenue. [TAM 9840002]

16. Internet businesses often make large investments in building a customer or membership base. Several examples of this are:

- a. Sites that give users rewards (points, products, discounts, services) in exchange for setting up an account with the site.
- b. Sites that make payments to business partners for referring new customers or members.
- c. Businesses that give users a PC and internet service for free if they are willing to spend a certain minimum amount of time on the internet each month and are willing to have advertisements reside permanently on their computer.

In each of these cases, a question may arise as to whether the costs represent customer acquisition costs or costs of building a membership listing that qualify for capitalization, e.g., by analogy to SFAS 91.

SEC Staff Comments: Most companies appear to be expensing such costs as incurred; therefore, there is little diversity in practice to make it urgent that this issue be addressed. If and when the issue is addressed, the model should apply broadly to costs of building customer and membership lists. Priority level 3.

Tax Considerations

Promotional Expenses: In Rev. Rul. 68-561, 1968-2 CB 117, the Service ruled that promotional expenditures of a utility company that were incurred to help increase energy consumption, had to be capitalized if they “secure benefits to the taxpayer that can reasonably be expected to have value extending beyond the years in which they were paid or incurred.” Otherwise, such expenditures are currently deductible. Also see *Gold Coast* discussed under Issues #13.

Expenditures Related to Acquisition of Customers or Customer-Related Assets: Rulings dealing with costs of developing customer relationships have reached varying results. In *PNC Bancorp Inc. et al. v. Comm’r.*, 85 AFTR2d 2000-_____ (3d Cir. 2000), the court overturned the Tax Court decision to hold that a bank did not have to capitalize certain costs of obtaining loans. The lower court (110 T.C. 349 (1998)) held that a bank had to capitalize the costs of originating loans, including related employee labor costs. PNC capitalized such costs under GAAP. The Service and the court supported its position on the basis that the loans were separate and distinct assets. Thus, the costs of creating such long-lived assets had to be capitalized. The Third Circuit noted that there is a “fundamental distinction between business expenses and capital outlays.” In approving a loan, including performing credit checks and appraisals, the bank did not “step out of its normal method of doing business.” PNC’s loan operations constituted its primary method of producing income. In addition, the costs that the Tax Court held had to be capitalized did not “create” the loans. To create means something similar to payments made by Lincoln Savings to form a Secondary Reserve Fund (403 U.S. 345 (1971)). Instead, PNC’s loan origination costs were only associated with origination of the loans and did not become part of the loan balance. The Third Circuit noted that to follow the Tax Court’s “broad” interpretation would be “to expand the type of costs that must be capitalized so as to drastically limit what might be considered as ‘ordinary and necessary’ expenses.” Because the loan costs did not create a separate and distinct asset, capitalization of the costs was not warranted. Finally, the Court did not find that SFAS #91 also justified capitalization of loan origination costs for tax purposes because of the differing purposes served by GAAP. And tax rules. The Court also noted that SFAS #91 was not issued primarily to address a capitalization versus expensing issue, but due to a concern that banks could otherwise make their financial condition look better than it actually was.

In contrast, in TAM 199952069, the Service held that T must capitalize the employee compensation and travel costs associated with soliciting, evaluating, and negotiation five long-term service contracts. The Service found that capitalization was warranted both because T was acquiring a long-lived asset and was receiving a significant long-term benefit.

Similarly, in TAM 9813001, the Service ruled that commissions paid by a telecom company to third-party distributors for acquiring new customers for cellular service had to be capitalized. Per the Service, the taxpayers are paying to acquire a new customer contract and data shows that a customer remains as such for an average of 57 months. Thus, a long-lived asset is acquired and the costs must be capitalized. How the Service dealt with taxpayer arguments:

i. The situation is not like *Fidelity Associates*, T.C. Memo 1992-142, where taxpayer was allowed to expense commissions paid for obtaining 2-year sponsorship agreements. There, the court stated that the commissions paid by dealers in connection with the sale of inventory were deductible under §1.263(a)-2(e). In the TAM, the commissions were not paid in connection with the sale of inventory or property and the taxpayer is not a dealer nor does it maintain inventory.

ii. Taxpayer argued that the contracts were short-lived assets because customers could terminate them upon 7 days notice, and the commission really only served to get customers to try the service for one month. If the customer continued service beyond that point, it was due to the good service, not from payment of the commission. The Service rejected this theory because it had not been followed in other cases, and just because other factors also helped to create a long-term contractual relationship does not make the commission deductible.

iii. Taxpayer argued that the commissions were similar to those paid to insurance agents for writing contracts. The Service stated that this was an historical exception to the general capitalization rule and did not control the present situation.

The Service also stated that where it is reasonably certain that a contract will be renewed, the month-to-month contracts can be considered to extend substantially beyond the end of the tax year. Taxpayer records indicated that over 70% of contracts were renewed for more than 12 months. Also, the size of the commission relative to how long a contract must be for the taxpayer to re-coup the costs indicates that it is a long-term contract.

However, in situations where the expectancy of a customer relationship being developed is speculative, costs should be currently deducted. In *Sun Microsystems, Inc.*, T.C. Memo 1993-467, the Tax Court held that the value of exercised stock warrants, issued to encourage customer purchases, constituted a sales discount and did *not* have to be capitalized as an expenditure to develop a long-term customer relationship. The Tax Court described the Service's argument for capitalization as whether capitalization was required per the "new look" which applies to §162 versus §263 issues after *Indopco*. The Court did not find the issue warranted discussion for various reasons. First, the Court stated that *Indopco* primarily stands for the proposition that it is not necessary to have a separate asset in order to be required to capitalize expenditures. Second, the facts in *Indopco* "clearly involved a capital transaction." Finally, the Supreme Court stated that the mere presence of an incidental future benefit may not be enough to warrant capitalization. The Court found the benefit resulting to Sun from the discount offered to its customer was an "incidental future benefit" and thus not subject to capitalization.

Miscellaneous Issues

17. The instruments often have conversion or exercisability terms that are variable based upon future events, such as the attainment of certain sales levels or a successful IPO. The issuer's accounting does not appear to raise new issues as it is covered in EITF Issues 96-18 and 98-5. For the holders, the instruments may be within the scope of SFAS 133. However, because one or more of the underlyings are often based on the holder's or issuer's performance, SFAS 133 will not always apply. In addition, it isn't clear that the change in fair value of the instrument should be entirely recognized as a derivative holding gain or loss, vs. an increase or decrease in revenues or operating expenses.

SEC Staff Comments: This issue seems to fit well with other issues being considered by the DIG. Resolution before SFAS 133 must be adopted would be helpful. Priority level 2.

Tax Considerations

Facts are not clear enough to discern whether any tax considerations exist.

18. SFAS 131 defines segments based on the information reviewed by top management in making decisions.

Therefore, if top management reviews information about the internet portion of a company's business separate from other operations, the internet operations should be considered a separate operating segment.

SEC Staff Comments: Ensuring that SFAS 131 is properly applied in this area and others will likely be a focus of the SEC staff.

Tax Considerations

No tax issue raised.

19. The staff has noted that classification of expenses between various categories (costs of sales, marketing, sales, R&D) sometimes varies significantly amongst internet companies for costs that appear similar. Examples include website development costs and expenses related to the various contractual rights discussed above.

SEC Staff Comments: It is difficult to identify common elements between the classification issues that have arisen, making the preparation of general guidance difficult. Priority level 3.

Tax Considerations

No tax issue raised.

20. Common practice when a company prints a coupon in the newspaper is to record a liability and marketing expense for the estimated amount of coupons that will be redeemed. The internet provides several new methods of distributing coupons that may raise questions within the existing accounting models. For example:

- a. Product or service providers post coupons on-line, often for long periods of time.
- b. Internet retailers or service providers send e-mails inviting the receiver to get a discount on a purchase.

SEC Staff Comments: The area of accounting for coupons, rebates, and discounts is growing more significant, but it is not limited to internet businesses. Developing a robust model to account for these arrangements would be helpful. Priority level 2.

Tax Considerations

An accrual method taxpayer may deduct expenditures when all events have occurred to establish the fact of the liability, the amount can be determined with reasonable accuracy, and economic performance has occurred. The timing of the cost of printing and distributing the coupon should be similar to running an advertisement and economic performance is met when the coupon is printed or distributed. The “liability” associated with the coupon, once a customer redeems it, should likely be treated as an offset to the sales price of the item sold per Rev. Proc. 76-96, 1976-1 C.B. 23 (see issue #3 above). If the customer incentive is a rebate following purchase of an item at full price, economic performance for the rebate is met once the payment is made to the customer. Treas. Reg. §1.461-4(g)(3).